

*High Executive Compensation: are Current Pay Levels Evidence of
Avarice or Just Reward for Performance?*



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Declaration

This thesis has not been submitted in support of an application for another degree at this or any other university. It is the result of my own work and includes nothing that is the outcome of work done in collaboration except where specifically indicated. Many of the ideas in this thesis were the product of discussion with my supervisors Prof. David Milman and Phillip Lawton.

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Abstract

The primary objective of the thesis is to examine high executive pay trends in the Anglo-American corporate system, in terms of its fairness and justice. Given that there is no objective standard for fair pay for executives, analysing the fairness of current pay trends would involve an examination on two levels: first, by looking at the pay setting process and possible irregularities within the latter which could compromise the integrity of the process as well as the outcome. Secondly, by putting high executive pay in a wider social context, an analysis against a background of wider income distribution. With respect to the latter, the thesis shows a causal relationship between high executive compensation and income inequality; the increase at the top end of the income distribution scale, could be attributable to the stagnation at the lower rungs. Considering the irregularities in the pay determination process and its role in income inequality, the thesis concludes that Anglo-American executive pay, at these levels, is unjust and in need of reform to enhance its fairness.

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To Kobe, let this be proof that anything is possible, if you walk in the will of the almighty. to Mel, for your thoughts, prayers and kindness.

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Chapter One

1. An Introduction

Adam Smith, in recognising income inequality as an inevitable outcome of a thriving capitalism, noted that it was perhaps needful in stimulating productivity and maintaining the so-called “*distinction of ranks*”. Proponents of the current executive pay culture might seize on this statement, while ignoring its wider context, as justification for the status quo. It would perhaps be fair to say that even Smith may have struggled to conjure a justification for not only the size of current pay levels, but the pace at which it has grown¹.

The acceleration of CEO pay levels precipitated a simultaneous increase in the CEO-worker pay gap. In 1980, the average U.S CEO earned a salary which was 42 times the wage of the average worker, at \$624,996². The gap increased to 312:1 according to 2017 figures, with average CEO pay standing at \$18.9m³. A similar growth trend is evident for UK CEOs, who in the 1980s were paid on average between 13 to 44 times

¹ By around mid-day on the 4th of January 2017—a day popularly known as ‘Fat Cat Wednesday’—the average FTSE 100 CEO had earned just over £28,000, the average annual salary for full time work in the UK¹. Going by 2015 figures, by the year’s end, same CEO would have earned on average, just under £4m, a figure that translates into an hourly wage of just over a £1, 000. An astonishing figure by any standard, which becomes even more befuddling when placed in the context of a society where a great portion of the citizenry earn below £10 an hour. Even worse, is the fact that UK CEOs are not the highest paid. Their American peers have themselves benefited from astronomical pay packets for decades, levels that make the UK levels pale in comparison. See, Katie Allen ‘UK bosses make more in two and a half days than workers earn all year’. The Guardian, 04 January 2017. On pay levels amongst American CEOs; Average pay for the top 200 CEOs within the S&P index with revenues of \$1bn, was \$19.3m. See, David Gelles ‘Top C.E.O. Pay Fell — Yes, Fell — in 2015’. The New York Times, May 27, 2016.

² John Byrne ‘Executive Pay: The Party Ain’t Over Yet’ Businessweek, April 25, 1993. Available at (<https://www.bloomberg.com/news/articles/1993-04-25/executive-pay-the-party-aint-over-yet>).

³ Lawrence Mishel and Jessica Scheider ‘CEO Compensation Surged in 2017’. Economic Policy Institute Available at <<https://www.epi.org/files/pdf/152123.pdf>> (accessed 18/08/2018), p.1

the average wage⁴. However, 2017 figures show that disparity to have grown substantially to 129:1⁵. Although, UK CEOs traditionally lag their American peers with regards to quantum of pay, they are however relatively well paid, with 2017 figures showing average FTSE 100 CEO pay to be about £5.65m⁶.

These facts suggest that executive pay has witnessed an inflation-adjusted growth rate of 949 per cent between 1978-2015. A rate which out-paced that of the stock market and ordinary wages, which grew by 73 and 10.3 per cent respectively, in the same time period⁷. This very statistic raises potent questions about the justifiability of high pay. That executive pay has out-performed firm growth, nullifies the argument that executive pay is indexed to firm performance. Also, that executive pay has far outpaced ordinary wages, indicates that CEOs have increasingly captured larger portions of the wealth gains from increased productivity.

1.2 Why High Executive Pay is a Problem

An *Oxfam* news briefing in 2016 noted that the richest 1 per cent of the UK population - just over 600,000 individuals - own more than 20 times the total wealth of the bottom

⁴ High Pay Centre Report '*FTSE 100 bosses now paid an average 130 times as much as their employees*'. Available at (<http://highpaycentre.org/blog/ftse-100-bosses-now-paid-an-average-143-times-as-much-as-their-employees>).

⁵ CIPD Research Report '*Executive pay Review of FTSE 100 executive pay packages*' August 2017. Available at <http://highpaycentre.org/files/7571_CEO_pay_in_the_FTSE100_report_%28FINAL%29.pdf>.

⁶ Average CEO pay within the FTSE 100 index was £5.65m, a figure which includes the compensation paid out to the CEOs of Persimmon Plc and Melrose Plc, which stood at £47.1m and £42.3m respectively. Excluding these figures brought the average to £4.85, which still represents a 6 per cent rise in pay from 2016 levels. Otherwise, including the two pay packages, would suggest an increase of 23 per cent. This increase is evident in the median as well, which rose by 11 per cent to £3.93m. High Pay Centre Report '*Executive Pay: Review of the FTSE 100 executive pay*'. Available at <http://highpaycentre.org/files/CEO_pay_report.pdf> (accessed 19/08/2018).

⁷ Lawrence Mishel and Jessica Scheider '*Stock market headwinds meant less generous year for some CEOs*' Economic Policy Institute. Available at <http://www.epi.org/files/pdf/109799.pdf>.

20 per cent-which represents about 13 million people⁸. Furthermore, it is estimated that the top decile of the wealth distribution scale collectively owns just over half-about 54 per cent-of the nation's wealth⁹. It is important to note that a lot of the wealth gains at the top are driven by executive pay, and this is evident in the U.S as well¹⁰.

High executive pay is problematic, in the sense that it contributes to extreme wealth disparities, which threatens the socio-economic well-being of the relevant society. Figures show, that the UK and U.S consistently rank highest amongst the most unequal societies in the developed world¹¹, this situation is made worse by the absence of tangible measures to address the situation. While it could be argued that this growth in inequality of income and well-being has led to fissures in Anglo-American societies. This is evident in the wave of economic populism and social upheaval, which has steadily grown both in form and impact, since the financial crisis. Manifesting in norm-shattering political events like the exit of Great Britain from the European Union. 'Brexit' was attributed in part to the pervasive disillusionment with wealth concentration at the top and the capture of the political process by a moneyed few, with specially corralled interests.

As part of a plan to tackle income inequality, the British government recognised the extent to which high executive pay had contributed to the dilemma and discussed a

⁸ *How to Close Great Britain's Great Divide*. Oxfam Media Briefing, September 13, 2016. Available at (<http://policy-practice.oxfam.org.uk/publications/how-to-close-great-britains-great-divide-the-business-of-tackling-inequality-620059>).

⁹ Ibid.

¹⁰ Mishel and Scheider (n3) 2.

¹¹ *Income Inequality*, OECD.org. Available at (<https://data.oecd.org/inequality/income-inequality.htm>).

string of regulatory changes intended to address the issue. However, despite some initially stern recommendations, the actual proposals lacked the earlier vibrancy.

Firstly, in the Green paper released in November 2016, plans to put total pay to an annual binding shareholder vote, were shelved. The latter it was suggested, could potentially be limited to “*variable pay elements*” and be made applicable to companies that had encountered “*significant minority opposition*” or who had lost previous advisory votes¹². Also, prior plans to have workers on boards in a supervisory capacity as is the case in Germany and parts of the continent, were excluded. It is believed that the chancellor had considered some of the concerns raised about the practicality of the intended reforms, by members of the business community¹³.

That Anglo-American executive pay has enjoyed an almost unfettered rise since the 1980s, could be attributed to the non-interventionist policy stance of previous governments. Furthermore, when steps have been taken to arrest its growth, they have often lacked the bite needed to be impactful. Prior attempts had been designed to recommend, rather than compel as is the case with the various incarnations of the *Corporate Governance Code*. As such, firms falling within the purview of the Code could choose to avoid compliance, provided they had reasons for so doing. Recent research shows that only 72 per cent of FTSE 100 companies comply with the code’s provisions, while only 62 per cent of the FTSE 350 do so¹⁴. This suggests that optional compliance is perhaps not the most effective means to address corporate governance

¹² Green paper: Corporate Governance Reform. Department of Business Innovation and Skills, November 2016.

¹³ Jim Pickard and Sarah Gordon ‘*May waters down plans for binding votes on executive pay*’ Financial Times, November 29, 2016.

¹⁴ Sarah Gordon ‘*Third of UK businesses do not meet corporate governance requirements*’. Financial Times, November 13, 2016.

matters in general and the high pay issue in particular. The following section would outline some of the issues with High executive pay.

1.2.1 High Executive Pay is the Outcome of Flawed Processes

High executive pay is problematic, not only when considered for its size, but due also to issues with the process of pay setting. As Nozick stated, outcomes derived through “*justice preserving means*”¹⁵ are in fact just, the inverse of this would be that outcomes via processes lacking the justice requirement, would therefore be unjust.

The popular justification for current pay levels is, that pay is just reward for performance. Challenging this view is the alternative argument that high executive pay is the outcome of managerial influence. Theories of “*board capture*” posited by Bebchuk and Fried, reject the mainstream justification for executive pay determined by performance, positing instead that managerial power and the latter’s ability to extract rents were the key determinants of pay quantum¹⁶. They argue that managers were enabled and indulged by complicit boards, either too distracted by self-interest or too apathetic to adequately marshal executive behaviour on behalf of investors. As such exorbitant pay packages are not the reward for good performance, but rather rewards unmatched by appreciable growth or given despite unmitigated failure. These

¹⁵ Which according to Nozick, are distributions which originate from a just situation and whose “*repeated transitions*”, either through acquisition or transfer, adhere to the demands of justice. Robert Nozick ‘*Anarchy, State, and Utopia* (New York: Basic Books) 152.

¹⁶ L. Bebchuk, J.M Fried and D. Walker, ‘*Managerial Power and Rent Extraction in the Design of Executive Compensation*’. The University of Chicago Law Review, [2002] Vol. 69, 751-846. See also, Lucien Bebchuk and Jesse Fried, *Pay Without performance: The Unfulfilled Promise of Executive Compensation*. (Harvard University Press; 2004).

arguments are evidenced by a plethora of instances where out-sized payments were made in the face of poor firm performance. With the bonuses paid to executives in the wake of a tax-payer funded bail out, representing some of the most egregious examples¹⁷.

Admittedly, not every exorbitant pay package is the product of a compromised pay setting process, in fact, an argument could be made that these may be in the minority. However, it is impossible to discountenance the impact even a handful of flawed pay packages could have. The utilisation of peer averages in the setting of executive pay, exacerbates the impact one flawed package could have. This latter fact, further highlights the difficulty of arguing for the performance-relatedness of executive pay.

1.2.2 The Rise in Executive Pay Appears Interminable

Executive pay grew by 950 per cent between 1979-2015, despite efforts to arrest its growth. Apart from legislative attempts which have had very limited success, the question of high executive pay has intermittently been placed before the courts. The Anglo-American courts have historically been reluctant to interfere in corporate governance matters. This attitude of non-interference is recognised and codified in some jurisdictions as the Business Judgement Rule. The Rule requires the judiciary when faced with questions that concern the exercise of valid business judgement, to defer to the director's expertise.

¹⁷ Frank Bass and Rita Beamish '\$1.6B of Bank Bailout Went to Execs' CBSnews.com, December 21, 2008 (<http://www.cbsnews.com/news/16b-of-bank-bailout-went-to-exec>).

Furthermore, company law doctrine dictates that the proper claimant in cases regarding wrongs done to the company, must be the company itself. This principle applies without exception to compensation cases, where claimants argue that disputed pay decisions constitute a waste of corporate assets. The problem is highlighted by the inability of the company to bring action by itself, due to its artificial status. Such claims are exclusively within the director's remit, to institute on the company's behalf or by a third party with leave granted by the company, through its directors¹⁸. Due to the high potential for conflict, the U.S courts devised *the Demand Requirement*, as an exception the rule. The latter allows third party claimants to be granted leave challenge pay decisions, provided they can evidence a prior demand had been made to the board of directors to remedy the situation or the futility of making such a demand¹⁹. Proving the futility of making a demand, does on its own present an onerous challenge, requiring the claimant to satisfy further obligations. It is perhaps no surprise that the clear majority of corporate waste cases fail at the preliminary hurdle²⁰.

With regards to executive pay cases, the current attitude of the U.S courts, represents a recognisable diversion from previous positions, as demonstrated in the decision in *Rogers v Hill*²¹. Here the court validated a corporate bye-law establishing a pay policy which allowed the CEO and other top executives, claim a percentage of the excess profits as a bonus. However, the court held that a \$1m pay-out to the CEO, was

¹⁸ S.7.42 *Modern Business Corporation Act*.

¹⁹ *Ibid*.

²⁰ Randall Thomas and Kenneth Martins, "*Litigation Challenges to Executive Pay: An Exercise in Futility*" Washington University Law Quarterly, Vol.79, 569 at 580.

²¹ [1933] 289 US. 582.

excessive and could not be justified given the prevailing economic circumstances²². It is remarkable that the court found the pay policy which produced the disputed compensation to be legitimate, but still decided against its justice because of its size and disparity from the norm. Holding that even a majority could not "*justify payments of sums as salaries so large as in substance and effect to amount to spoilation or waste of corporate property*"²³.

However, the Delaware Supreme Court in *Brehm v Eisner*²⁴, rejected the plaintiffs argument that an agreement entered by the board with a CEO, which guaranteed a gratuitous exit package-allowing him earn more if his contract was terminated-was a waste of corporate assets. The court decision was taken 70 years after *Roger* and was based on claimant's failure to provide particularized facts proving the board's failure to meet the standard required for the compensation decision to be regarded as a valid business decision. The court decide thus, even though the CEO was awarded an exit payment of \$38m, following a dismissal for poor performance.

It has been suggested that reluctance of the courts to engage in compensation matters, arises from a need to discourage class actions suits being brought against corporations²⁵. Regardless of the reasons, the court is required to meet its primary responsibility to address injustices and inequities at play in society, for which high or excessive executive pay often appears to fall within those categories.

²² Carl T. Bogus 'Excessive Executive Compensation and the Failure of Corporate Democracy' Buffalo Law Review, [1993] Vol.41 No.1, at 48.

²³ *Rogers v Hill* (n20) 591.

²⁴ 746 A.2d 244.

²⁵ Bogus (n20) 57.

Legislative attempts to curb the growth in CEO pay have also proven largely ineffective and in some cases inadvertently aided its growth. The U.S legislature had sought to curb the growth of executive pay, by limiting its tax deductibility²⁶. However, that the provision only applied to fixed salaries and not variable pay, allowed companies to circumvent its provisions by an emphasis on performance-related pay, which led to an explosion in pay levels²⁷.

Similarly, the Greenbury report required companies to disclose their compensation policy and to include total pay for executives, the performance criteria for realization of said pay, as well as comparator groups²⁸. It is argued that increased disclosure enables companies ratchet up pay, referencing the salaries of CEOs of peer companies as justification²⁹. Despite a caveat within the provisions of the code which required companies to “*take account of relative performance*” in making comparisons.

It would be fair to say that legislative and regulatory attempts at addressing the issues with high pay, have yet to have the desired impact, as evidenced by the continuous rise in pay.

²⁶ Robert Reich ‘*There’s One Big Unfinished Promise by Bill Clinton that Hillary Should Put to Bed*’ available at (<http://robertreich.org/post/150082237740>).

²⁷ Ibid.

²⁸ Greenbury Report was commissioned by the Confederation of British Industry and was released in 1995

²⁹ Alexander Mas ‘*Does Disclosure affect CEO Pay Setting? Evidence from the Passage of the 1934 Securities and Exchange Act*’. Available at (<https://www.princeton.edu/~amas/papers/CEODisclosureMandate.pdf>)

1.3 High Executive Pay, Represents One of the Greatest Challenges of the 21st Century, Because of the Social Justice Implications

Thomas Piketty in his book, *Capital in the 21st Century*, noted that the growth in income inequality coincided with the rise of the “super manager”³⁰. As the fetishization of managerial talent increased, so did the rewards for possessing such talent and as managerial compensation grew, average wages stagnated. It is noteworthy that pay grew not only because CEOs could command higher wages-as a premium for their skill-but also the growth in CEO pay was partly driven by wage stagnation at the lower levels³¹.

Executive pay began to accelerate in the 1980s in response to a multiplicity of factors. First, was the wholesale adoption of a neoliberal economic perspective, which began to gain traction in the 1970s. These ideas began to permeate economic policies on both sides of the Atlantic in the 1980s, and were promptly adopted by the business community³². The engendering of the neoliberal market mentality in policy making, manifested itself in a widespread trimming of the state and its role in the ordering of the market and its activities. In Britain, the regression of the statist apparatus gave greater margins to the market and private interests, who began to fulfil obligations

³⁰ The idea that managerial talent and skill was invaluable to firm success and required compensation commensurate with that of other highly skilled individuals. Thomas Piketty ‘*Capital in the 21st Century*’ (HUP, 2014), 273.

³¹ Josh Bivens and Lawrence Mishal ‘*Understanding the Historic Divergence Between Productivity and Typical Workers Pay*’ EPI Briefing Paper. Available at (<https://www.smcm.edu/democracy/wp-content/uploads/sites/29/2015/07/wage-stagnation-and-productivity.pdf>).

³² Steve Pearlstein ‘*When Shareholder Capitalism Came to Town*’ The American Prospect, April 19, 2014. Available at (<http://prospect.org/article/when-shareholder-capitalism-came-town>).

previously met by the government. The privatization of erstwhile state-mandated services, created an opportunity for those with the means to step into these previously state-occupied roles, with significant financial benefits. Thus, creating a new class of shareholders and highly remunerated executives, whose remuneration was no longer constrained by government banding, but determined by market forces.

Furthermore, efforts were made to slacken the controls over the private sector by revising previously enacted legislation, with the aim of freeing the market from the weight of bureaucratic red tape. In the U.S, the Reagan administration implemented policies that restricted the ability of the regulatory authorities to oversee share buy-backs by corporations amongst others³³. Also, the government passed legislation lifting capital controls which encouraged growth in market activity. The lifting of the controls on share buy-backs allowed CEOs to manipulate the share prices by investing large sums of corporate funds to repurchase company stock. The widespread use of equity as part of CEO compensation packages, made these buy-back schemes of immense financial benefit to executives³⁴.

To further the neoliberal agenda, attention turned to limiting employee rights and power, notably by stifling the unions. In Britain, the Conservatives led by Margaret Thatcher, passed the various *Employee Acts*³⁵. The earlier version in 1980 had limited the power of the unions to lawfully picket and required a ballot for the operation of a closed shop provision. The 1982 version went further, by outlawing employee

³³ William Lazonick 'The Financialization of the U.S Corporation: What Has Been Lost, and How Can It Be Regained' Seattle University Law Review [2013] Vol.37, 857 at 880.

³⁴ William Lazonick, 'The Value-Extracting CEO: How Executive Stock-Based Pay Undermines Investment in Productive Capabilities' Institute for New Economic Thinking, Working Paper No.54, p.5.

³⁵ *Employee Act 1980 &1982*.

dismissal for non-union membership and increased significantly the compensation that could be claimed in that event³⁶. More significantly the *Act* lifted some of the immunities against civil action previously enjoyed by trade unions, making them more vulnerable to civil damages³⁷. These acts were intended to soften the unions and employee resistance with the full effects brought to bear with the failure of the 1984 miners' strike. This precipitated a decline in union membership, which fell from 13.5m in 1980 to 9.9m ten years later³⁸.

It was important to disable the unions, given the impact that unionized jobs have on corporate performance³⁹. They also have a sobering effect on earnings disparities within various industries⁴⁰. The legacy of a successful war on the unions is evident today and manifest in phenomena such as: wage stagnation-wages have failed to keep pace with inflation. The latter has left ordinary workers worse off in real wage terms today, than in the 1970s. Furthermore, the decline in unionization has encouraged the widespread utilization of employee contracts, designed to strip employees of their statutory rights and the attendant costs⁴¹. The war on the unions led to union decline and excoriation of workers' rights, to the benefit of shareholders and executives⁴².

³⁶ Employee Act 1982, S.2 & S.3.

³⁷ *Ibid*, S.16.

³⁸ Richard Disney, Amanda Gosling and Stephen Machin, '*British Unions in Decline: Determinants of the 1980s Fall in Union Recognition*' *Industrial and Labour Relations Review*, [April 1995] Vol.48, No.3, 403.

³⁹ *Ibid*.

⁴⁰ *Ibid* at 404.

⁴¹ These are infamously known as 'zero hour' contracts, the effects of which were brought to the fore in 2016, when it was revealed in 2016, that the retailer, Sports Direct had contrived to pay staff at its warehouses-most of whom were hired through third party organizations-less than the minimum wage. 80 per cent of whom were employed on reprehensible zero-hour contracts. John Murray Brown and Jim Pickard '*Sports Direct to use fewer zero hours contracts after criticism*' *Financial Times*, September 6, 2016.

⁴² Jake Rosenfeld, Patrick Denice, and Jennifer Laird 'Union decline lowers wages of non-union workers' *Economic Policy Institute*, August 30, 2016 at p.2.

Furthermore, the espousal of a neoliberal approach to governance, with its market emphasis and deregulatory tilt, precipitated the financialisation of the market economy. Focusing on the share price as the measuring unit of the company's performance trajectory and shareholder value, it became necessary to maximise the share price, sometimes at any cost. What followed, was a deviation from the previous regime of empire building and corporate expansion, to a focus on efficiency and cost limitation⁴³. Corporations began to downsize operations, situating jobs within low wage countries, while failing to retrain workers skilled within the particular field. Leaving blue-collar labour with the binary options of either being out of work or accepting unskilled and often poorly paid labour. With this having the twofold effect of placing a huge squeeze on wage growth for ordinary workers, while simultaneously stimulating firm profitability and executive compensation.

1.4. What are the Questions to be Answered By this Thesis?

As stated, the objective of the thesis is to examine the justice of high executive pay. The thesis defines executive pay as high, due to the disparity from the norm, when considered in relative terms. That executive pay could be deemed to be relatively high, does not connote its injustice. For the purpose of this thesis at least, the justice of high executive pay could be determined by evaluating its antecedents and externalities. The thesis adopts the approach that a justice evaluation of high executive pay must

⁴³ Jiwook Jung 'Shareholder Value and Workforce Downsizing, 1981–2006' *Social Forces*, Vol.93(4) 1335, 1337.

do so by putting the latter in a wider social context. Failure to do the latter, would subject evaluations of high pay to the personal bias of the evaluator and lead to a biased outcome.

Given the premise that high executive pay is not indicative of a failure to meet normative standards of justice, how then do we come to determine its justice?

The answer to the above question must consider the process by which pay is determined, as well as its impact, within the immediate environment. Hence, the integrity of the pay setting process becomes of utmost importance in determining the justice of the outcome. Furthermore, the outcome would be examined in relation to its externalities.

Concerning the above objective, two key research questions must be answered;

(1) Do possible compromises in the pay setting process render high executive pay unjust?

The first question addresses one of the key justifications cited in defence of high executive pay i.e. that executive pay is the outcome of an agreement between an independent disinterested board, acting in the company's interests and an executive looking to maximise her earnings. This conventional narrative possesses two aspects; first, that the independent board negotiates from a position of strength with the CEO, in determining fixed pay, while variable pay is made dependent on targets that ensure value maximization. Secondly, that variable pay is a reward for meeting these performance targets. This justification is premised on the somewhat questionable notion, the corporate governance safeguards intended to eliminate-or at least limit-managerial interference in the pay setting process are fit for purpose.

This thesis challenges the narrative by examining the pay setting process against the justice standards inherent within Nozick's entitlement theory. That Nozick posits that anything that emanates from just processes is just, suggests that whatever arises through fraud, deception or undue influence, would fail to meet the standard. The latter is noteworthy when considering arguments which suggest significant managerial influence over the pay setting process. Therefore, by examining empirical and anecdotal evidence, this thesis would challenge conventional justification for high executive pay, using Nozick's justice theory as a reference point.

Although evidentially trivial correlation between pay and performance⁴⁴, lends validity to the managerial interference theory, it would perhaps be hasty to suggest this to be the case in all instances. As the evidence suggests, the governance reality shows managers wield greater influence over pay decisions than conventional theorists would want to admit. This first question is underpinned theoretically by Nozick's justice theory, which only grants validity to outcomes which emanate from just processes.

(2) Is high executive pay rendered unjust, via its sheer size, and disparate impact on income distribution?

Through this second question, the thesis analyses the wider ramifications of high executive pay, by highlighting some of its externalities, including its disparate impact on income distribution cum income inequality. This question forms the second half of

⁴⁴ Weijia Li and Steven Young 'An Analysis of CEO Pay Arrangements and Value Creation for FTSE-350 Companies' Report Commissioned and funded by CFA Society of the United Kingdom. December 2, 2016.

this two-part analysis. High executive pay could only be determined to be just if it could evidentially be justified by its means, but also if the externalities it produces do not negatively impact the well-being of those it touches. Whereby the first question rests on Nozick's theory of justice, the second question would be tested against the Rawlsian difference principle, which requires inequalities to be to the benefit of all. Hence, if high pay could be said to be the outcome of just processes, do the inequalities it produces work to the benefit of the least within the company on the one hand, and society at large?

To answer this question, the thesis would examine pervasive operational strategies aimed at boosting productivity and profitability. The shift to shareholder value maximization necessitated a trimming down of company operations, making the firm leaner and nimbler with increased output. As such, the thesis argues that the shift to automation and increasing mechanization of production and service provision, is an attempt to further this end. With the consequence being, an increase in executive pay, with a corresponding decline in the fortunes of the firm's ordinary employees.

Whilst the first and second waves of industrialization in the 19th and 20th centuries caused skilled workers to earn higher wages-hence industrialization in this sense was dependent on manpower in the productive process-the third wave has sought largely to bypass this erstwhile pivotal aspect of the entire process⁴⁵. The pivot to automation and other advanced technologies, coupled with a failure to retrain workers to adapt to these new technologies, has left labour deskilled and with a diminished relevance.

⁴⁵ *The third industrial revolution*. The Economist, April 21, 2012.

Furthermore, there has been a systematic outsourcing of the aspects of production and service provision, untouched by automation, to low wage countries⁴⁶. This allows goods and service production to be maximized at a fraction of the cost. It is important to note, that a combination of all these factors, have had a wage-suppressive effect on those remaining in the workforce. Left without options and with little or no union support, labour was forced to work on vastly diminished terms. Simultaneously, given that pay is often linked to performance, the productivity boom has meant higher wages for CEOs.

In the current regime, we have a situation where the wealth gains from increasing productivity are not being distributed effectively enough for the benefits to be felt widely. Increased corporate wealth has not translated to higher wages, in fact workers arguably earn less than in the post-war years, as wages fail to keep pace with firm productivity⁴⁷. Therefore, if the factors that drive CEO pay to very high levels, do not appear to be in the interest of anyone but managers, executive pay would appear to fall short of the requirement of the Rawlsian principle.

⁴⁶ William Lazonick *'How Stock Buybacks Make Americans Vulnerable to Globalization'* Air Industry Research Network, Working Paper #16-0301, at 5.

⁴⁷ David Cooper and Lawrence Mishel *'The erosion of collective bargaining has widened the gap between productivity and pay'* Epi.org. January 6, 2015. Available at (<http://www.epi.org/publication/collective-bargainings-erosion-expanded-the-productivity-pay-gap/>)

1.5. Research Methodology

In answering the above research questions, the method adopted would be largely doctrinal. By utilising legal rules and doctrine, the thesis would examine the issues raised by the enumerated questions, in the light of the broad underlying theme of distributive justice and equity. The thesis takes on a comparative approach in engaging the subject, by juxtaposing the two dominant common law jurisdictions; the UK and U.S.A. This comparative approach, in analysing the executive compensation culture in the UK and U.S.A, is important for a few reasons:

Firstly, very little separates these two jurisdictions from a jurisprudential stand-point, share substantive and procedural similarities of their respective bodies of law. Furthermore, the two are largely homogenous, in so far as they share socio-cultural and economic similarities. For example, both operate vibrant market economies and have a similar cultural tolerance for income inequality amongst other things. This stated similarities, may partially explain why they have the highest CEO pay levels globally and rank poorly-as well as closely-in the global income inequality index.

Although the UK lags the U.S in overall compensation levels, it adopts a similar compensatory template to their American counter-parts. An example would be the use of equity-based incentives, which were more widely used in the U.S, before the widespread adoption in the UK. It is no coincidence therefore that pay has grown in the UK and ranks second only to the U.S in international standings.

Lastly, despite the jurisprudential similarities, there is however a general lack of UK case law regarding compensation in public companies. The majority of the current body of compensation-related case law, generally concerns small privately held firms.

Which perhaps is useful when examining the pay against stated legal doctrine, but less so when placing pay in a wider context as is the approach of the thesis. In contrast, American corporate law jurisprudence is inundated by a healthy body of shareholder derivative case law. Where existing pay levels have been tested against legal dogma, even if only at a preliminary stage. This difference could perhaps be a reflection of the disparity in litigation funding across these two jurisdictions.

The thesis adopts a “law in context” approach in a bid to fully analyse the justice of high executive pay. This approach extends the debate beyond questions of quantum and considers its impact on wider society. By adopting the underlying themes of distributive justice and equity, through the contrasting theories of Rawls and Nozick, the thesis hopes to provide a platform for an evaluation of high pay in a real-world context. The enumerated objective, necessitates the implementation of a socio-legal approach.

The thesis as reflected by its subject-matter and methodology, aims to examine executive pay in accordance with the broader themes of justice and with less regard to its compatibility with UK/U.S company law. This is an approach free of the restrictiveness which a strict rudimentary application of the legal doctrine might yield. The thesis seeks to engage the process of executive compensation setting, the outcome of the process and its impact in a wider social context. To this end, it is irrelevant that these outcomes were derived in strict adherence with legal norms.

1.6. Original Contribution to the Subject-matter

The issues surrounding executive pay have been widely researched. There is quite a solid body of work on the two key subjects addressed within this thesis; the pay setting process and the disparate impact of high executive pay. Generally, the focus in most of literature examining the justice of high CEO pay is largely on issues regarding quantum i.e. the size of the CEO pay packages, including the determinants of high pay. Thus, there exists a wealth of literature on the pay-setting process, and the failures therein. With a broad focus on managerial power or board capture, emphasising the likelihood of managerial influence over the pay setting process.

However, there is not as much of the existing literature which considers the justice and fairness of executive pay, much less from a socio-legal standpoint. With regards to the latter approach to discussing high executive pay, the existing literature consists largely of work by Charlotte Villiers⁴⁸ and Jared Harris⁴⁹. These authors addressed arguments surrounding executive pay, from the vantage point of justice and social justice by utilising Nozick's and Rawls' principles of justice.

Villiers stated the importance of establishing a careful definition of justice within the context of pay⁵⁰. In discussing the justice of high executive pay, her work focused both on the pay setting process as well as the antecedents of high pay.

⁴⁸ Charlotte Villiers 'Executive Pay: A Socially-Oriented Distributive Justice Framework' *Company Lawyer* [2016] Vol.37 Issue 5, 139. Charlotte Villiers 'Executive Pay: Beyond Control' *Legal Studies*, Issue 15, 260.

⁴⁹ Jared Harris 'What's Wrong with Executive Compensation' Vol.85, 147-156. Also, Jared Harris 'How Much is Too Much? A Theoretical Analysis of Executive Compensation from the Standpoint of Distributive' in 'The Ethics of Executive Compensation' R.Kolb (ed) (Blackwell's: 2006) p.67-86.

⁵⁰ Villiers 'Executive Pay: Beyond Control' 263.

Villiers analyses the justice of executive pay setting utilising the theories of Rawls and Nozick. Using the standards espoused by these theories as a touchstone for establishing the justice of high pay. While highlighting the dissimilarities of these theories in terms of their overall approach to distributive justice, she does acknowledge however the procedural bent of Nozick and Rawls' theses⁵¹. With Nozick, she highlights the voluntarism that underpins his transactive-based assertions. Wherein the giver of a thing must choose to and be willing, to part with the thing, to benefit another. The absence of the latter, would indicate that the outcome of said transaction would fail to meet the standard of justice⁵². In terms of Rawls, she mentions that while the Rawlsian theory was concerned partly with the process of distribution, he however countenanced the function of the outcome as well⁵³. Much in contrast to Nozick who cared less for the impact of the outcome, when the justice of the process could be established.

With regards to role of the law in constructing a just system of compensation determination, Villiers mentions that Nozick's thesis, could be used as a "*basis for the regulation*" of executive pay. While the Rawlsian difference principle, could be used to construct a system of laws which would ensure that inequalities function to benefit all within society. She posits that Rawls' idea of justice requires the regulation of executive pay to extend beyond the company laws, but also to the relevant distributive framework⁵⁴.

⁵¹ Ibid 265.

⁵² Ibid.

⁵³ Ibid 264.

⁵⁴ Ibid 265.

Villiers also addressed the antecedents of high pay while utilising the difference principle⁵⁵. In so doing, she critiqued the current regime of executive pay citing its distributional consequences, with a focus on its contribution to inequality. She argues that the Rawlsian difference principle encourages equality of opportunity and was based “*on the ground of equal respect for persons*”⁵⁶. Something she believes the inequality of income-which partly results from high executive pay-threatens.

In a similar vein, Harris discussed the problematic nature of current compensatory practices within corporations from an equity standpoint in addition to the negative consequences of incentive pay for company executives⁵⁷. Harris highlights the fact that common objections to executive pay are usually based on its gross and comparative magnitude. Which generally centre on the size of executive pay and how it compares with average income. Harris however, criticised this approach for its sensationalist nature. He argues that the use of pay ratios could be misleading and incredibly difficult and complex to determine⁵⁸. He states, that because executive pay is deemed to be unfair, does not necessarily imply that it is in fact. That a true determination of the justice of executive pay should consider the pay setting process and that of CEO selection, in line with Rawls’ difference principle⁵⁹.

He mentions the possible circumstances which could sully and ultimately compromise the pay-setting process, including CEO celebrity and influence over pay decisions. Other factors he mentioned are cognitive dissonance resulting from shared

⁵⁵ Villiers ‘*Executive Pay: A Socially-Oriented Distributive Justice Framework*’ 147.

⁵⁶ Ibid 147.

⁵⁷ Harris ‘*What’s Wrong with Executive Compensation*’ 152.

⁵⁸ Ibid 149.

⁵⁹ Ibid 150.

backgrounds and prior relationships and the *"norms of reciprocity"* which could result. He argues that these may cause the pay setting process to fall short of Rawls' expectations⁶⁰.

Similar to Villiers, Harris applies Nozick's process-oriented thesis to the pay setting process. Arguing that the process may fail to meet the libertarian standard for justice if *"all the libertarian tenets of individual responsibility, market transfer and consumer liberty"* are not present within the transaction. Concerning the way high executive pay impacts the wider community, Harris states utilising Nozick's theory, that; *"Because Nozick argues that a thief is not entitled to his ill-gotten gains, it follows that executives who use an insider's advantage to enrich themselves at the expense of other stakeholders also do not attain just entitlement"*⁶¹. Suggesting, that the determination of the fairness of executive pay, must extend beyond an examination of the pay setting process.

He concludes, that unlike the objections to CEO pay based only upon its gross or comparative magnitude, an analysis of executive pay based on its justice and fairness *"potentially has strong validity"*⁶².

Taking what has been said with regards to the justice of current executive pay levels, using Nozick's and Rawls' justice theories, this thesis attempts to advance the subject matter. First, by combining an examination of the pay setting process, with an analysis of the wider impact of executive pay.

⁶⁰ Ibid.

⁶¹ Ibid 151.

⁶² Ibid 152.

The existing literature on the subject-matter, as represented by the work done in the area by Villiers and Harris, focused largely on an application of the justice theories to the pay-setting process. While Villiers went beyond the pay-setting process and put forward a contextual analysis, her arguments veered largely toward the egalitarian objections to high pay. This thesis also considers the egalitarian objections to high pay, but goes beyond questions of equality and considers the externalities of high pay, in determining its fairness. Such that, if the requirements of justice-as represented by Nozick's entitlement theory-are met within the pay setting process pay cannot be deemed to be fair solely on these grounds. As such, the thesis considers the corporate actions which precede the meeting of the firm's objective. Like practices discussed in Chapter Four, which increase productivity and suppress costs, including wages for the ordinary workers. Thereby increasing value in the short-term, but at the expense of the long-term health of the firm and the community it inhabits. The approach adopted by the thesis, is predicated on the notion that executive pay cannot be just, if its externalities negatively impact the wellbeing of those touched by the corporation.

Therefore, the approach adopted to examine the justice of high executive pay, would be carried out thus:

First, by a quantum-based analysis of high executive pay, which includes the pay setting process and the pay for performance argument for high executive pay. This first test is underpinned by Nozick's requirement that outcomes must be determined by justice preserving means, to be just.

Regardless of the outcome of the first test-even if pay-setting process is shown to be without compromise-high pay can only be said to just if it meets the fairness

requirement. As one of the major drivers of income inequality, pay must be measured against the Rawlsian difference principle—that validates inequalities only when they work to benefit the least in society. As such, the second test considers the externalities of high pay on all constituencies impacted by corporate activity, besides investors.

CEO pay at its current level could only be determined to be just if it is determined by *“justice preserving means”* on the one hand AND meets the fairness standard, that is, must work to the benefit of all within society. Failure to meet both requirements, leaves executive pay short of the justice requirement.

1.7. A Brief Outline of the Thesis by Subject-matter

The rest of the thesis goes as follows;

Chapter Two attempts to lay a foundation for some of the arguments within the thesis, by examining the notion of executive pay as an issue of public policy. The latter would be determined by whether a society perceives the firm as a wholly public or private institution. Contemplation of the firm as wholly private, excludes all firm activity from the falling within the purview of public policy, the reverse would be the case, if the firm was considered to be a public institution. The Chapter argues for the latter, given the inextricability of corporate activity from wider society. It would therefore be implausible to consider the firm as wholly private, when so much of corporate activity impacts the society it inhabits. As argued within the Chapter, the latter contemplation

would therefore bring the firm within the purview of public policy. Opening the doors for the legislative approach to reforms, intended to enhance its fairness.

The thesis goes on in Chapter Three to answer the first research question by analysing the pay-setting process, using Nozick's process-oriented justice perspective. It began by highlighting the arguments both for and against the current pay levels. It mentions the conventional view of an arm's length bargaining process as well the managerial influence/captive board theory put forward by Bebchuk and Fried. The Chapter highlights some of the failings within the Anglo-American corporate governance structure, which potentially compromise board independence and facilitate managerial influence over the pay-setting process. Comparing the pay-setting process to Nozick's postulation of a legitimate process in income determination and distribution. The Chapter argues that the inherent failures could potentially compromise the integrity of the latter and the fairness of the outcome. As part of this wider analysis, the Chapter examines the widespread use of comparator averages in pay setting. Arguing that this furthers arguments against the fairness of executive pay, making it unlikely to meet the justice requirements of Nozick's thesis.

In the Fourth Chapter the thesis attempts to answer the second research question; determining the justice of high executive pay by analysing its impact on wider society. In doing so, the thesis references differing theories of justice: Nozick's libertarian theory and Rawls's difference principle. With regards to executive pay, Nozick's process-oriented argument would render high executive pay just, provided the pay setting process was uncompromised. Rawls's alternative viewpoint that income disparities must benefit the least in society to be just, would be used both to counter

Nozick and to debunk notions of justice regarding high executive pay. Here the thesis considers some of the externalities of CEO greed and excess. Here particular focus would be given to growing automation and pervasive adoption of modern technologies in production and service provision. The Chapter would consider how these have facilitated the globalisation of firm operations. Highlighting the impact of offshoring and production relocation-a fact which has had a suppressive effect on wages at the bottom, while simultaneously causing CEO pay to increase, in response to productivity gains.

The thesis proceeds in the latter stages of the Chapter to examine the debate regarding the convergence of corporate governance systems globally. The move towards the Anglo-American system of governance and its impact on executive compensation levels globally. It could be argued that the expansion of equity markets, and the dispersion of share-ownership, as well as a reduction in the number of family-held firms globally, could be regarded as evidence of convergence. This argument is further strengthened by evidence of Anglo-American compensatory practices in jurisdictions not naturally inclined to such methods. This section sought to further the argument that the current pay levels-particularly outside the U.S- are more responsive to external factors and thus, has little to do with value creation.

In Chapter Five, the thesis considers potential reforms to the current executive pay culture. Considering a role for the judiciary in arresting the growth of executive pay, as well as the legal constraints which make such an intervention unlikely. Here, the history of executive compensation litigation in both jurisdictions is discussed. The Chapter documents the shift in judicial attitudes towards excessive pay, from the

decision in *Rogers v Hill*, to the more liberal positions taken in more recent cases. The Chapter would discuss the attitude of non-interference adopted by the courts in general and would extensively consider the codified Business Judgment Rule.

The latter portion of the Chapter would explore possible reforms to enhance the fairness of executive pay. First, by exploring the effectiveness of the recent legislative enactments, like the *Enterprise and Regulatory Reform Act 2013* and the *Dodd-Frank Act* of 2010, both aimed at improving the transparency of executive compensation setting. The thesis goes on to argue that, although progress had been made since the passing of the aforementioned, more radical measures had to be pursued for meaningful progress to be made. To this end, the thesis discussed tightening some of the existing provisions within the ERRA, as well as the implementation of more stringent measures like maximum upper limits on executive pay.

The final Chapter concludes the thesis and identifies possible measures that could be taken at state and institutional levels to curb high executive pay. With regards to the former, the possibility of state-mandated caps-as are in place in some jurisdictions-is discussed as well as institution level changes geared towards making pay fairer. It is concluded that state-mandated pay caps are a highly unlikely proposition particularly in the face of precedent from other jurisdictions where similar measures have been taken with less than desirable outcomes. The Chapter concludes with a call for a more balanced view with regards to what the corporate objective should be, as an antidote to CEO excess and its externalities.

Chapter Two

The Corporate Objective: Shareholder Primacy, Executive Pay and Public Policy

2.1. Introduction

For the most part since the last century, academics and business scholars have debated on what function the corporate form should have. Should it be geared towards profit-maximization or should the corporation being a social entity, like all other social entities, be established and operated for the common good?¹ Limited liability confirmed the status of the modern corporation as the primary vehicle for business operations. Not simply because it created an avenue for investors to create wealth, but also and perhaps more importantly, it created an artificial entity, with a veil that protected its members from the negative consequences of business failure. Though adaptation to this business form was slow, it would eventually become the prime vehicle for investment in business and innovation in the twentieth century². As

¹ This was the subject of the famous debates by Harvard academics Adolf Berle and Merrick Dodd. With the former holding the view that the corporation was most efficient when administered in favour of investors, Dodd disagreed stating that business at the very least had a social responsibility to consider the interests of all stake holding constituents. For their respective arguments see, Adolf Berle, "*Corporate powers are Powers in Trust*" 44 Harvard Law Review; 1931 1049-1074 and E. Merrick Dodd "*For Whom Are Corporate Managers Trustees*" 45 Harvard Law Review 1932, 1145-1163.

² Lorraine Talbot, *Progressive Corporate Governance for the 21st Century*, (Routledge 2013) at 70.

such, the attention shifted from the morality and ethics of the business form to its objective and functionality. To whom did this business entity owe its allegiance?³

Limited liability began the process of separating ownership from control. The corporation being a legal person, having rights and obligations, did not have to be managed by its owners. As investments increased, the resultant diffusion of ownership brought with it the need for the corporate manager⁴, at the same time, the corporate dichotomy of capital and labour was birthed.

Adam Smith stated in the, '*The Wealth of Nations*⁵' that only labour and entrepreneurs were to be regarded as the primary recipients of the proceeds of a company's assets, not investors. Smith's view on the objective of the company is said to have been borne out of his disdain for investor capitalism, which was the order of his day⁶. However, the view point was to change over the next few decades and investor interests were continuously and progressively prioritised. This followed the expansion of the limited liability corporation as it became a mainstay in the Anglo-American business polity.

However, the Anglo-American approach to corporate governance, with its focus on shareholder primacy differed from the approach adopted in most of Europe and Asia.

With the latter opting to view the company more as a social entity having

³ Freeman argues that the corporation should be dealt with as a "*major social institution*". Their size and importance within the modern economic system, means they cannot be considered to be mere vehicles through which private individuals could further their wealth-based objectives. See, R. Edward Freeman '*Stakeholder Theory of the Firm*' Perspectives in Business Ethics, Vol.3, 144.

⁴ A phenomenon which was more quickly embraced in the inter war years in the U.S than in Britain. While the former witnessed several large managerial corporations, a lot of the major British firms were still largely family-run and managed. See, John C. Coffee '*The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control*'. Available at (<http://ssrn.com/abstract=254097>).

⁵ Adam Smith, '*An Inquiry into the nature and Causes of the Wealth of Nations*' (First Published 1776, Penguin 1999).

⁶ Talbot (n2) 71.

responsibilities in service of public interests⁷. It has been argued that a society's approach to corporate governance is substantially influenced by its political and socio-cultural institutions⁸. Given that Anglo-American societies have historically leaned towards a *laissez faire* attitude, with a non-communitarian preference for free markets and limited state interference, it should come as little surprise that it approaches corporate governance in such a manner. As such, shareholder primacy has gained traction in recent decades, riding the wave of neo-conservatism that took hold in the 1980s on both sides of the Atlantic⁹.

As such the staunchest proponents of this governance approach would scoff at the concept of the altruistic business entity. Nor would they countenance the notion of a corporation having its scope of interests broadened to include and prioritise those of its wider community. On this note, the neoliberal economist, Milton Friedman famously stated that the company has but one social responsibility: to maximize the wealth of its members¹⁰. A view to which other commentators including Adolf Berle appeared to be similarly inclined¹¹.

Much like Friedman, Berle believed in the efficiency of shareholder primacy, but differed in the way he rationalised his support for this governance approach. His opinions were borne out of a genuine belief that managing for shareholders was the

⁷ Henry Hansmann and Reiner Kraakmann, "*The End of History of Corporate Law*". Georgetown Law Journal [200-2001] Vol.89, 439-468, 446.

⁸ Mark J. Roe, *Political Foundations for Separating Ownership from Corporate Control*, [December 2003] Stanford Law Review, Vol. 53. p.539-606.

⁹ Alan Dignam and Michael Galanis: *The Globalization of the Corporate Governance* (Ashgate 2009).

¹⁰ Milton Friedman, *The Social Responsibility of Business is to Increase Profits*, New York Times Magazine, 13 September 1970.

¹¹ Adolf A. Berle '*Corporate Powers as Powers in Trust*' Harvard Law Review [1930-31] Vol.44, 1049. Also, Adolf Berle, Jr. "*For Whom Corporate Managers Are Trustees: A Note*," Harvard Law Review, 45 (1932) 1365.

most effective way to combat managerial indiscipline and excess¹². Thus, it was for the benefit of all that the company be run in the benefit of some. But many have questioned the basis for shareholder ascendancy as the prime focus of the corporate objective. With their ownership rights, no longer a solid base to lay their claim, it becomes necessary to understand the justification for shareholder primacy.

The question of shareholder primacy becomes even more significant with regards to the debate surrounding executive pay, where greater shareholder engagement has been identified as the antidote to rising pay levels. The counter-intuitiveness of the latter proposition becomes apparent, were one to consider the argument that the high executive pay culture is largely a by-product of a shareholder-centred approach to corporate governance¹³. The focus on the share price as the prime measurement of corporate growth and value creation, coupled with the need to ensure managers prioritised the latter, inadvertently stimulated the growth of wages at the top. The growth in productivity excused the inequities it created, even as it upset the overall balance of income distribution. For these inequalities were justified as expedient given the benefit a thriving corporation could have on the aggregate social wealth¹⁴.

The question of shareholder exclusivity is central to the executive pay debate. Because it concerns solutions to the problem and the question as to whether high executive

¹² Berle, "For Whom Corporate Managers Are Trustees: A Note," 1367.

¹³ B. McSweeney 'The Pursuit of Maximum Shareholder Value: Vampire or Viagra?' Accounting Forum, Vol.31, Issue 4, 325-331. David Collinson et al 'Shareholder Primacy in UK Corporate Law: An Exploration of the Rationale and Evidence'. Available at (<http://www.accaglobal.com/content/dam/acca/global/PDF-technical/business-law/rr-125-001.pdf>) and Steve Pearlstein 'When Shareholder Capitalism Came to Town' The American Prospect, April 19, 2014. Available at (<http://prospect.org/article/when-shareholder-capitalism-came-town>).

¹⁴ William Lazonick 'How Stock Buy-backs make Americans Vulnerable to Globalization'. AIR Working Paper #16-0301 (March 2016). Available at (http://www.theairnet.org/v3/backbone/uploads/2016/03/Lazonick.BuybacksAndGlobalization_AIR-WP16-0301.pdf).

pay is a private matter to be resolved within the corporation? Or is it to be regarded as public matter requiring a statist solution? In other words, is high executive pay a public policy or a shareholder issue?

The distributive justice implications of high executive pay strengthen the argument that executive pay could be subjected to the whims of public policy. Some of the arguments against the justice of very high pay, centre on its social justice implications, particularly the effects on income distribution. We could make an argument for its consideration as a public policy issue, if the focus is placed not simply on pay quantum, or consideration given also to its externalities. However, the latter issue cannot be isolated from the broader debate concerning the place of the corporation with regards to public policy.

For the view of the firm as a wholly private institution requires that firm -based issues be best settled within the endogenously. However, this Chapter explores the contrasting view that the externalities of corporate activity require the firm to be subject to public policy. As such, the firm cannot be regarded as a wholly private institution as so much of corporate activity directly impacts its immediate environment. This argument is bolstered by the fact that, almost every aspect of the corporation is subject to some form of governmental regulation. Could a similar argument therefore be made with regards to executive pay? For the latter to be the case, it must first be shown that the externalities of high executive pay, sufficiently warrant a public policy interventionist approach. To an issue which could understandably be considered a wholly private matter.

The arguments in this Chapter, form the basis for the two research questions. The failure to show the company as a socially responsible institution, ensures that arguments regarding the implication of its compensation policies become irrelevant. In contrast, the view of the firm as a socially responsible public institution, invariably opens the door for state sanctioned reformative agenda. Hence, the arguments here are also intended to lay a foundation for some of the proposals on executive pay reform that would be discussed in Chapter Five. This Chapter would address the executive pay issue within the larger debate on the corporate objective, while considering the various arguments with regards to the latter. The arguments within are set out as follows: The following two sections would discuss briefly the growth in executive pay, outlining some of the commonly held reasons for the latter trend. While highlighting some of the arguments concerning the externalities of high executive pay, which would be expounded upon later.

The fourth and fifth sections would examine the executive pay debate within the wider context of the role of the firm. Here the Chapter would consider arguments which favour the status quo of shareholder primacy within the corporate objective. Measured against more egalitarian conceptions of the firm as a public institution and its implication of executive pay as an issue of public policy. Section six would consider the contrasting arguments for the consideration of executive pay as an issue of public policy. While section seven would briefly touch on some of the externalities of high executive pay, by considering the distributive implications of high executive pay. The section would favour Rawls' outcome-based justice thesis and consider Nozick's thoughts on the issue.

2.2. The Growth in Executive Pay: Financialism and the Effects of Shareholder Wealth Maximization

Anglo-American executive pay has grown astronomically since the 1980's. Figures record a growth rate of 940.9 per cent since 1978, for U.S CEO's, while the UK has witnessed a similar level of growth¹⁵. The gap between executive pay and ordinary wages has widened significantly in that time, due on the one hand to the already mentioned rise in executive pay and the relative stagnation in ordinary wages¹⁶.

This section would briefly highlight some of the reasons for this; which include the neoliberal conception of the firm as a nexus of contracts, which spawned shareholder primacy as the Anglo-American governance model. The prioritisation of the share price as a key performance indicator and the financialised corporate objective, worked to create and aid a culture of excess, allowing executive pay to flourish.

2.2.1 Shareholder Primacy as a Governance Approach

The Anglo-American corporate governance model prioritises the interests of shareholders above all other competing interests. The reasons for the governance approach would be dealt with in greater detail later in the Chapter. It is sufficient to not here however, that the prioritising of shareholder interests led to the

¹⁵ Chris Matthews 'This One Chart Shows How Obscene CEO Pay Has Become' Fortune.com. Available at <http://fortune.com/2016/07/15/ceo-pay-2/>>. High Pay Centre Report 'Cheques with Balances: why tackling high pay is in the national interest' Available at < http://highpaycentre.org/files/Cheques_with_Balances.pdf>

¹⁶ Ibid (HPC Report) at 9.

centralisation of shareholder value creation within the corporate objective. As a result, share price movements have become the key indicator of company performance¹⁷.

The preoccupation with the share price has led to a more financialised outlook. Whereas in times past, indicators of firm growth may have centred on attainment of scale or innovation, this appears to no longer be the case. Returns to shareholders is the primary target and this focus brings with it, certain negative implications. The following section would discuss the issues with a financialised corporate objective.

2.2.2. Financialism as a Symptom of Shareholder Primacy

Lazonick bemoaned the fact that the focus on shareholder interests had led to financialisation of the Anglo-American economy, with a negative impact on its productivity levels¹⁸. On a similar note, Lawrence Mitchell, argues that the American economy had shifted from capitalism to financialism¹⁹.

It has been noted that the shift towards financialism coincided with a period when the corporate focus shifted to creating shareholder value²⁰. The corporate obsession with the share price could be said to have originated from a school of thought that began to gain traction among economists in the 1960s. This stems from the efficient market

¹⁷ Lawrence Mitchell 'A Very (brief) History of Financialism.' Creighton Law Review [2010] Vol.43, 323.

¹⁸ Lazonick contends that the need to maximise shareholder value, makes the economy more vulnerable to the harmful effects of globalisation. Lazonick (n14) 5.

¹⁹ Mitchell (n17) 326.

²⁰ Ibid, 323. Also, Lawrence E. Mitchell: *The Speculation Economy: How Finance Triumphed Over Industry* (Berrett-Koehler, 2007). See also, Lazonick (n14) 2.

hypothesis-which espouses the efficiency of markets and believes the share price fully captures the firm's value²¹. These views began to take hold following the wave of neo-conservatism in the 1980s. As such the share price, has been wholly and religiously upheld as the clearest index of corporate value and potential. This period also preceded the expansion and ascendancy of the financial markets.²²

The shift to a financialised economic system has brought with it some of its own disadvantages. On this note, Lazonick highlighted rationalisation, marketization and globalization as some of the structural changes, that were necessitated by the focus on shareholder value and the share price²³. He posits, that rationalism began to take hold in the 1980s following the inability of businesses to keep pace with foreign competitors. Who had superior organisational and hierarchical structures and as such higher quality and less costly output. The loss of a competitive advantage meant they had to find alternative ways to remain profitable.

Firms increasingly opted to downscale their operations, as a groundswell of workforce reductions began to take place. This was worsened when the markets began to react favourably to companies who adopted these measures²⁴. In support, Jung notes that these changes were easy to rationalise, given that the firm was increasingly viewed as accountable to a narrower constituency of stakeholders. Even as managers began to

²¹ Jonathan Clarke, Tomas Jandik, Gershon Mandelker, '*The Efficient Markets Hypothesis*'. Available at <http://m.e-m-h.org/CIJM.pdf>. Also, see Eugene Fama '*Efficient Capital markets: A Review of the Theory and Empirical Work*' [1970] *Journal of Finance*, Vol. 25 Issue 2, 383-417.

²² Dignam and Galanis (n9) 230-232.

²³ Lazonick (n14) 3.

²⁴ *ibid*, 2.

face increasing pressure from external investors to increase profits, Jung mentions that more firms resorted to workforce reductions to increase investor wealth²⁵.

The marketization phase originated in the early 1990s when the very large firms began to wind down the previous implicit promise to provide lifetime employment to a dedicated work force. This worsened with the advent of technological advances, which encourages the globalisation of operations. Allowing companies cut costs by situating large portions of their operations in low-wage countries at a fraction of the costs²⁶.

Accordingly, the financialisation has led to a loss of innovation and industry. Characterised by a fixation on share price movement firms have become increasingly short-termist in their approach. A manifestation of this is the widespread use of share buy-backs at the expense of long-term value creating investments²⁷. With an overwhelming number of corporations reinvesting corporate profits to bankroll buy-back schemes²⁸. As Lazonick notes, that these buy-backs which on the surface appear driven by the need to increase shareholder value, maybe driven instead by managerial self-interest. Given that significant portions of executive compensation are equity based; executives stand to benefit personally from share price gains. Shareholder value may therefore be the perfect disguise for managerial greed.

²⁵ Jiwook Jung 'Shareholder Value and Workforce Downsizing, 1981–2006' *Social Forces*, Vol.93(4) 1335, 1337.

²⁶ Lazonick (n14) 4, 5.

²⁷ *Ibid*, 7.

²⁸ *Ibid*, 893.

2.3. How the Focus of Shareholder Value Theory Negatively Impacts Income

Distribution?

As noted already, there is an almost linear connection between the adoption of shareholder value approach and the growth in executive pay. Furthermore, a similar connection could be made between soaring managerial compensation and the growth in income inequality²⁹. Since CEO pay began to rise in the 1980s, CEOs and other executives consistently inhabit the top deciles of the earning spectrum³⁰. This could be attributed largely to the utilisation of pay for performance to maximise managerial performance and eliminate agency conflicts³¹.

This approach to incentivization necessitated the use of equity-based compensatory methods. Making executive pay variable and subject to share price movements and returns to shareholders, would ensure that the fortunes of managers and investors would be sufficiently intertwined³². The point being made is, performance-related and equity-based pay made shareholder value enhancement a personal pursuit for managers, as they had just as much to gain from firm success. Not to say making pay subject to performance is of itself a bad idea, however systemic corporate governance

²⁹ Brian Bell and John van Reenen, 'Bankers Pay and Extreme Wage Inequality in the UK' Available at (<http://cep.lse.ac.uk/pubs/download/special/cepsp21.pdf>). Also, Lazonick (n14) 6.

³⁰ Executive pay grew 940 per cent between 1978-2015, three times faster than the growth of the income of the top 0.1 per cent. Far outpacing the stock market, which grew by 73 per cent in the time. See Lawrence Mishel and Jessica Schieder 'Stock Market Headwinds Meant Less Generous Year for some CEOs' July 2016. Available at (http://www.epi.org/publication/ceo-compensation-grew-faster-than-the-wages-of-the-top-0-1-percent-and-the-stock-market/?utm_source=Econo).

³¹ Steve Pearlstein 'When Shareholder Capitalism Came to Town' The American Prospect, April 19, 2014. Available at (<http://prospect.org/article/when-shareholder-capitalism-came-town>).

³² Carola Frydman and Dirk Jenter 'CEO Compensation' NBER Working Paper Series 16585, December 2010, p.9

weaknesses have allowed managers to manipulate the system and extract rents in the process³³.

Symptomized by a patently irrational fixation on share-buy backs, dividend payments etc. none of which appear to be of great benefit to the firm, employees and the surrounding communities. But instead enrich managers as well as investors, perpetuating a wealth distribution system that places the greater share in fewer hands³⁴.

This raises questions as to whether executive pay could be regarded as an issue of public policy. Given the nature of the modern corporation, it is an issue which would inevitably be contentious and fraught with debate. Arguing, that high executive pay has a wider negative impact, provides the basis for its recognition as a public policy issue. Which could in turn support the notion of state intervention in the public's interest. The other side of the debate would be the market argument: that corporate matters are private and solutions to issues, sourced from within the market. These are questions which must be answered before a discussion on the current state of executive pay could be undertaken.

³³ Lucien Bebchuk and Jesse Fried: *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, HUP 2004).

³⁴ Oxfam reports that the richest 1 per cent own half of the global wealthy. With the wealth inequality worsened by the 2008 crisis, and a recovery that was driven by increasing wealth at the top. Company CEOs constitute a significant portion of the top 1 per cent.

2.4. Executive Pay and the View of the Corporation as a Private Entity

It has been argued that issues related to executive pay should be privately ordered and resolved endogenously within the corporation³⁵. But a contrasting argument could be made, that the externalities of high pay make it a public policy concern and an issue best resolved by the promulgation of mandatory rules³⁶. It is therefore difficult to separate the debate regarding executive pay reform, from the wider contentions concerning firm governance and the corporate objective. Opinions regarding the creation of mandatory rules to govern executive pay, would very likely be influenced by the individual's perception of the corporate objective.

Advocacy for the view of the corporation as a private institution with an overarching profit-oriented responsibility, finds judicial support in a number of historical cases. Foremost is the English Appeal Court's decision in *Greenhalgh v. Arderne Cinemas*³⁷, where the court stated that the phrase "*in the interest of the company as a whole*" was intended to require directors to act in the interest of shareholders. The above decision was echoed in *Dodge v Ford*³⁸, where the court also seemed to suggest, that the business of the corporation should be steered towards the attainment of shareholder ends. Stating further, that directors owed a responsibility to ensure the latter. Prior to this ruling, the 19th century corporation was viewed as an instrument for the furtherance of the state's public policy aims³⁹.

³⁵ Alex Edmans 'Stop Making CEO Pay a Political Issue' Harvard Business review, July 18, 2016.

³⁶ Pierre Yves Neron 'Egalitarianism and Executive Compensation: A Relational Argument' Journal of Business Ethics [2015] 132; 171-184 at 173.

³⁷ [1946] 1 All ER 512.

³⁸ (1919) 204 Mich. 459.

³⁹ A. Sundaram and A. Inkpen, "The Corporate Objective Revisited" Organization Science, [May-June 2004] Vol.15 No.3, 351-363 at 351.

Shareholder primacy is underpinned by two major intellectual views: One precipitated by a rejection of an increasingly managerialist corporation brought on by the separation of ownership and control. The other emerged from the contractarian school of thought, with its view of the corporation as a '*nexus of contracts*'. Both principles espoused shareholder primacy, albeit for very different reasons, i.e. the former attributed largely to the work of Adolf Berle and Gardiner Means and the latter by law and economics scholars of a neoliberal persuasion⁴⁰.

2.4.1 The Public Policy Debate: Shareholder Primacy or Corporate Pluralism?

2.4.1.1 The Berle-Means Thesis and the Theory of the Firm as Nexus of Contracts

Central to the corporate objective debate, are questions regarding the degree of consideration corporate managers should be required to give to the public interest, while managing the corporation. Or indeed if managers have a duty to consider the public interest at all.

Those in opposition to the above statement, would argue that the primary objective is the satisfaction of investor interests, which should take precedence over all other competing interests⁴¹.

⁴⁰ This view developed from a series of articles published, including; Eugene F. Fama '*Efficient Capital Markets: A Review of Theory and Empirical Work*', *Journal of Finance* [1970] Vol.25 (2): 383–417; M. Jensen and W. Meckling '*Theory of the Firm: Managerial Behavior Agency Costs and Ownership Structure*', *Journal of Financial Economics* [1976] Vol.3 (4): 305–60; H. Demsetz '*Toward a Theory of Property Rights*', *American Economic Review* [1967] Vol.57: 347–59.

⁴¹ Michael C. Jensen '*Value Maximization, Stakeholder Theory and the Corporate Objective Function*' *Journal of Applied Finance* {2010} Vol. 22, No.1 at 34.

Berle and Means argued that the corporation ought to be managed to the benefit of shareholders, but ultimately disagreed with the general notion that this shareholder entitlement was a proprietary benefit⁴². The idea of shareholders as proprietors originated from 18th century entrepreneurial capitalism and from the pre-industrial notion of businesses being an extension of its ownership⁴³. The Berle-Means thesis, acknowledged that unlike the traditional family-owned business, the dispersed owners of the corporation were at best providers of passive capital. That the passive nature of their investments did not endow them with an especial status⁴⁴. That said, they believed that managing the firm on behalf of investors was the most effective way to curtail managerial power. Believing, that the separation of control from ownership had created a power vacuum, which if filled by managers unchecked, would lead to absolutism⁴⁵.

Perhaps most notable with regards to Berle's thesis, is his acknowledgement of the corporation's moral significance, and its responsibility to consider the public interest, just like any other public institution would⁴⁶. To this end, they stated; *"It seems almost essential if the corporate system is to survive, that the 'control' of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community and assigning to each a portion of the*

⁴² In *Bligh v Brent* [1897] AC 22, the court reset the ramifications of the concept of share ownership. Prior to this case it was believed that share ownership entitled the holders to an equitable interest in the benefits of the company's assets. But the court in delineating the company from an ordinary partnership stated that unlike the latter, where ownership was regarded as part ownership of the assets entitling the part owner to a share of the benefits or liabilities because of their right of ownership.

⁴³ John Boatright, *"Fiduciary Duties and the Shareholder-Management Relation: or what's so special About Shareholders?"* Business Ethics Quarterly, 1994 vol.4 Issue 4, pp. 393-407 at 394.

⁴⁴ Adolf Berle, Jr. and Gardiner C. Means, *The Modern Corporation* (New York: Macmillan) at 355.

⁴⁵ Adolf Berle, Jr., *"For Whom Corporate Managers Are Trustees: A Note,"* 1372.

⁴⁶ *Ibid* at 1366.

*income stream on the basis of public policy rather than private cupidity*⁴⁷. Ultimately, the Berle-Means view of the corporation is collectivist in its perception of the firm as a socially responsible institution, even if shrouded in arguments for shareholder primacy.

In contrast, the neoliberalist contractarian view considers the corporation as a wholly private institution, a view which finds its roots in Coase's theorem which considered the corporation as a means of limiting transaction costs⁴⁸. Continuing in this tradition, contractarianism views the firm as a "*nexus of contracts*", between a collection of individual parties i.e. managers, employees, creditors and shareholders. With each of these parties having a direct contractual relationship with the other in contributing to the execution of the firm's productive operations⁴⁹. Here, the firm provides the parameters within which the contracting parties could interact, with each of the parties offering their respective inputs, in exchange for a corresponding output.

To this end, corporate law exists to facilitate the governance arrangements that underpin private contracts, by providing "*off the shelf*" templates which the contractors can adhere to or alter to suit their needs⁵⁰. The fluidity of contract arrangements is pivotal to the contractarian view point, given its conviction that the heterogeneity of firm needs, demands that firms be allowed to contract on diverse terms that suit them. Founded on the belief that firms are better placed to determine their governance needs than outsiders not similarly privy to the information held by

⁴⁷ Berle and Means (n43) at 313.

⁴⁸ R .H Coase '*The Theory of the Firm*' *Economica* 4, 386.

⁴⁹ Marc T. Moore '*Private ordering and Public Policy: The Paradoxical Foundations of Corporate Contractarianism*'. *Oxford Journal of Legal Studies* [2014] Vol.34, No 4, 693-728 at 699.

⁵⁰ *Ibid.*

insiders⁵¹. Contractarianism eschews mandatory rules for this reason and other reasons, which could include its belief, that mandatory rules are made irrelevant by a lack of externalities resulting from these types of private contracts. This is due to the fact that “*market mediated individual choices would lead to socially optimal contracts*”⁵².

Of these contractual relationships, contractarians place greater value on that between managers and investors. In this relationship, managers promise effective corporate governance arrangements engineered to maximise shareholder value, in return for the premium paid for a stake in the firm, in the form of shares⁵³. Contractarianism justifies the promotion of shareholder primacy within the firm governance matrix claiming their entrepreneurial risk-taking situates them as residual claimants. As such corporate law in recognising their importance, as well as the precarity of their position, grants certain rights to compensate, for their restricted claim to the firm’s resources⁵⁴. This irony-of the contractarian reliance on mandatory legal rules to provide justification for one of its core tenets, was highlighted by Moore⁵⁵. For this reason, shareholder exclusivity is justified not only as the most effective strategy towards corporate goal attainment, but to ensure a return on the investment made by shareholders. The following section would examine some of the common arguments for shareholder primacy.

⁵¹ Michael Klausner ‘*The Contractarian Theory of Corporate Law: A Generation Later*’ *Journal of Corporation Law* [Spring 2006] 781.

⁵² *Ibid*, 783.

⁵³ *Ibid*.

⁵⁴ Moore (n48) 701.

⁵⁵ *Ibid* at 707.

2.4.2 Justifications for the Shareholder Primacy Model

2.4.2.1 Shareholders are a Vulnerable class

Contractarians argue that the position of shareholders as residual claimants places them in a vulnerable position, thereby imposing a moral duty on directors to prioritise their interests⁵⁶. The fact that shareholders are not generally given any preference in the process of liquidation of assets, ensures they must wait till all other competing interest have been satisfied⁵⁷. Therefore, directors have a moral duty to look after their interests while the firm is solvent. Which is necessitated by their position as capital providers and the firm-specificity of their investments⁵⁸.

In retort, this argument however fails to consider the dispersion which hallmarks the Berle-Means corporation, as well as the increasing rarity of the singularly-vested investor. Of the competing interests within the firm, shareholders are in reality the least invested in the firm's long-term future, often having an unmatched ability to divest their interests and diversify their investments. Employees, consumers and host communities over time make investments, specific to firms and mostly lack the mobility enjoyed by investors. Particularly the host communities which become economically dependent on the firm, and are often unable to withdraw their interests,

⁵⁶ Kenneth Goodpaster, "Business, Ethics and Stakeholder Analysis" Business Ethics Quarterly, 1 (1991) at 69.

⁵⁷ Andrew Keay, 'The Shifting of Directors Duties in the Vicinity of Insolvency' International Insolvency Review [2015] Vol.24, 140-164. Also, Andrew Keay 'Shareholder Primacy in Corporate Law: Can it Survive? Should it Survive?' European Company and Financial Law Review [2010] Vol.7 369 at 377, 398.

⁵⁸ Andrew Keay and Rodoula Adamopoulou, "Shareholder Value and UK Companies: A Positivist inquiry" European Business Organization Law Review, [March 2012] Volume 13, Issue 01, 1 – 29 at 7.

without suffering major economic loss. Given the often steep, sunk costs, put towards infrastructure, manpower and patronage⁵⁹.

Furthermore, some argue, that the absence of recourse through contract law, exacerbates the vulnerability of shareholders. Sundaram and Inkpen note that, other constituencies i.e. employees and creditors can enforce their rights through the courts. For instance, labour laws provide employee protections, while bond-holders have their entitlements to interest and principal repayments secured by contract law, there is a distinctive disparity in the protections provided to shareholders⁶⁰. While acknowledging the derivative rights afforded to investors under corporate law, they cite the negligible success rates as a major limitation. Arguing further, that when these suits are successful, the benefits accrue to the firm, not the litigating shareholder directly⁶¹.

2.4.2.2 *Reducing Agency Costs*

Berle argued that the dispersion of share ownership placed managers in a privileged position with regards to the power they could wield⁶². In a bid to prevent the rampant managerialism which would inevitably result, Jensen believed that shareholders would need to incur costs in monitoring managers to have them focus on maximising shareholder value. Therefore, these monitoring costs would entitle shareholders to an

⁵⁹ Freeman believed that functioning on behalf other constituencies would ultimately benefit shareholders on the long-run. See Freeman, Parman and Wick, "Stakeholder Theory and the Corporate Objective Revisited" *Organization Science*, Vol.15 No.3 May- June 2004, 364-369, 366.

⁶⁰ A. Sundaram and A. Inkpen, "The Corporate Objective Revisited" *Organization Science*, [May-June 2004] Vol.15 No.3, 351-363. Also, see, Stephen Bainbridge 'Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship (877).

⁶¹ Sundaram and Inkpen (n58) 355.

⁶² Berle (n44) 1367.

exclusive status, wherein they have their interest prioritised⁶³. Contractarians argue for an agency relationship between managers and shareholders, whereby the former work on behalf of and in the interest of the latter⁶⁴

However, the very notion of an agency relationship between managers and shareholders was challenged by Boatright, justifying his arguments on the apparent lack of an express or implied contract between both parties, the very basis of any agency relationship⁶⁵. He further challenged the agency claims stating that the relationship lacked the key ingredients of an agency relationship which he stated to be:

Firstly, that agents should have power to act on the principal's behalf without prior recourse. Managers sometimes require shareholder approval to take decisions that affect the prospects of the firm, i.e. decisions regarding corporate restructuring etc.⁶⁶. Also, a primary characteristic of an agency relationship is the control the principal exerts over the agent, which in his opinion cannot be found within the manager/ shareholder continuum. Investors lack the day to day control over the decision-making process and the opportunity to review decisions taken by management only presents itself on a limited basis⁶⁷. Therefore, when decisions taken are not in shareholder's interests, they have very few options for redress, besides litigation. Furthermore, the

⁶³ Andrew Keay, "Ascertaining the Corporate Objective: An Entity maximization and Sustainability Model" *The Modern Law Review* September 2008, Volume 71, Issue 5, pp.663–698. On board accountability, see A. Keay and J. Loughrey 'The Framework for Board accountability in Corporate Governance' *Legal Studies* [2015] Vol.35 No.2, pp.252-279.

⁶⁴ John Boatright 'Fiduciary Duties and the Shareholder-Management Relation: Or, What's So Special about Shareholders?' *Business Ethics Quarterly* [2004] Vol.4 Issue 4, 397-401 at 399, 400.

⁶⁵ *Ibid.*

⁶⁶ *Ibid.*

⁶⁷ By virtue of the *Companies Act 2006*, shareholders in the UK would only be able to voice their opinions or concerns during the company's Annual General Meeting, held once every business year. However, there are other instances as provided under the Act, where either directors or members may requisition a meeting.

workings of the Business Judgement Rule, further complicate the issue. Unless of course the plaintiffs can prove the decisions were not made free of any conflict of interest and were not based on “*reasonably thorough information*”⁶⁸.

2.4.2.3 For Efficiency and in the Interest of the Public

It is argued, that managing primarily on behalf of shareholders would make for efficient corporate governance⁶⁹. Sustaining the interests of one constituency of stakeholders in the firm ensures that the executive is clear on its objective and as Jensen put it “*multiple objectives is no objective*”⁷⁰. Berle argued that it was in the public interests that shareholder interests be prioritised⁷¹. Berle believed that managing for shareholders was the only way to protect the firm and community from managerial abuse. It is asserted that because Berle was communitarian in his approach⁷², he believed that the only way to ensure a socially responsible corporate entity, would be to manage on behalf of shareholders⁷³. As such a focus on firm value would evidently increase social wealth.

Admittedly, shareholder wealth maximization obviously positively impacts the firm’s immediate environment in the sense that an increase in corporate value could affect job creation and spending, both having obvious benefits to the local economy. In

⁶⁸ It was held in the *Disney Company Derivative Litigation* [2005] 907 AC 2d 693, that business decisions should not be questioned solely because they fail to adhere to what could be best practice.

⁶⁹ T. Smith, “*The Efficient Norm for Corporate Law: A Neo-Traditional Interpretation of Fiduciary Duty*” (1999) 98 Michigan Law Review 214, 215.

⁷⁰ Michael. Jensen, “Value Maximization, Stakeholder Theory and the Corporate Objective Function” *European Financial Management*, [2001] Vol.7 No.3, 297-317.

⁷¹ Berle (n13) 1367, 1368.

⁷² Lorraine Talbot, “*Enumerating old Themes? Berle the Progressive*” University of Warwick School of Law, Legal Studies Research Paper No 2010-02 at p.24.

⁷³ Berle and Means (n43) 312.

contrast, the shareholder value approach could lead to directors managing in the short-term at the expense of true value creation⁷⁴. It could also negatively impact inequality and skew income distribution, by creating wealth for a privileged class. A class which includes company executives, whose pay packets are often affected by share price movements⁷⁵. This creates a cycle whereby managers become entirely focused on raising the share price often at any expense, bearing in mind the positive effect on their own compensation and regardless of the effect on the environment or employees and so on⁷⁶. It becomes extremely difficult to comprehend how shareholder value could be in the public's best interest.

Dodd countered Berle's efficiency argument, by questioning the rationality of insisting that the company, a separate legal person, be managed primarily in the interests of its investors. He answered this question from two logical perspectives: firstly, positing that since corporations are separate from their owners, the managers who run these companies should be regarded as fiduciaries not of the members, but of the company. Which itself is more than an aggregate of its members, "*as they are..... trustees for an institution rather than attorneys for stockholders*"⁷⁷. Second, if the corporation was to be regarded as a legal person, then it should be held to the same standards as any other in a similar position, with regards to its standing and responsibilities to society.

⁷⁴ The focus on short-termism has often been fuelled more by managerial greed than a desire to enhance shareholder value. This could largely be blamed on the design and structure of incentive arrangements, which tie compensation closely to movements in the share price. Managers seeing the need to enhance their personal wealth could be driven more by the latter need, than the need to optimize shareholder wealth. On this point see, Alfred Rappaport: *Saving Capitalism from Short-termism: How to Build Long Term Value and Take Back Our Financial Future* (McGraw Hill, 2011).

⁷⁵ Lucien Bebchuk and Jesse Fried, "*Pay Without performance: An Overview of the Issues*" *Journal of Applied Corporate Finance*, Vol. 17 No 4 2005 pp.8-23, at p.18.

⁷⁶ See Stuart Gillan and John Martin, "*Financial Engineering, Corporate Governance and the Collapse of Enron*" University of Delaware, College of Business, Economics and Corporate Governance Working Paper No: 2002-001, p. 22.

⁷⁷ Dodd (n1) 1160.

He stated further that increasing designation of 'business' as a profession, would imply that it be held to some ethical standards as any other professional person, and such a standard could not be exercised to the benefit one stake-holding class to the exclusion of all others⁷⁸.

Furthermore, shareholder primacy does raise concerns about its potential to create an enabling environment for managerial excess, which it is ironically supposed to inhibit. Agency theorists argued, that closely linking executive pay to company performance, would lead to greater efficiency, both in its comparative and intrinsic value. That said there is a tangible link between shareholder primacy and high executive compensation, which skews the income distribution framework and concentrates wealth at the top. That research shows higher levels of income inequality in the jurisdictions which adhere to shareholder wealth maximization, cannot be dismissed as mere coincidence. The latter makes it difficult therefore to follow the argument the shareholder primacy works in the public interest or increases aggregate wealth⁷⁹.

2.5. A Case for the Pluralist Corporation: The Stakeholder Theory of the Firm

In contrast to the latter argument, there are those who contend against the notion that shareholder primacy works in the public interest, arguing instead, that

⁷⁸ Ibid at 1161.

⁷⁹ Paddy Ireland 'Shareholder primacy and the Distribution of Wealth' Modern Law Review [January 2005] Vol.68, No.1 49-81, 66.

considering the public interest in corporate governance, works to benefit the firm and all its stakeholders.

Freeman believes managing for stakeholders is the most pragmatic form of corporate governance, as profits should be the outcome and not the *raison d'etre* of value creation. Freeman posits that, the primary goal of corporate value creation is best attained when value is created for all the firm's stakeholders⁸⁰. He argues further, that a pluralist approach to corporate governance would lead to the long-term value creation and create sustainable wealth for investors.

One of the strongest criticisms of shareholder primacy is the overarching focus on the share price, which could lead to "*managerial myopia*" and lead to short-term value creation often with quite significant and negative consequences in the longer-term⁸¹. It could be argued, that this overarching focus on shareholders, often works to the detriment of the other constituencies. When the dominant goal is profit maximization, firms are more likely to cut jobs, suppress wages, or less likely to consider the environment or the welfare of its immediate community, with even greater externalities.

The crux of the debate is the role of the corporation in the society it inhabits; are corporations to be considered solely to be profit-oriented, amoral institutions, obligated only to investors? or are they to have a broader remit, having a moral responsibility to society as a whole? Donaldson believed corporations had a moral

⁸⁰ R. Edward Freeman '*Stakeholder Theory and "The Corporate Objective Revisited"*' *Organization Science*, [May-June 2004] Vol.15, No3, 364-369 at 366.

⁸¹ Lucian Bebchuk and Lars Stole '*Do Short-Term Objectives Lead to Under or Over-Investment in Long-Term Projects?*' *The Journal of Finance* [June 1993] Vol.68, No.2, 719.

obligation which exceeded the need to be profitable⁸². The preceding view may seem out of kilter with modern corporate ideology, however, this appeared to be the more normative approach over a century ago.

That the corporation was to be viewed as more than a profit-making entity was reflected in the attitude of the 19th century courts, which urged the consideration of wider interests, so long as doing so worked to the benefit of the shareholders⁸³. However, in *Dodge v Ford*, the Delaware court seemed to suggest that it was the duty of directors to manage the corporation in the interest of shareholders. This ruling witnessed the beginning of a change in attitudes and precipitated a debate on the issue of corporate social responsibility. Shareholder primacy advocates argue that corporations are to be primarily responsible to shareholders, stating further that was ultimately to the benefit of all corporate stakeholders, that the former's interests be prioritised⁸⁴.

2.5.1 In Whose Benefit Should the Corporation Be Managed?

s.172 of the Companies Act 2006, introduced the enlightened shareholder value approach to corporate governance. The section urged directors to “*act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole*”. But in so doing, they were to have regard for the interests of the other stakeholders, like employees, creditors etc. Although the

⁸² Thomas Donaldson ‘*Corporations and Morality*’ (Prentice-Hall,1982) at 21.

⁸³ *Harlowe’s Nominees Pty Ltd v Woodside (Lakes Entrance) Oil NL (1968) 121 CLR 483 at [493*. For the position of the Delaware Courts, see *Paramount Communications Inc. v. Time Inc. [1989] 571 A.2d 1140*.

⁸⁴ Sundaram and Inkpen (n58) 353.

section exceeded the erstwhile common law position, by calling for a broader approach to corporate governance, it however, left little doubt as to whom the corporate objective should benefit primarily. This approach was not coincidental, but rather resulted from the drafter's deliberate intention to broaden the corporate objective, while consolidating shareholder rights⁸⁵.

The *Company Law Reform Steering Group* (CLRSG) was tasked with identifying the best approach to corporate governance. The committee was also charged with the codification of director's duties, which was previously grounded in common law. The group's objective was to maintain the common law approach of shareholder primacy. But sought to "*strike a balance*" between the competing stake-holding interests, to achieve the stated goal⁸⁶. This approach was deemed necessary to encourage the cultivation of long-term relationships, which would help corporations to avoid being overly focused on the short-term.

In deciding the best governance approach, the CLRSG considered and subsequently rejected the pluralist approach, for the following reasons: first, the group was of the opinion that latter would necessitate a wholesale reform of the director's duties, already established in common law. Also, they viewed the pluralist approach as "*unworkable*" and a distraction from the goal of shareholder wealth prioritisation⁸⁷. Instead it adopted the enlightened shareholder value approach, which maintained the erstwhile focus on shareholder wealth creation. The approach additionally obliged

⁸⁵ Andrew Keay '*Enlightened Shareholder Value, the Reform of the Duties of Company Directors and the Corporate Objective*' [2006] 3 Lloyd's Maritime and Commercial Law Quarterly 335, 346 and 347.

⁸⁶ John Armour '*Shareholder Primacy and the Trajectory of UK Corporate Governance*' [2003] 41 British Journal of Industrial Relations 531, 531.

⁸⁷ Keay '*Enlightened Shareholder Value, the Reform of the Duties of Company Directors and the Corporate Objective*' (n85) 335, 347.

directors to take “a proper balanced view of the short and long term: the need to sustain effective ongoing relationships with employees, customers, suppliers and others”⁸⁸. Here, the drafters viewed relationships with the other constituencies as a means to maximize shareholder wealth.

Dodd on the other hand, believed that the corporation and those who managed it owed a duty not only to shareholders, but to all those touched by corporate activity. Dodd challenged the contractarian notion of the corporation as private property. He argued that when private property was used in the provision of services to the public, such property is only private in a “qualified sense”, being subject to regulation and the dictates of public policy⁸⁹. He argued thus, due to his perceived limitations on shareholder’s private property rights, which may include-but not restricted to-regulations such as labour laws which are placed to secure worker rights. That the latter did in fact dilute the strength of the argument that corporations were private institutions to be utilised solely for the optimisation of profits.

Dodd believed the corporation’s profit-making prerogatives were subject to the will of the state. That where the law, through the state, allows a business to make “unregulated profits” it would be in consequence of a recognition of this being in the best interest of society at large. That this was not to be considered as deferent to the corporation’s or indeed its owner’s private property rights⁹⁰. Believing that the corporations right to conduct its business, was recognised and permitted by legal

⁸⁸ Company Law Review, *Modern Company Law for a Competitive Economy: The Strategic Framework* (1999), at para 5.1.13

⁸⁹ Dodd (n1) 1149.

⁹⁰ Ibid, 1148.

institutions because it ultimately served the wider community to do so, and not in recognition of its duty to generate profits for its owners⁹¹.

Dodd believed the corporation should work to benefit anyone affected by corporate activity. He argues that the contractarian view originated from the erroneous perception of the firm as an aggregate of its members. Stemming from a rejection of the right of managers to wilfully utilise private property, in ways which do not directly benefit the owners. Due to a view of managers as agents acting on behalf and in the interest of investors⁹². Dodd rejects this view and argues that, the consideration of the firm as a legal unit with varied membership, required managers to be trustees for the entire unit, without a preference for any individual stake-holding constituency⁹³.

Corporate law progressives have argued that a pluralistic approach to corporate governance is the most strategic means to ensuring sustainable shareholder wealth. This goes against the conservative view of pluralism as wasteful altruism⁹⁴. Dodd posits, that by accepting the communitarian approach to corporate governance, managers would be fulfilling their primary objective to maximise profits⁹⁵. Because socially responsible policies would naturally engender goodwill from a beneficiary community, with the inevitable positive impact on the bottom line. For instance, higher wages would often translate into greater consumption levels.

The pioneer Henry Ford recognised the viability of the above and sought to reinvest some of his company's profits into higher wages for its employees. He withheld the

⁹¹ Ibid.

⁹² Ibid, 1147.

⁹³ Ibid, 1157.

⁹⁴ Daniela M, Salvioni 'Sustainability and Convergence: The Future of Corporate Governance Systems?' Sustainability [2016] 8, 1203.

⁹⁵ Dodd (n1) 1156.

issuance of dividend payments to shareholders, to reinvest the firm's profits in the business. The ensuing controversy formed the basis for the litigation in *Dodge v Ford*. The ultimate intent was to expand the company's customer base, by producing affordable vehicles and increasing wages within the firm. Ford believed that higher wages would lead to productivity gains for the firm, and greater consumption of the company's products, which would translate to higher profits. His instincts were validated, when the company enjoyed a significant growth in sales and profits⁹⁶. The decision to withhold dividends, was challenged by aggrieved shareholders and the court decided that it was arbitrary and not lawful.

What was most notable about the court's decision, is that the court did not rule on the decision to invest the firm's resources in strategic expansion-choosing to defer to the board on this issue-but ruled specifically on the issue of dividends. Which it may be argued, lends support to the notion that firms exist for shareholder wealth maximization.

The communitarian view of the corporations as a public institution is particularly important to discussions concerning high executive pay. Considering the corporation as a public institution brings executive compensation within the realm of public policy, which brings with it a number of implications:

First, that the issues surrounding managerial pay in terms of its determination and quantum, cannot be detached from the discussions regarding the pay of the general workforce. Considering executive pay to be a private matter allows advocates of the private market approach to governance defend very high pay for instance, as a

⁹⁶ Jeff Nilsson 'Why Did Henry Ford Double His Minimum Wage?' Saturdayeveningpost.com, January 3, 2014.

justifiable outcome of an arm's length contract. In that case, the issue of quantum becomes irrelevant, as the question shifts from what the compensation was, to why the level of compensation is necessary. If the latter answers meet the required normative standards accepted within private enterprise, then the compensation is just.

Secondly, questions regarding executive pay reform would fall within the prerogative of legislative and regulatory bodies. Whereas free market ideologists would argue that executive pay issues should be left to the market, this becomes implausible, as the corporation as a public institution, leaves room for legislative attempts at reform. This latter issue would be revisited in Chapter five.

2.6. Executive Pay and the Shareholder Primacy Debate: Could Executive Pay be Considered a Public Policy Issue?

As discussed, the view of the firm as a private institution, would require that executive pay issues be resolved within a private market framework. The argument changes dramatically however, when the firm is considered as fully woven into the fabric of the community it inhabits, as well as a producer of externalities. Given that so much of corporate activity is regulated, a strong argument could be made also, for the subjection of managerial compensation to the volition of public policy.

The egalitarian argument provides the strongest contentions in favour of treating executive pay as a public policy issue. Here, the major consideration is of pay and its

impact on income distribution and as a contributor to inequality⁹⁷. Egalitarians view income inequality as a root cause of power imbalances which work in the favour of executives and the corporations they represent. Egalitarians posit, that the inherent complexities of the firm make it akin to “*private governments*” and share deep similarities with political regimes. A fact which highlights its incompatibility with the notion of the corporation as a private entity⁹⁸. Therefore, it is in the public’s interest that executive pay levels are mandated by the state, to ensure it is representative of the income distribution levels both within the firm and its wider environment.

They argue that incorporated status is a privilege, with corresponding responsibilities, which gives the endowing state a right to mandate its behaviour, at least in some respects-to meet these responsibilities⁹⁹. Therefore, the argument that the state cannot interfere in or regulate compensation matters becomes moot. However, having already established the state’s right, the question becomes, whether the state should in fact intervene?

The contractarian response to the aforementioned question would understandably be in the negative. Viewing the private firm as a platform for the privately negotiated and executed contracts that define it, restricts the law to having a facilitative and not an interventionist function. Therefore, legislating or indeed regulating how much company executives could earn, by so doing, causes the legal framework upon which

⁹⁷ Neron (n16) at 175.

⁹⁸ Ibid.

⁹⁹ Joseph Heath ‘*Morality, competition, and the firm: the market failures approach to business ethics*’ (New York: OUP 2014).

these contractual relations are built, to transcend its role as a facilitator. A state of affairs, which contractarianism abhors and ultimately rejects.

To understand the contractarian resistance to legislative interference in executive compensation matters, particularly with regards to how much executives could earn, we must first highlight, albeit briefly, the major justifications for current pay levels. Moriarty highlights three common justifications, the *Agreement argument*-that executive pay is the outcome of an arm's-length bargaining process, the *Desert argument*-that high pay is earned and a reward for optimal performance, the *Incentive argument*-that high pay is required to attract and retain talented managers in a competitive labour market¹⁰⁰.

2.6.1 Theoretical Justifications for the Consideration of Executive Pay as a Private Matter.

The proponents of the *Agreement* justification argue that executive pay is the outcome of negotiations between managers and the board of directors. Accordingly, for compensation to be optimal, the process must meet two important requirements: compensation must have been agreed to by an independent and adequately informed board and be designed to optimise firm performance. Accordingly, provided these requirements are met, negotiations are regarded to have been done at arms-length and the resulting agreement is just¹⁰¹.

¹⁰⁰ Jeffrey Moriarty 'Do CEOs Get Paid Too Much?' Business Ethics Quarterly [2005] Vol.15, No.2, 251-281.

¹⁰¹ Ibid, 259.

The *Desert* justification for high pay, views it as reward for performance. This argument views the role of the CEO as pivotal to firm success, hence the need for their compensation to reflect the growth and productivity gains. In the latter case, pay quantum becomes irrelevant. The major challenge with this view is the quantification of managerial contribution to firm success, as we know managers are not solely responsible for success in the same way they are not solely liable for failure. The reality is, that the average corporation consists of thousands of employees, each making a limited but significant contribution to the company's operations and strategy. The manager's role therefore is to effectively oversee and manage these operations. The significant responsibility borne by CEOs, is not in dispute. But the major criticism of the desert view, is whether the responsibility matches current pay levels. Moriarty argues they do not.

He criticises the view on two points, putting aside the performance-related aspect of CEO pay, and if contribution is in fact the basis of desert, he questions what the CEOs initial compensation should be. In many instances, even the non-performance elements of CEO pay are multiple times higher than the average wage within the firm. Secondly, he criticises the argument that compensation is significantly higher than the average, to maintain parity with the responsibility CEOs bear. He does this by comparing CEO pay to the remuneration of managers in other high responsibility, public sector roles, who earn significantly less¹⁰².

Finally, the utility or incentive-based justification, on the other hand determines a just wage by its ability to attract, retain and ultimately motivate optimal managerial

¹⁰² Ibid, 267.

performance. Whereas the desert argument views pay as a reward for performance, the incentive view on the other hand views pay as a means to incentivize optimal performance¹⁰³. This view is highly focused on individual talent and sees compensation as a way to extract optimum performance from the individual and assumes monetary incentives as the most efficient motivator. A shortcoming of this view, is its emphasis on external incentives, to the detriment of intrinsic motivations which could precipitate optimal performance¹⁰⁴. Also, assuming that paying above the odds, does indeed lead to more efficient performance, it however becomes more challenging to measure the impact paying multiple times above the average, has on performance¹⁰⁵.

The utility of the preceding in arguing against the subjection of executive pay to public policy, is found in its privately ordered underpinnings. Therefore, where high executive compensation is paid by agreement, to reward or incentivize, these are manifestations of the corporation's ability to contract as a privately ordered enterprise. With executive compensation being one of the more salient embodiments of the free market ethos, upon which the corporation subsists.

Arguments that executive pay should be subject to public policy could be based on the impact high pay has on the wider society. Much has been made of the fact that executive compensation contributes to income inequality in Anglo-America, however these arguments transcend the income distribution concerns alone. But they challenge the very notions of egalitarian justice, upon which the modern democratic

¹⁰³ Ibid, 268.

¹⁰⁴ Bruno Frey and Margit Osterloh 'Yes, Managers Should Be Paid Like Bureaucrats' *Journal of Management Inquiry*, [2005] Vol.14, Issue1, 96-111.

¹⁰⁵ Ibid, 272.

society is built. These perhaps characterise the most compelling arguments for a public policy intervention with regards to executive pay.

2.7 Executive Pay and the Distributive Justice Problem

The argument for pay to be regarded as a public policy issue is that current levels are unfair or unjust. High or excessive pay is argued against not only for its sheer size, but for the distributive justice implications. That is the widening gap between executive and ordinary worker pay and how the former contributes to this phenomenon.

The difficulty with current pay levels, from an egalitarian view point, is that it works to benefit CEOs and shareholders. None of the other stake-holding constituencies seem to benefit-at least not in any quantifiable sense-when CEOs are exorbitantly compensated. The age-old argument for high pay based on its impact on firm performance fails to hold water in the face of modern reality.

This results from the key metric of measuring firm success via the creation of shareholder value in other words through share price movements, and the fact that share price movements often are not a reflection of a sturdy economy. By utilising short-term value creation mechanisms, like buy-back schemes, workforce reductions etc. managers could effectively create value for shareholders, but very little or in some cases value losses for the firm's other stakeholders. This is further made worse when we consider the fact that shareholders represent a small subset of society, we are then left with a scenario where firm value creation translates to wealth creation for a "*small*

privileged elite” of financial asset owners¹⁰⁶. High executive pay, would need to benefit more within the society to be justifiable¹⁰⁷.

2.7.1 The Justifiability of Current Pay Levels: the Rawlsian Difference Principle

To determine the justifiability of high executive pay, this section would consider the Rawlsian difference principle. The difference principle is two-pronged, the first argues that; *“each person is to have an equal right to the most extensive scheme of equal basic liberties compatible with a similar scheme of liberties for others”* and

That; *“social and economic inequalities are to be arranged so that they are both (a) reasonably expected to be to everyone’s advantage, and (b) attached to position and offices open to all”*¹⁰⁸.

This portion of the Chapter is concerned with the second principle and in a bid to determine how high executive pay benefits the least of the firm’s stakeholders. The common neoliberal argument justifying inequalities of income, is that a rising tide would eventually lift all boats, hence wealth placed in the hands of those at the top would eventually filter downwards to those at the bottom ends. This would apply to the corporation, where high executive pay would motivate and incentivize the executive to maximize profits, which would lead to greater firm performance. To the benefit of all the stake-holding constituencies. However, this neoliberal assertion fails to reflect reality and is left vulnerable on two grounds:

¹⁰⁶ Ireland (n77) 52.

¹⁰⁷ John Rawls: *A Theory of Justice* (HUP, 1971) 54.

¹⁰⁸ *ibid.*

First, by the lack of a provable association between high pay and improved firm performance. In fact, if anything, the available evidence leads us to contrary conclusions, that paying executives more, does not always lead to greater value creation¹⁰⁹. Some evidence suggests it could lead to loss of value or short-term value creation, with negative consequences in the longer term¹¹⁰.

Second, assuming that high pay does lead to better performance, the argument here, is that the other constituencies are not positioned to benefit from said success. The reality is, better firm performance does not always lead to higher wages; this is underlined by the sluggish wage growth for average workers since the 1980s, relative to the rise in CEO pay. In fact, the growth in executive pay has outpaced that of the stock market index¹¹¹. The facts show that the productivity gains of the last three decades have not translated to better wages for average employees within the firm and community. Instead, most of the benefits have gone to shareholders¹¹². Which is problematic from a distributive standpoint, as the composition of the shareholding body shows that the majority of company shares traded on the stock exchanges are either held institutionally or by very wealthy individuals¹¹³. Therefore, to assert that

¹⁰⁹ Lucien Bebchuk and Jesse Fried 'Pay Without Performance: The Unfulfilled Promise of Executive Compensation' (HUP, 2004).

¹¹⁰ Michael J. Cooper 'Performance for Pay? The Relation Between CEO Incentive Compensation and Future Stock Price Performance' Available at SSRN: <https://ssrn.com/abstract=1572085> or <http://dx.doi.org/10.2139/ssrn.1572085>.

¹¹¹ Lawrence Mishal and Alyssa Davis 'Top CEOs Make 300 Times More than Typical Workers' <http://www.epi.org/publication/top-ceos-make-300-times-more-than-workers-pay-growth-surpasses-market-gains-and-the-rest-of-the-0-1-percent/> at p.5. Also see, Chris Matthews 'This One Chart Shows How Obscene CEO Pay Has Become' Fortune.com, (July 15, 2016).

¹¹² Ibid (Mishal and Davis) at 7.

¹¹³ The Office of National Statistics estimates that UK based institutions constitute about 30 per cent of shareholding beneficiaries in the UK, while private individuals hold just over 12 per cent, a figure which includes shares held by CEOs and company directors. ONS Bulletin 'Ownership of UK Quoted Shares: 2016'. Available at <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/bulletins/ownershipofukquotedshares/2016#holdings-of-uk-quoted-shares-by-sector-of-beneficial-owner>.

shareholder management increases social aggregate wealth, appears to be more fantastical than factual. Although these issues would be examined further in Chapter Four, it is important to note here, that a distributive justice evaluation of high pay, suggests that it fails to meet the egalitarian standard embodied by the difference principle. Instead, high executive pay could be said to produce sufficient externalities that could cause it to go against the public interest. Thus, justifying its consideration as a public policy issue.

2.7.2. Nozick's Argument

As touching on the impact of executive pay on the income spread, Nozick's thesis is less concerned with the distributional consequences of high executive pay, as he is with the manner in which said pay was obtained¹¹⁴. Nozick's arguments as they relate to the pay setting process, would be examined in greater detail in the next chapter. It is however fair to state at this juncture, that the process-oriented bent of his libertarian thesis validates the outcome of all just processes, irrespective of the latter's consequences.

For a distribution to be just, according to Nozick, then the process of acquisition or transfer must meet the stringent justice requirements. That is, the historical antecedents of the distribution must be law compliant, i.e.. the goods must neither be stolen or obtained via unjust means. Once this requirement has been met, the distribution could be determined to accord with the requirements of justice, obviating

¹¹⁴ Robert Nozick '*Anarchy, State, and Utopia* (New York: Basic Books) at 151.

the need for a further analysis of its quantum and the inequities which may result¹¹⁵. Being a strong believer in the minimalist state, Nozick believed that the state's role with regards to market interactions was simply to guarantee a conducive environment for the latter to be undertaken. As such, any action taken by the state of an interventionist nature, was manifestly unjust and an encroachment¹¹⁶.

On this note, Nozick's thesis differs from the Rawlsian principle. While Rawls is ultimately concerned with the externalities of executive pay and would ultimately determine executive pay to be an issue of public policy. Nozick on the other hand, would deem it to be an entirely private matter, to be determined in the absence of external influence. Nozick's libertarian ethos would suggest a lack of concern with the current pay levels, provided they could be shown to meet the demands of justice-this would be discussed in Chapter Three. It may be fair to conclude that if the latter were proven not to be the case-that high executive pay is shown to be unjust and the pay setting process compromised-that Nozick would require that reform is left within the purview of the firm.

To conclude, the decades long debate on the corporate objective, has renewed saliency with the issue of high executive pay. Raising the issue as to whether the issues surrounding executive pay, should be privately ordered or resolved within a public policy framework. However, it is fair to say at this point, that the distributive consequences and externalities it could sometimes produce, makes a strong argument for some form of regulatory intervention. Which brings us to the issue of executive

¹¹⁵ Ibid.

¹¹⁶ Jared Harris 'How Much is Too Much? A Theoretical Analysis of Executive Compensation from the Standpoint of Distributive' in 'The Ethics of Executive Compensation' R.Kolb (ed) (Blackwell's: 2006) p.67-86, at 80.

pay reform-assuming we agree it needs reform-and who should be responsible for it. Market enthusiasts would argue that executive pay should be left to the shareholders to decide what an appropriate pay level should be, and executives may be paid in accordance. Thus, there exists little or no tolerance for external interference in pay matters. On the other hand, those who view the firm as a socially responsible institution, would consider the negative social effect high pay could have and conclude that pay should be subject to the public policy mandate. Which would not be far-fetched, considering other aspects of the firm are thus mandated.

2.8. In conclusion

The decisions in *Greenhalgh* and *Dodge*, amongst others, could be interpreted to imply judicial support for the notion, that the corporation should be run primarily in the interest of the shareholders. The reasoning behind this conclusion could be brought to question at this time, considering the established view of the firm as a producer of externalities. As a result, this view has been challenged in recent times, especially with the animus over executive compensation and rising income inequality. As studies show a linear connection between the diminishing wages the ordinary worker and rising shareholder capitalism. It is not merely coincidental, the U.S and UK-the poster-children for this model of corporate governance-have the highest and most extreme levels of inequality and rent-seeking of all the advanced nations.

Considering the role of the corporation in the context of the society within which it subsists, is particularly important to the executive pay debate. For to subscribe to the notion of the firm as a public institution, would suggest a conformance to the

consideration of corporate governance matters against a backdrop of the public interest. In that case, executive compensation becomes a public policy issue. One could argue, that in many ways, executive pay is somewhat already being considered to be a public policy issue, in the light of the recent legislative attempts at reform. Particularly in the light of its omnipresence in the public discourse.

It is however, fair to note, that said attempts have thus far fallen short of the radicalism needed to effectuate true reform. It could be argued that the latter restraint from heavy-handedness, may in fact be a nod to and an acknowledgement of the firm's autonomy from public policy demands.

To consider the corporation a public institution, would be to consider executive pay a public issue and subject to state intervention, like all other issues touching on public policy. Although previous judicial declarations on this issue have sided with the notion of the firm as a private entity, it is an issue perhaps in need of a judicial declaration which fully considers the complexities of the modern corporation and of its role within a broad social context. The absence of which, would continue to encourage the current state of uncertainty regarding the firm and the pay of its executives.

Chapter Three

Capturing the Pay Setting Process: Questions of Managerial

Interference in the Fixing of Executive Pay.

3.1. Introduction

Current levels of executive compensation in Anglo-American firms, particularly CEO pay, have been the subject of public scrutiny, maybe even outrage. Outrage which is understandable given that overall wage growth has stagnated over the past few decades¹. Something interested parties have failed to agree on is the reason(s) behind the persistent rise, what is needed to curb this rise or whether indeed it should be curbed.

Bebchuk et al argued, that high pay results from corporate governance failures, which enable rent extraction by company executives². Counter-arguments have sought to negate this thesis and regard current pay levels as the proceeds of efficient processes³. Arguing, that current pay levels result from an efficient bargaining contest between a disinterested board and a CEO or prospective CEO looking to earn his worth. The preceding is the conventional view of the pay setting process, known as the optimal contracting view.

¹ Statistics show that with executive pay far outpacing average wages by a ratio of 180:1, 78 per cent of the public would support a maximum limit on how much the highest paid could earn in relation to the lowest paid, within any given company. See High Pay Centre Report, 'Reform Agenda: *How to make top pay fairer*' www.highpaycentre.org (accessed on 25/01/2015).

² L. Bebchuk, J.M Fried and D. Walker, '*Managerial Power and Rent Extraction in the Design of Executive Compensation*'. The University of Chicago Law Review, [2002] Vol. 69, 751-846.

³ Randall S. Thomas, '*Explaining the International CEO pay Gap: Board Capture or Market Driven*' Vanderbilt Law Review, Vol.7 Issue 4, 1172 [2004].

The contrarian argument, states that a flawed governance system allows managers too much power and leaves them in a position of influence over the board, which translates into higher salaries. This, irrespective of whether there is corresponding firm performance⁴. This theory of the pay setting process is known as board capture theory/managerial power approach, intends to highlight the naiveté of the mainstream arms-length or optimal contracting narrative⁵. They argue, that the latter results from vulnerabilities which arise from the hierarchical managerial structure- where some U.S firms have the positions of CEO and board chair vested within the same entity. Also, the fact that managers are usually allowed a broad discretion on issues such as the nomination and dismissal of directors. Highlighting the strong potential for creating a compromised and captive board⁶. It is safe to assume, that a captive board serves, rather than monitors.

These points call into question the justice of Anglo-American executive pay levels. An argument could be made that current pay levels are not just high, but excessive. Given the subjectivity of the latter term, here the Chapter defines excessive pay, as that which exceeds the minimum effective compensation, needed to attract, retain and motivate the recipient to maximise firm value. This definition is premised on the assumption that managers are inherently self-serving⁷.

⁴ Viral Acharya, Marc Gabarro and Paolo Volpin, 'Competition for Managers, Corporate Governance and Incentive Compensation' July 2013 http://pages.stern.nyu.edu/sternfin/vacharya/public_html/pdfs/AGV_paper_040713.pdf (accessed 15/03/2015).

⁵ Lucien Bebchuk and Jesse Fried, *Pay Without performance: The Unfulfilled Promise of Executive Compensation*. (Harvard University Press; 2004).

⁶ Vincent Warther, 'Board Effectiveness and Board Dissent: A Model of the Board's Relationship to Management and Shareholders' *Journal of Corporate Finance* [1998] Vol.4 53.

⁷ Jeffrey Moriarty 'How Much Compensation Can CEOs permissibly Accept?' *Business Ethics Quarterly* {2009} Vol. 19, No.2, 235.

But beyond questions regarding quantum and the excessiveness thereof, is an issue which goes to the core of the high pay debate: the pay setting process. It goes without saying, that failures within the pay setting process not only sully the outcome but ensure its failure to meet required justice standards. To this point Nozick argues, that the process of acquisition, determines the justice of the thing acquired and the holder's right to it.

The crux of Nozick's process-oriented view, is that executive compensation is justified by its process of determination and distribution⁸. Nozick's libertarian outlook, and its predisposition towards "*entitlement*", is less concerned with the outcome of the process-pay quantum-than he is with the process itself. He views any distribution derived through "*justice preserving means*" to be just, regardless of the inequities which may consequence said distribution. To this point he declares, that "*whatever arises from a just situation by just steps is just*"⁹.

To meet this justice standard, the awarded pay packet must adhere to the core libertarian principles of voluntarism/liberty, transparency and acquiescence¹⁰. Which implies the absence of inordinate influence by the CEO over the determinative process. As well as the utilisation of clear and easily decipherable performance metrics, set out as part of an accessible remuneration policy and approval by an informed and unbiased shareholding body.

⁸ Ibid, at 237.

⁹ To Nozick, any holding derived in accordance with the above standard is said to have been obtained by a "*legitimate means*" or process. This includes all holdings acquired by means which are subject to the principle of justice in acquisition and transfer. Robert Nozick '*Anarchy, State and Utopia*' (Blackwell, 1974) 152.

¹⁰ Jared Harris '*How Much is Too Much? A Theoretical Analysis of Executive Compensation from the Standpoint of Distributive Justice*' in R. Kolb (ed) *The Ethics of Executive Compensation* (Blackwell 2006), 67-86 at 81.

This Chapter is intended to answer the first research question, which is concerned with the integrity of the pay setting process and the compromises therein, which may sully the outcome. As such, it will proceed to examine the issues regarding the pay setting process, exploring the depictions of the latter as an adversarial, arms-length process. As well as those which view the pay setting process as anything but arms-length and adversarial. This Chapter would utilise Nozick's libertarian theory of entitlement to analyse the pay setting process, in a bid to determine the justice of high executive compensation.

The Chapter therefore will be outlined thus, the following section would consider the conventional narrative on the pay setting process, with its view of the latter as an arm's length bargaining process. Wherein the independent board negotiates an optimal compensation package with the executive concerned, in a bid to attract, retain and incentivize good performance. The conventional argument for current pay levels is intended to justify the outcome by highlighting the adversarial nature of pay negotiations, which would bring the outcome in line with Nozick's thesis. The section would also highlight some of the justifications for current pay levels.

Section three will examine contrasting arguments of managerial interference in the pay setting process, as encapsulated within the board capture/managerial power thesis. There the Chapter would consider arguments which favour a compromised pay setting process and outcome, as well as some of the drawbacks within the corporate governance framework, which inhibit the efficiency of the process.

The following portion will examine the pay setting process, utilising the requirements for a legitimate process-transparency and voluntariness of the transactive process-as

highlighted by Nozick. Concluding that the highlighted failures within the process of executive pay setting, made it difficult to justify the outcome. This argument was furthered in the final portion of the chapter, where the utilisation of peer-averages was considered in the light of Nozick's postulation of a legitimate process. The conclusion being, that the basing of an executive's wage on that of another, could not be considered to be in tandem with Nozick's process-oriented view of income distribution.

3.2. *The Conventional Narrative on the Executive Pay Setting*

Process

3.2.1. *The Role of the Independent Board in Pay Negotiations*

Berle and Means believed that the dispersion of shareholdings would have the unintended effect of giving managers wide and unfettered powers, which needed to be curtailed for owners to maximise their investment¹¹. The burden of this task was supposed to be the primary function of the Board of directors, which should consist of executive and independent members. The intent being that Independent directors drawn from outside the firm, are better positioned to deal objectively with the CEO on behalf of investors. With the aim being, that managerial functions are carried out with maximum efficiency at the lowest cost possible¹².

¹¹ Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1932).

¹² Bebchuk and Fried, (n5) 17, 18.

Alongside these objectives is the negotiation of compensation of members of the management team, primarily that of an incumbent or incoming CEO¹³. The conventional narrative, is that board members embark on this function at arms-length, bearing no other interests but those of shareholders. In this instance, the independent board functions, as an agent acting on behalf of investors¹⁴. In performance of this, the independent directors are to populate the compensation committees specifically established for purpose, which in carrying out its duties is to be completely autonomous and free of managerial influence¹⁵. Aiming to negotiate a compensation package, that should incentivize managers to take the risks needed to maximize efficiency and firm output, at minimal costs. This view is widely known as the optimal contracting or arms-length bargaining view to executive compensation. Although theoretically sound, there have however been viable concerns about its practicality¹⁶.

3.2.2. The Optimal Contracting/Agreement View on Compensation: Fact or Fable?

Bebchuk et al, define the optimal contract as the one which minimises agency costs the most¹⁷. This theory, acknowledges that no contract could possibly eliminate the attendant managerial costs and perfectly align managerial interests with those of investors. As such, the optimal contract should aspire to attract, retain and incentivize the best executives to maximize their efforts, while keeping overall operational costs

¹³ B.K Boyd, 'Board Control and CEO Compensation' Strategic Management Journal [1994] Vol.15 335-344, 336.

¹⁴ Ibid.

¹⁵ Bebchuk, Fried and Walker (n2) 765.

¹⁶ See, Bebchuk and Fried (n5) 19.

¹⁷ Bebchuk, Fried and Walker (n2) 761.

at a minimum¹⁸. Managers on the other hand, being aware of the need to keep costs down, would however seek to negotiate compensation that at the very least meets their “*opportunity costs*” or “*reservation value*”¹⁹. For this Chapter, the pay setting process needs to accord with Nozick’s conception of a legitimate process for the outcome to be just.

Nozick’s legitimate process could best be described as one which adheres to the core principles of justice in transfer and acquisition. One which is transparent, voluntary and through which pay decisions are reached via mutual agreement²⁰. These are characteristics the optimal contracting/agreement view seeks to embody. The latter view assumes an arms-length negotiating relationship between managers and management boards. Here, the board assumes an adversarial role in the pay negotiation process, poised with intent to get the best deal for shareholders. The theories’ veracity, has been challenged by optimal contracting cynics, due to the theories’ failure to explain the continuous rise in pay levels, even in the absence of corresponding performance²¹.

But the mainstream argument would insist that current pay levels are efficient²².

Below, are some of the reasons proffered to support the aforementioned:

¹⁸ Martin Conyon ‘*Executive Compensation and Incentives*’ *Academy of Management Perspectives* [2006] Vol.20(1) pp.25-44, 25. Ibid, 762.

¹⁹ Ibid. See also, Thomas, (n3) 1229.

²⁰ Nozick (n9) 160.

²¹ Ivan Brick, Oded Palmon and John Wald, ‘*CEO Compensation, Directors Compensation and Firm performance: evidence of Cronyism?*’ *Journal of Corporate Finance* [2006] Vol.12 403, 404.

²² Alex Edmans and Xavier Gabaix ‘*Is CEO Pay Really Inefficient?*’ *European Financial Management*, Vol.15 No.3 2009, 486–496 at 488.

3.2.3. Some Reasons why the Current Pay Levels are said to be Efficient

The mainstream view argues basically that current pay levels are mostly the efficient outcomes of an efficient process²³. Under agency theory, compensation packages are designed to align pay with firm performance with the intent being, to cause managerial wealth to move simultaneously with shareholder value²⁴. This according to agency theorists is the solution to the agency problem and the optimal way of reducing transaction costs.

Agency theory is premised on **three** key factors; a moral hazard problem, managerial greed and risk aversion²⁵. These could negatively impact managerial output and cause them to shirk their duties, seek rents, and greatly inhibit their effectiveness. All these problems per agency theory enthusiasts, are best countered by utilising interest aligning incentives²⁶.

3.2.3.1. As a Solution to Agency-Related Problems:

Agency theorists, argue that there would be diverging interests between managers and investors and this divergence could lead to residual losses²⁷. Manifestations may include, an excessive appetite for perquisites or unwarranted acquisitions causing the firm to grow larger, but less efficient. These are managerial idiosyncrasies which accordingly could be traced back to an inadequate incentive regime between the firm

²³ Conyon (n18) 25.

²⁴ Ibid, 28.

²⁵ Ibid, 29.

²⁶ Michael Jensen and William Meckling 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure, Journal of Financial Economics, [1976] Vol.3 No.4 305-360.

²⁷ Ibid.

and management²⁸. Therefore, the way to effectively stem these losses, would be to pay executives well enough to eliminate the need for empire building or the thirst for superfluous perks. While ensuring that pay, is effectively and efficiently aligned to a firm growth index²⁹.

As it goes by paying more and efficiently linking pay to performance, the firm could eliminate the moral hazard problem. That managers, being aware of this link between pay and performance, would be less likely to shirk and more likely to maximise effort. In the same vein, be more willing to take the risks required to grow the firm and maximize potential and profits. It is important to note, that the efficacy of agency theory is premised on managerial self-interest and one to which agency theory has failed to legislate a proper cure. How do you eliminate greed in the manager-owner continuum?

The failure to find an answer to the above question would mark a flaw in the agency/principal, pay for performance argument, and has possibly rendered it not quite as effective as it would have been intended to be. Some authors have recognised that managers being naturally greedy, would seek avenues to extract rents and having the kind of power they wield in the Anglo-American dispersed shareholder model of governance, makes it even more likely that they would succeed³⁰.

²⁸ Michael Jensen and Kevin Murphy 'Remuneration: Where we've been, how we got to here, what are the problems, and how to fix them', Finance Working Paper No. 44/2004, July 2004, 21.

²⁹ Bebchuk and Fried (n5) 19.

³⁰ Lucien Bebchuk and Jesse Fried 'Pay Without Performance: An Overview of the Issues' Journal of Applied Corporate Finance [2005] Vol.17 No.4 p.8, 15.

Although the performance related pay theory looks valid in principle, the application rings a different tune entirely. It could be argued, that there exists a linear connection between performance-related pay and the current high executive pay culture.

Pay for performance represents a fine concept which sought significance within a flawed system and took on different kind of significance far drawn from what could have been its original intent. The flaws could not be said to be with the concept itself, at least not entirely, rather with the governance structure in place in the system, within which it was meant to operate. This misuse could be owed in no small measure to the status quo of powerful managers and an inadequate or unwilling monitoring apparatus. It must be said that the current profligacy in the design and composition of CEO compensation, could mostly be attributed to a weak or possibly compromised monitoring framework³¹. Whether this bears as evidence managerial influence is yet to be seen, what it does state however, is that the system of compensation both in its structure and output is far from optimal, much unlike the mainstream narrative would like us to believe.

3.2.3.2. Because Managers Deserve High Pay:

High pay is frequently justified as the just deserts for CEOs in relation to their marginal productivity³². This argument is premised on the fact that larger portions of executive

³¹ Bebchuk et al critiqued the design of compensation packages stating that the use of 'at the money' options aided the growth of managerial compensation levels and further evidenced the influence managerial power had over the pay setting process. See, Bebchuk, Fried and Walker (n2).

³² Randall Thomas (n3) 1201.

pay are performance-related³³. It is believed, that company boards set performance-related compensation higher than they would have if it were a fixed wage regime, as an additional incentive to naturally risk-averse managers. Bebchuk et al argue, that performance-related compensation is worth less to executives than a fixed salary. Therefore, those who design compensation structure it in such a way, to ensure that the manager's potential earnings are similar to or higher than the manager's reservation value³⁴. As such, the board could tie pay to the attainment of certain performance metrics i.e. share price increases, return on earnings etc. which would trigger an award of shares and/or an accounting-based cash bonus. Plus, in some instances additional perquisites could be given as part of the system of reward. In the event of an award of company shares, the compensation realised would be determined by the share price at the time of vesting. Therefore, if the firm had experienced major growth spurts over the vesting period, the manager would be well rewarded thus.

These share award programs have become an integral part of the compensation policies of most publicly traded companies in the U.K and U.S³⁵. The apparent simplicity of this approach, ensures that it ignores certain important factors which would be looked at in the next section.

³³ A survey of firms within the FTSE 350, has shown that salary payments comprise only a fifth of top manager's total compensation, with incentive-based compensation making up the rest. See, High Pay Centre Report '*Executive remuneration in the FTSE 350 – a focus on performance-related pay*' October 2014. http://highpaycentre.org/files/IDS_report_for_HPC_2014_final_211014.pdf. (accessed 16/03/2015).

³⁴ Bebchuk, Fried and Walker (n2) 762.

³⁵ Jensen noted in the early 1990's, the negligible impact firm performance had on CEO pay and called for pay to be made more sensitive to company growth, by making CEO's hold substantial amounts of firm stock. That being said, today it is estimated that over 95 per cent of U.S managers received some form of their compensation in equity.

Furthermore, proponents of the mainstream view, argue that executive pay is just reward for talent. This is further exacerbated, they argue, by a shrinking pool of global CEO talent³⁶. Citing the apparent lack of credible and tested managerial talent, which they believe gives managers leverage in the negotiation process. That the independent board, in a desperate bid to attract and retain the best talent, are forced to negotiate exorbitantly priced pay packets.

This argument, appears to ignore figures which reveal that, more managerial talent is drawn from within the firm, than those hired from outside³⁷. Although, it is said that outside managers usually command higher sums in wages, than those hired from within the firm³⁸.

Further on the managerial talent argument, one author has stated that CEO's are paid better than other employees, due to their uncanny forecasting and risk assessment abilities and the importance of these skills in the post-crisis economy³⁹. Srivastava, disregards prior research, which put current pay levels down to managerial rent-seeking behaviours. He argues instead, that because CEOs can forecast share price movements and the firms overall risk exposure, better than the market can in some instances, they are able to command higher wages. Stating that research had shown, that firms recognising the importance of this skill have begun to link certain components of compensation to these forecasting abilities. Which he believes could

³⁶ Bebchuk and Fried (n5) 20. Randall Thomas (n3) 1230.

³⁷ A recent study showed that 80 per cent of companies within the global Fortune 500, recruited CEOs from within the company and of those with outside recruits, only four of such recruits were hired while holding CEO posts. See, David Bolchover '*Global CEO Appointments: A Very Domestic Issue*'. Available at (http://highpaycentre.org/files/CEO_mobility_final.pdf).

³⁸ Kathryn J. Kennedy "*Excessive Executive Compensation: Prior Federal Attempts to Curb Perceived Abuses*" Houston Business and Tax Law Journal, Vol. 10 2010 pp. 198-259 at 207.

³⁹ Anup Srivastava '*Do CEOs possess any extraordinary ability? Can those abilities justify large CEO pay?*' Asia-Pacific Journal of Accounting & Economics, Vol.20, No.4, 349-384.

explain the unparalleled rise in managerial compensation, which is maximized to encourage the utilisation of this 'rare' skill⁴⁰.

3.3. *Rebuttal Evidence of Managerial Interference and Influence on Compensation Decisions*

To contrast the mainstream view, some commentators see the prevailing trends as evidence of managerial interference in the pay setting process⁴¹.

Bebchuk, Fried and Walker, recommended an alternate perspective to the mainstream optimal contracting view of compensation setting; the managerial power approach⁴². They posit that managerial power more adequately explains current trends in executive compensation. This theory however, is not intended to provide a wholesale replacement for the extant mainstream view, but instead they believe current pay trends would be best understood by utilising both approaches⁴³. Much unlike the mainstream approach which uses compensation to counteract the agency problem, the managerial power view sees executive compensation largely as a manifestation of this problem. Accordingly, managerial power allows managers use compensation as a pretext to extract rents⁴⁴.

Although asymmetrical managerial power is a concomitant of the Berle-Means corporation, it is however exacerbated by failures inherent within the structure and operation of Anglo-American corporate governance and its manner of

⁴⁰ Ibid 350.

⁴¹ Bebchuk, Fried and Walker (n2) 786.

⁴² Ibid 784.

⁴³ Kevin Murphy 'Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options' University of Chicago Law Review [2002] Vol.69 847,849.

⁴⁴ Bebchuk, Fried and Walker (n2) 784.

compensation⁴⁵. Such as must do, with the relationship between the CEO and the board of directors.

These failures are nowhere more evident, than that fact that CEOs can play an active role, in the nomination of non-executive directors (NEDs). Considering, that the latter almost entirely constitute the membership of all the key monitoring committees, including the compensation committee⁴⁶. Brudney states that due to these failures, boards are compromised in some cases, making it that much harder to assume the adversarial stance required to effectively function as a monitoring unit⁴⁷.

It must be said, however, that this hypothesis would not be the definitive explanation for every highly paid executive and there are many instances where boards adequately and are quick to replace underperforming CEOs⁴⁸. That notwithstanding, the lack of informational parity between the CEO and the NED's, which could be attributed to the limited time NEDs must devote to the firm, would arguably constrict their effectiveness⁴⁹.

⁴⁵ Murphy, K. and Sandino, T 'Executive pay and 'independent' compensation consultants', *Journal of Accounting and Economics* [2010] vol. 49(3), pp. 247–62 at 248, 249.

⁴⁶ The UK Corporate Governance Rules along with the NYSE Rules require listed firms to have remuneration committees to be comprised of directors who meet the independent requirement. While the UK rules require the committees to have a minimum of three NEDs, the NYSE requires them to be made up entirely of NEDs.

⁴⁷ Victor Brudney, "Independent Directors-Heavenly City or Potemkin Village?" *Harvard Law Review*, [1982] Vol.95 597.

⁴⁸ As figures from 2007 study show, underperforming CEO's were more likely to be removed in the 2000's than in the 1990's, the statistics show that the global rate for dismissals for underperforming CEO's, is 4.2 per cent, which is said to be higher than it was in the 90's, while overall CEO turnover was said to be about 13.8 per cent for the same year. Which actually marked a slight reduction from the previous year. However, the figure show that CEOs are increasingly being given more time to settle even when underperforming as the median CEO fired in the year 2007, was said to have spent at least 6 years in office. (see, Per-Ola Karlsson, Gary L. Neilson and Juan Carlos Webster, "CEO Succession 2007: The Performance Paradox" <http://www.strategy-business.com/article/08208?pg=all>, (accessed on 20/01/2015).

⁴⁹ A recent publication has shown that directors on average spend about 10-12 days a year on their duties. See, Christian Castal and Christian Casper 'Building a Forward-Looking Board' *Mckinsey Quarterly*, February 2014. Available at www.mckinsey.com (accessed 22/03/2015).

3.3.1. How willing are Non-Executive Directors in the Monitoring of Managers?

Unfortunately, NEDs are faced with the same agency-related problems they are tasked to limit. Some of which could mostly be classed as motivational or incentive related⁵⁰, while others are either systemic or more domestic to the directors themselves. The Chapter would proceed to examine some of these issues.

3.3.1.1. The Lack of Proper Financial Incentives as an Impediment to Director Effectiveness

It is well known that independent directors are not compensated as well as the executives they are tasked to monitor⁵¹. This pay disparity, is merely a function of the wider disparity in their obligations and duties. While managers take charge of the day to day of management to which they are primarily obligated, NEDs on the other hand are barely involved in firm management⁵². As their board duties often represent secondary or tertiary roles⁵³. Research has shown director busyness as having a

⁵⁰ Thomas Clarke 'A Critique of the Anglo-American Model of Corporate Governance' Comparative Research in Law and Political Economy, [2009] Vol.5 No. p.4.

⁵¹ The average FTSE 100 CEO currently earns about 40 times the average FTSE 100 NED. With the average chairman, currently being paid just a 9th of the average FTSE 100 CEO. See, High Pay Centre, 'Chairmen and Non-Executive Director Compensation' 29 April 2013.

⁵² There appears to be an informal rule that directors spend 1.5 days per week on their board duties. It is said that the total time commitment for the average FTSE 100 NED currently stands at some much improved 46 days per annum, while the chairman is said to spend 3-4 days in some instances due to the increased complexity of the role. First Flight Non-Executive Directors Ltd and ShareSoc Report, 'Chair and Non-Executive Director Guidelines (search, selection and remuneration)' http://www.growthcompany.co.uk/article_assets/articledir_4289/2144598/ p.23, (accessed 4/03/2015).

⁵³ A report shows that 10% of UK NEDs sit on the boards of more than 10 different companies, (see, *ibid* p.14). A trend which contradicts the provisions of the UK Corporate Governance Code, which requires, "all directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively" (B.3).

negative effect on firm performance⁵⁴. Contrasting research has found busy directors to be a positive, with smaller firms⁵⁵. While this is understandable given the sparseness of what is required of them, the problem however is not with what directors are compensated, as much as it is with the way they are compensated. NED compensation is not only lacking in terms of its size and composition but could be found wanting in its method of determination as well.

Directorial seats are relatively lucrative. Relative in the sense that although remuneration for occupying one of those pales when compared to average executive pay, they are still tastefully rewarding, when considered alongside the level of responsibility directors are said to bear⁵⁶. It could be argued that the power and prestige of board membership make them too lucrative to give up. Creating a new kind of incentive one not linked to the fortunes of the company, but instead the protection of the director's interests. Creating the same agency conflicts that the board was intended to help assuage⁵⁷. Causing one to ponder the limited use of performance-related compensation for NED's. Although research shows the increasing use of performance related pay for NEDs in the UK, this is still not as widespread as it is amongst American executives⁵⁸. It has been argued against its use, citing concerns

⁵⁴ George D. Cashman, Stuart Gillan and Chulhee Jun, *'Going Overboard? Director Busyness and Firm Performance'*. *Journal of Banking and Finance* [2012] Vol. 36, 3248-3259, 3249.

⁵⁵ Laura Field, Michelle Lowry and Anahit Mkrтчnya *'Are Busy Boards Detrimental?'* *Journal of Financial Economics* [2013] Vol.109 (1) 63-82.

⁵⁶ As noted earlier, the average FTSE NED on average spends less than 50 days a year on their board responsibilities for which they earn on average £61,000 in base fees, excluding further payments for committee membership. Not a bad return for minimal amount of work considering the median pay for an ordinary employee, working full time hours, which according to the Office for National Statistics, currently stands at £518 per week, adding up to a pre-tax income of just under £27,000 per annum. See, <http://www.ons.gov.uk/annual-survey-of-hours-and-earnings/2014> (accessed 12/03/2015)

⁵⁷ Martin Conyon and Lerong He *'Compensation Committees and CEO Compensation Incentives in US Entrepreneurial Firms'* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=546110, p.6.

⁵⁸ It has been reported that in 2014, 50 per cent of S&P 500 companies within the, financial and industrial goods sectors amongst others, have a stock-based component in retainer fees paid out to

about the implications on the 'independence' criteria for NEDs⁵⁹. Linking some portion of NED pay to certain performance metrics might prove to be effectively incentive aligning.

Directors in the UK are said to earn considerably higher than their counterparts in the rest of Europe⁶⁰. Though the levels appear to have stagnated somewhat since the crisis, due in part to cost cutting on the part of companies. The past few years however, have witnessed a notable rise in NED compensation, with fees for 2013 said to have risen by 5 to 6 per cent in some firms in the FTSE 100⁶¹. It is noteworthy that membership of the remuneration committees has proven to be the most lucrative, with some fees said to have risen to 140 per cent⁶². The figures are said to be even higher in the U.S⁶³. This is in addition to the perks and other indirect benefits of being a board member. It would not be over reaching to mention how this could potentially influence NEDs in the exercise of their discretion.

Additionally, the fact the CEOs have a say in directors' pay could further compromise their effectiveness. Potentially creating a *quid pro quo* situation, which could compromise the pay setting process. Brick, Wald and Palmon state the concurrent rise

directors. See, C-Suite Insight 'Governance Outlook: a new focus on the governance Committee' Issue 16 2015, p.12 www.equilar.com (accessed 19/03/2015).

⁵⁹ Chris Mallin, Andrea Melis, Silvia Gaia 'The remuneration of independent directors in the UK and Italy: An empirical analysis based on agency theory'. International Business Review (2014), <http://dx.doi.org/10.1016/j.ibusrev.2014.07.006>.

⁶⁰ Ibid.

⁶¹ PricewaterhouseCooper Report on 'Non-executive Director Fees for 2013' at p.5, <http://www.pwc.co.uk/assets/pdf/pwc-non-executive-director-fee-summary-2013>

⁶² NED's on the committee are said to earn about £12,000 per annum, rising from £5,000, which was the average for the previous year. This as well as the £20,000 reportedly received by the chair of the said committee.

⁶³ For the year 2012, Average director pay for firms within the S&P 500 index, rose by 15% since 2007 to \$250,000 per annum for 250 hours of work. With the highest paid board receiving \$9.5m in retention fees. Jeffery Green and Hideki Suzuki 'Board Director Pay Hits Record 250,000 for 250 hours' www.Bloomberg.com (accessed on 17/03/2015).

in CEO and director compensation, as evidence of “*mutual backscratching and cronyism*”⁶⁴. Believing that the rise in both CEO and NED compensation was evidence of a permissive and cronyistic governance culture, ruled more by self-interest, than a desire to protect and preserve company interests. They state that directors tend to benefit financially from powerful and entrenched CEO’s. Citing evidence that directors in firms where one person occupies the dual positions of CEO and board chair, tend to receive larger compensation⁶⁵.

While the method of nomination and appointment of NEDs would generally support the notion of deference and subservience to the CEO. It would be somewhat hasty however to assume this as having a major positive impact on director’s compensation in all cases. As Brick et al note, reported rises in NED compensation could also be put down to increased responsibility⁶⁶. As we know NEDs in some instances are compensated on a per meeting basis, this could positively impact pay, where the directors are required to meet more times than the average. This explanation could be relevant in the UK, where NEDs have in the post crisis era been required to be more proactive in monitoring the executive than in previous times. In 2009, the *Walker Review* recommended the overall time commitment of NEDs should be greater, stating that they should be required to give a minimum 30 to 36 days a year to their board duties⁶⁷. An increased time commitment on the part of NEDs would undeniably cost more, this could in turn offer a substitute explanation for the rise in directors’ pay.

⁶⁴ Brick, Palmon and Wald (n20) 404.

⁶⁵ Ibid, 410.

⁶⁶ Ibid, 417.

⁶⁷ *A Review of Corporate Governance in UK Banks and other Financial Industry Entities*. Final Recommendations, 26 November 2009.

3.3.1.2. The Problem of Shared Backgrounds and the Cognitive Biases that result

As stated previously, a vast number of NEDs are either serving or erstwhile CEO's⁶⁸. This could hardly make for effective monitoring, as it is human nature to be permissive of situations with sufficient notoriety or to which one has become accustomed. This is known as the bandwagon effect.

Defined as the, "*the process of diffusion of a thought, behaviour, idea, or else in any given group, team, community, organization, or society due to its popularity*"⁶⁹.

Described as a powerful form of groupthink the bandwagon mentality ensures that individuals go with the popular view or 'follow the crowd', even when the said view is far removed from rationality⁷⁰. This is most significant with regards to executive compensation, where board members could also be serving executives. There would expectedly be few dissenters to pay suggestions either by the remuneration committee, pay consultants or the CEO himself, which would normally be unjustifiable. Research has shown that when corporate elites are faced with "*complex business situations*" their interpretations would usually reflect their functional backgrounds⁷¹.

It must be noted however, that the bandwagon mentality could also in some instances have the reverse effect of encouraging dissent. As Vincent Warther reports, when companies release information which elicits outrage-e.g. a bonus award in a down market-a step taken by one director in opposition of management would usually

⁶⁸ High pay Centre Report, (n1).

⁶⁹ David Secchi and Emmanuelle Bardone, 'A Model of Organizational Bandwagon' International Journal of Organisation Theory and Behaviour [2013] Vol.16 (4) 521-572, 521.

⁷⁰ Drake Baer and Gus Lubin, "58 Cognitive Biases That Screw Up Everything We Do" Business Insider, June 18, 2014.

⁷¹ Michael Jensen and Edward J. Zajac, 'Corporate Elites and Corporate Strategy: How Demographic Preferences and Structural Position Shape the Scope of the Firm. Strategic Management Journal, Vol. 25, No. 6 (Jun. 2004), pp. 507-524, 509.

precede a full-fledged mutiny, with the majority toeing the line of the dissenting director⁷².

The shared influences on the director's cognition, being immersed within a high pay culture would prove the more likely pivot, when faced with testy pay situations. Such as whether to approve payments which are non-comparative with performance or the setting of metrics which are not guaranteed to enhance firm value. This could be explained by the fact that individuals operating within a field, "*overtime become inculcated and socialized within the areas dominant mode of thinking and acting*"⁷³, so much so, that rational decisions take a back seat to normative perceptions.

These shared backgrounds or strong social ties which precipitate a biased view of fairness and desert on the part of NEDs and could originate from shared social institutions. For example, a prestigious or exclusive secondary and tertiary educational institution, economic sectors known to draw its members from a certain social or intellectual class, for example financial institutions etc. These institutions act as a melting pot for individuals drawn from these exclusive classes, facilitating the establishment of networks, which in some instances are carried into the boardroom⁷⁴. Sociologists describe this pattern of behaviour as falling within its resource dependence theory, which explores the links between members of elitist classes and the institutions that facilitate these links⁷⁵.

⁷² Warther (n6) 56.

⁷³ Ibid.

⁷⁴ Bang Dang Nguyen, '*Does the Rolodex Matter? Corporate Elite's Small World and the Effectiveness of Boards of Directors*'. Management Science, [2012] Vol.58 (2) pp.236-252.

⁷⁵ Ibid, 237.

These networks could also manifest themselves in board interlocks. Boards interlock when directors hold multiple directorships, a fact which as research shows, has a positive effect on managerial pay in firms which interlock⁷⁶. These mutually beneficial relationships/networks could aid the diffusion of social norms, which encourage a relaxed attitude towards excessive rewards.⁷⁷.

Social norms in this regard could be necessitated by political orthodoxy or promulgated by market mechanisms. Emphasising the importance of social norms, in the three-decade long surge in executive pay, Kim, Kogut and Yang contend that in the setting of executive pay, boards “look around in their networks to determine what others view as acceptable compensation, this reliance on others and those in the same network in particular reproduces a self-reproducing social structure”⁷⁸. The importance of social norms to the growth of high pay, cannot be understated⁷⁹.

The effect of networks in the diffusion of high pay norms is evidenced mostly in the use of peer groups in setting compensation. Aside from the use of pay consultants, NEDs who serve on company boards, over time could forge an idea of what the going rate for CEOs in similar positions earn. To which they may collectively decide to pay him, a decision not related to performance or shareholder value. As Kim et al aptly put it, “the reference point of the board as reflected in the network of its relationships

⁷⁶ Boards interlock when, you have a director A in company (Y) serving on the board in (X) company, either as a NED or member of the executive so much so that his relationship with another director B happens to cut across both companies via their cross directorships, placing them in situations where they could mutually benefit-or derail- the other’s interests. Kevin F. Hallock “Dual Agency: Corporate Boards with Reciprocally Interlocking Relationships” available at (<http://digitalcommons.ilr.cornell.edu/articles/234/>).

⁷⁷ Jerry Kim, Bruce Kogut and Jae Suk-Yat, ‘Executive Compensation, Fat Cats, and Best Athletes’. October 30, 2014. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1948531 (accessed 03/02/2015).

⁷⁸ Ibid, 12.

⁷⁹ Joe Nocera, ‘Buffet Punts on pay’ New York Times (Accessed on 06/10/2014).

shapes what management and boards believe to be legitimate and acceptable practices". Research shows that CEOs of the most connected firms earn 13 per cent more in total compensation than those of the least connected firms⁸⁰.

3.3.1.3. *The Impersonal Cost of Ineffectiveness: indemnity clauses and the Business Judgement Rule*

It could be argued that directors could afford to defer to CEOs because they are not properly incentivized to do otherwise. Having already discussed incentives for NEDs or the lack thereof, this Chapter would not engage in a further discourse of the monetary kind, but incentives in the sense of the price for failure. What is the cost for failed boards?

It may be argued that the reputational and possibly economic costs could function as a sufficient deterrent to board ineffectiveness⁸¹. However, there is no evidence that most the directors of failed boards are unable to find new positions after being removed. Neither is the compensation earned by serving NEDs so high as to be unobtainable in other paid positions. The argument here is not that directorships are not sufficiently prestigious to be coveted enough to want to do a good job at it, but rather that the consequences for negligent based failures are not a sufficient enough deterrent to ensure that they do.

Furthermore, directors are granted a further layer of protection from negative consequences, by way of the reluctance of the Anglo-American courts to hold directors

⁸⁰ Ibid, 13.

⁸¹ Stephen M. Bainbridge: *Corporate Governance after the Financial Crisis* (OUP, New York: 2012) P.95.

responsible for the failure of their business judgement. This attitude of non-interference is commonly known as the Business Judgement Rule⁸². It is now taken for granted that executive compensation decisions fall within the purview of the rule⁸³.

The implication of the Business Judgement Rule is that barring the rare instance where directorial conduct could be deemed to be egregiously negligent, directors would not be held liable for business decisions. Unless it can be shown that the directors acted with gross negligence, which has a notoriously low standard of proof⁸⁴. So much so, that successful business judgement suits are a rarity and non-existent in compensation matters⁸⁵. Which is hardly ideal, if the objective is a board which is effective in its role as a check on the executive. The aim should be to encourage board accountability and not to hold NEDs wantonly liable for business decisions, as this could be detrimental to board participation⁸⁶. Also, the issue of hindsight bias-that the flaws in failed decisions are always obvious to an observer with full knowledge of the outcomes-

⁸² The rule is recognised by statute in most of the common-law jurisdictions including the United States is chief. However, civil jurisdictions like Germany have codified the rule within the corporate law framework.

⁸³ Held in *Heller v Boylan*, 29 N.Y. S.2d 653, that executive pay decisions qualified for protection under the Business Judgement Rule, except the plaintiffs met the requirements set out in *Aronson v Lewis*, 473 A.2d 805, 2 EXC 28 (Del. 1984). Decision followed more recently in *Brehm v Eisner*, 746 A.2d 244.

⁸⁴ S.8.31 of the American Model Business Corporations Act, sets out the standard of liability of serving directors, and states that a disgruntled shareholder in a derivative suit must prove that at the time of taken the action the affected director did; not act in good faith, was not reasonably informed on the merits of the decision made and did not reasonably believe the decision to be in the best interest of the company.

⁸⁵ Majority of the shareholder derivative suits in America have failed to proceed beyond the preliminary stages due to the steep requirements of the demand principle. Causing one jurist to liken a successful compensation based derivative suit to a sighting of the “loch Ness” monster (*Steiner v Meyerson*, No. 13139, (Del. Ch. July 19, 1995).

⁸⁶ In *Air Line Pilots Association, International v. UAL Corporation*, 897 E2d 1394 (7th Cir. 1990), the U.S courts commented on the possible effects of a regime personal liability for directors thus, “*The [Rule] encourages competent individuals to become directors who otherwise might decline for fear of personal liability*”.

cannot be ignored⁸⁷. A system which encourages accountability, by setting adequate standards for liability would do little harm.

Further worsening the incentive problem for NEDs is the presence of indemnity clauses in director contracts, which stipulate the companies' obligation to bear the financial burden should a director be found personally liable for business decisions, due to negligence. These agreements have become standard corporate practice in the UK and America and even required by statute in places like Delaware⁸⁸. These contractual clauses, commonly known as '*Qualifying Third Party Indemnity Provisions*' are made legitimate by the Companies Act⁸⁹. Accordingly, UK companies are currently permitted to indemnify directors, who are parties to civil or criminal proceedings instituted by third parties, the company or regulatory authorities, which allege a breach of duty, trust or directorial negligence.

In civil or criminal proceedings, the company can offset the costs incurred by the director, however such payments are to be regarded as loans made to the director. Which would be immediately repayable should the director be found liable, convicted in criminal proceedings or when his application for relief is unsuccessful. However, where the director makes a successful defence, the company may be permitted to waive the loans. When proceedings are brought by a regulatory authority, the indemnity is not required to be made by way of loans, also were the directors defence

⁸⁷ Stephen M. Bainbridge, "*The Business Judgement Rule as a Rule of Abstention*" Vol. 57 Vanderbilt Law Review 83 2004, pp.83-129, 114.

⁸⁸ Following the Delaware Supreme Court's decision in *Smith v Van Gorkom* [Del.1985] 488 A.2d 858, 3 EXC 112, the Delaware Code was amended, per S.102 (b) (7) thus, "*A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director...*"

⁸⁹ Hogan Lovells and Zoey Handforth '*Directors Indemnities Under the Companies Act 2006*' <http://www.lexology.com/library/detail.aspx?g=09/02/2015>.

is not successful, the company may not pay the required penalties and/or levies on the director's behalf⁹⁰.

As well as indemnity clauses, companies are permitted to take out insurance policies with directors as beneficiaries. These are known as directors and officer's insurance policies and are permitted to insure directors for costs/personal losses for which the company is not permitted to indemnify the director⁹¹. These policies also indemnify the beneficiaries against the effects of the company becoming insolvent⁹². To note, these policies are available to both executives and NEDs.

It is noteworthy that in Germany, S.93 (2) of *the Stock Corporations Act* ((*Aktiengesetz* – *AktG*), which was revised in 2009-allows companies to take out D&O insurance policies only on behalf of members of the management board. Furthermore, in the event of a claim directors are required to pay a deductible of no less than 10 per cent of the total liability. With the upper limit set at no less than one and half times the director's fixed annual remuneration. The approach opted for by the Germans would more likely incentivise due care from managing directors, than that which is operative within Anglo-America.

⁹⁰ Chris Pearson 'Directors Indemnities'
<http://www.nortonrosefulbright.com/knowledge/publications/27089/director-indemnities> (accessed on 09/02/2015).

⁹¹ Lovells and Handforth, (n88).

⁹² Ibid.

3.3.1.4. Economic and Reputational Costs of Dissent

The economic repercussions of challenging management could be nugatory to NEDs as well as shareholders.

Brudney states that directors' willingness to challenge managerial self-dealing, may be hampered by the realisation that such a challenge might not necessarily be in the interest of investors. He believes in the possibility that NEDs might allow managers to have their way, because over-restricting them might cause them to engage in behaviour which may be more detrimental to shareholders, than if there were no such restrictions⁹³.

Regardless of the arguments Brudney makes, about the possible altruism underlining NED inaction, there is no denying the personal interest that could motivate these monitoring inefficiencies. Organically, the lucrateness of board seats, both in monetary terms and in other non-pecuniary ways i.e. status, could go some way to limiting board effectiveness⁹⁴. It goes without saying that CEO's are generally in a position to benefit directors financially and otherwise and are able to reward NEDs generously. Like Graef Crystal notes, "*Whenever you find highly paid CEOs, you will find highly paid directors. It's no accident.*"⁹⁵

In addition, NED effectiveness may be impeded further by the reputational consequences of doing so. It would be fair to say that given that CEOs play a direct role in NED appointment, one would expect they would aim to fill vacant board seats with

⁹³ Brudney (n46) 611.

⁹⁴ Bebchuk and Fried (n29) 12.

⁹⁵ Graef Crystal '*In Search of Excess; the overcompensation of American executives*' (1st Edition, W.W Norton & Co 1991).

agreeable characters. Meaning that directors with a reputation for opposing management would readily find board opportunities scarce. Finally, it is worth noting that, aside from the direct economic benefits of board membership in terms of fees earned, NEDs who themselves are serving executives, stand to benefit with every rise in average pay. According to Bebchuk et al, this arises as a result of “*self-serving cognitive dissonance*”⁹⁶.

A combination of one or more of these factors could arguably make CEO’s disproportionately powerful as far as directors are concerned. It is possible the managerial power theory has been critiqued as much as it has, due to a misplaced understanding that the theory dictates the wresting of power from the board by managers. However, the theory could be understood to be more than the deliberate power grab by managers, but rather a partial relinquishing of control by the board for stated reasons.

The managerial power theory could be understood alternatively to have arisen from board failure to effectively assume its control and monitoring duties, leaving a power vacuum which managers stepped into with consequences on overall CEO pay.

⁹⁶ Bebchuk, Fried and Walker (n2) 769.

3.4. Executive Pay and Nozick's Theory of Entitlement: Does the Pay Setting Process Compromise its Justice?

Before analysing the pay-setting process using Nozick's theory, it would be proper to briefly discuss the theory itself. Nozick's theory which is premised on entitlement, espouses the view that the justice of a particular holding is determined by its origin, or "how it came about"⁹⁷.

Accordingly, holdings could only be justly held, if they result in agreement with either or both principles of justice in acquisition and transfer. For a distribution to meet the demands of justice, it must have been duly acquired that is, obtained through legitimate means. Hence, "a distribution is just if it arises from another just distribution"⁹⁸. One can only legitimately claim ownership and be entitled to a thing, if the process of acquisition was uncompromised by illegality or injustice, similarly one can only transfer a holding to another if one is entitled to the thing in the first instance. Which consequently impacts the rights of the recipient to that holding. He states:

"Some people steal from others, or defraud them, or enslave them, seizing their product and preventing them from living as they choose, or forcibly exclude others from competing in exchanges. None of these are permissible models of transition from one situation to another"⁹⁹

⁹⁷ Nozick (n9)153.

⁹⁸ Nozick (n9) 151.

⁹⁹ Ibid, 152.

Nozick believed that a justice analysis of a situation only need consider the matrix of the distribution. It is perhaps trite, but important to note that due to Nozick's libertarian ideals, his conception of justice is less concerned with wealth disparities and outcomes, as it is with the process of wealth acquisition and transfer. Accordingly, the latter processes must adhere to the core libertarian principles of individual responsibility, free and unfettered market transfer and liberty in choice¹⁰⁰.

Harris argues with reference to executive pay, that for a distribution to meet the stated libertarian ideals, the beneficiary must have acted in accordance with normative principles of conduct and the transaction must meet the standards of economic justice i.e. be a free unencumbered transfer by adequately informed parties¹⁰¹. In emphasising this point, Nozick gave the popular Wilt Chamberlain example. Wherein, an American sports star enters into an agreement with his employers, which entitles him to 25 cents for every ticket sold to fans, allowing him to earn an additional \$250,000, more than anyone else within his immediate environment. Nozick opines, that despite the resulting inequality in income, Chamberlain was entitled to the earnings. He argued thus for two main reasons: one, that the agreement entitling him to a percentage of the earnings, was a consequence of his star quality and ability to attract a fan base. Having noticed this, his employers in anticipation of the impact his 'celebrity' would have on revenues-opted to contract on those terms. Secondly, the paying fans, duly informed of the terms and knowing that a portion of every ticket had to go to Chamberlain, voluntarily 'chose' to pay for the ticket¹⁰².

¹⁰⁰ Harris (n10) 80.

¹⁰¹ *ibid* 81.

¹⁰² We know the fans are fully informed of the transaction, as they were required to place the 25 cents in a separate box, which had chamberlain's name on it. See Nozick (n9) 161.

Nozick's thesis is founded on the concept of desert, as such, relatively high compensation is justified by the scalability of the recipient's talent and voluntariness of the parties to transact thus. For these reasons, Wilt Chamberlain's share of the distribution was just, because his income was considered to be commensurate to his value proposition. The situation would be markedly different however, if Chamberlain lacked the status to warrant such an agreement and was only able to contract on such favourable terms, for less meritorious reasons i.e. due to prior relationships with certain members of the managerial hierarchy. Furthermore, the transaction would lack the key libertarian element of 'choice', if the paying fans were unaware of the agreement the team had with Chamberlain or were unable to opt out of it. On this note, Harris states that for pay to be just, it must meet the requirements of liberty, transparency and acquiescence¹⁰³.

3.4.1. The Requirements for Justice in High Executive Pay

A key ingredient of Nozick's thesis is the 'choice' exercised by the transacting parties, particularly the transferor of the holding in question. What Nozick, attempts to emphasize as well, is the perceived value received which precedes or follows the exercise of one's choice in the transference of the said holding to another. It is the "*value proposition*" of the recipient that causes the giver to transfer a portion of his holdings. As such, Nozick believes that in a free market society, distribution of income should be in tandem with "*the perceived value of a person's actions and services*"¹⁰⁴.

¹⁰³ Harris (n10) 80.

¹⁰⁴ Nozick (n9) 158.

Applying this theory to executive pay trends, the latter could only be just, where it results from a free exercise of the giver's right to give and pay is commensurate with the executive's value proposition.

In addition, the transparency of the distributive process is necessary for it to meet the required justice standards. While parties have the right to transfer to another that which is theirs, however, to justify the distributive unevenness that would result, the reason for the transfer must be plain and obvious. Whether it be an exchange for services or a mere gifting of one's resources to another. This Chapter would at this juncture proceed to examine each of these requirements as they relate to the debate surrounding the justice of high executive pay.

3.4.2. The Requirement of Voluntariness in Transfer of Holdings: Freedom of Choice in Exchange for Value Received

Nozick criticised what he characterised as the egalitarian focus on "*end-state principles*", which he believed inordinately focused on the right of the recipient to receive, while completely ignoring the giver's right to bestow¹⁰⁵. A libertarian critique of the debate surrounding current pay levels is that the debate is mostly concerned with how much executives earn and focuses less on the firm's right to set pay at such a level. For the libertarian, pay is just when it is given freely, of one's own volition and in exchange for received value. This view of transactional relationships is earmarked by the phraseology "*to each according...*". Although Nozick intended his thesis as a

¹⁰⁵ Nozick (n9) 161.

riposte to egalitarian paternalism, this approach could however be adopted in distributive justice evaluations in a much broader context, including executive pay.

The freedom which must undergird distributive transactions is best illustrated when Nozick declares *“from each as they choose, to each as they are chosen”*¹⁰⁶. Here the transferor’s choice is pivotal, wherein he chooses to allocate a portion of his distribution to another, of his own volition. It is assumed that in choosing to give to another, the transferor is unconcerned with the consequences of the transaction i.e. whether the recipient would end up with more than he. This is best illustrated by the Wilt Chamberlain example, where the sports fans chose to pay a premium to watch the latter play, supposedly aware of the unequal distribution that would result.

Perhaps most important from the libertarian perspective, is the reason for the transfer. Nozick argues that in free market societies, distributions must be value-based and merited by the recipient. Therefore, *“to each according to how much he benefits others, who have the resources for benefitting those who benefit them”*, suggests just distributions should be in response to the value proposition of the recipient¹⁰⁷. With reference to the Chamberlain illustration, the fans chose to pay the premium to see him play, but only in anticipation of the entertainment value the transaction presented. Hence, the value received from the transfer is equally as important as the choice to transfer one’s holdings.

Applying Nozick’s principle in analysing theory to high executive pay, elicits two fundamental questions; are pay awards the voluntary exercise of the director’s

¹⁰⁶ Ibid,160.

¹⁰⁷ Ibid 158.

discretion and could it be definitively affirmed that high pay is an apt return for value created?

This Chapter has already highlighted the debate with regards to the pay setting process and the potential for managerial control over the board. The perceived shortcomings of the Anglo-American corporate governance structure, heighten the plausibility of the managerial power thesis- which views high executive pay as the result of a captive board and powerful managers. The constitution of the board-in terms of the backgrounds of the membership-as well as the processes of nomination and subsequent appointments, call into question the 'independence' of its members. As well as their ability to exercise discretion in pay decisions. It goes without saying that for the pay setting process to adhere to the principle of liberty in choice within Nozick's theory, it must eschew the merest hint of managerial influence. That said, when we consider factors surrounding board nomination, its composition, including the shared backgrounds of the membership, the likelihood of board capture and managerial influence over the pay setting process, becomes highly probable¹⁰⁸. The latter could be countered by the argument that shareholders determine executive pay. However, the reality is, that shareholders only approve remuneration proposals made by the board and have very little say in the formulation of those proposals.

Furthermore, it remains inconclusive whether executive pay levels are commensurate with company performance, as studies evaluating the sensitivity of pay to

¹⁰⁸ Particularly in the light of the continued prevalence of CEOs occupying dual roles of CEO and board chairman. Although the last 10 years has seen a decline in the trend, figures from 2014 show 60 per cent of S&P 500 companies combining both roles within one individual. See, Equilar Blog Post '*Split Decisions: CEO/Chair Positions Decline in Response to Shareholder Concerns*' <<http://www.equilar.com/blogs/73-split-decisions.html>>.

performance have often spawned contrasting results. That regardless, there is incontrovertible evidence of excessive pay packets, including performance related bonuses, paid to CEOs and other executives, following a downturn in performance or outright corporate failure¹⁰⁹. Anecdotal evidence of this nature makes it extremely tasking to make a shareholder value argument in favour of high executive pay. Given the libertarian requirement that the compensation be anticipative of the value proposition of the recipient, it is fair to conclude that current pay levels would ultimately fail to meet the justice standards espoused by Nozick's theory of justice in distribution.

3.4.3. Transparency in Distribution

In addition to the principle of liberty in exchange, Nozick's process-oriented view of justice in distribution requires for transparency within the distributive matrix for the end result to be just. Hence, though the parties within a free market economy should be free to transfer voluntarily from one to another, the reason for the transfer must be made clear. Which becomes even more important, where the transfer leads to an unequal distribution.

¹⁰⁹ The recent failure of British services firm Carillion, provides a case study. The firm which went into administration in January 2018, following years of shrinking profits. It has been reported that the firm paid lavish bonuses to its directors even as it released profit warnings indicating its poor financial health. Simon Goodley 'Carillion's 'highly inappropriate' pay packets criticised' The Guardian, 15 January 2018.

Nozick realised that distribution of income in exchange for value rendered forms but one strand of the entire distributive matrix. Which also includes transfers due to inheritance or arbitrary gifts. However, regardless of its precipitancy, society requires the reason for the transfers to be clearly stated, for it to be regarded as just and one to which the beneficiary is entitled. To this end, payments made to company CEOs are no exception.

The last 20 years have witnessed an increased agitation for greater transparency within the pay setting process, later years have seen this requirement codified within both hard and soft corporate law rules¹¹⁰. The intent being to allow companies to show the thought process or reason behind remuneration awards. Hence, s.79 & 80 of the *Enterprise and Regulatory Reform Act 2013*, require directors to produce a remuneration report setting out the firm's remuneration policy. The contents of the said report are outlined in Part 4 of the *Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008*. The aforementioned statute, requires that the report should contain information about the remuneration committee and the metrics for determining performance-related compensation. Also, the remuneration policy should take into consideration the pay of other employees, and "*liabilities in respect of directors' contracts*". The report is also required to contain information with respect to the compensation of each individual director, a breakdown of salary, bonuses and share awards etc.), as well as a statement of the returns to shareholders within the preceding 5 years. It should also set out details on

¹¹⁰ S.420(1) of the Companies Act 2006 as well as the UK Corporate Governance Code 2016, D2. In the U.S, *The Wall Street Reform and Consumer Protection Act (2010)*.

the director's pension and other retirement benefits¹¹¹. Furthermore, the report is to be put forward for shareholder approval every 3 years¹¹².

These requirements have been a moderate success in terms of channelling shareholder outrage¹¹³. There are concerns about the willingness of the relevant directors to fulfil the disclosure and transparency requirements, judging by the complexity of some published reports. This could be attributed in part, to the increasing list of disclosure requirements on the one hand, even if, a more cynical mind might suggest is evidence of directorial subterfuge. The bottom line remains, that investors are left uninformed about the company's remuneration policy and thus unable to make informed decisions concerning their right of approval. This led to calls for increased transparency in remuneration reporting¹¹⁴. Consequently, the UK Corporate Governance Code 2016, as part of its provisions, called for "*a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors*"¹¹⁵.

If we consider transparency as a prerequisite to meet Nozick's standard of distributive justice, this then would place a duty on the directors to outline clearly and understandably the policy driving the pay decisions. These must be described such that

¹¹¹ Peter King, Lauren Pau and Rebecca Grapsas, 'Disclosure of executive remuneration in the UK: recent developments and US comparison' < [https://uk.practicallaw.thomsonreuters.com/1-523-1863?lrTS=20171215043728701&transitionType=Default&contextData=\(sc.Default\)](https://uk.practicallaw.thomsonreuters.com/1-523-1863?lrTS=20171215043728701&transitionType=Default&contextData=(sc.Default))>

¹¹² S.439A of the Companies Act.

¹¹³ Aditi Gupta et al 'Form Over Substance? An Investigation of Recent Remuneration Disclosure Changes in the UK'. Available at < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2798001>

¹¹⁴ The defunct Department for Business Innovation and Skills released a consultation paper on Executive pay, wherein it called for recommendations on what needed to be done to improve the transparency in pay reporting. See, *Department of Business Innovation and Skills 'Executive Remuneration' Discussion Paper*. Available at < https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31660/11-1287-executive-remuneration-discussion-paper.pdf> .

¹¹⁵ UK CGC 2016, at 21.

shareholders lacking the necessary technical background could easily decipher the contents of the report. Evidentially, this is shown to not always to be the case, as published reports are often very technical and voluminous, and lacking in understandability¹¹⁶. When shareholders are unable to make informed decisions about the firm's remuneration policy, it hampers the resulting pay decision's ability to meet the requisite justice standards. As Villiers notes, the voluntary nature of the exchanges within Nozick's thesis, must be counterbalanced by stringent regulation, to ensure the fairness of the outcome. The fulfilment of which would require adequate disclosure¹¹⁷.

Where the requirement for transparency through disclosure, in a clear and concise manner is not met, it raises questions about the process and ultimately affects the justice of the outcome. As Nozick notes the justice of a distribution is largely dependent on how it is conceived, as such when the distribution lacks transparency, the justifications thereof cannot be easily understood. As he states, "*we feel more comfortable upholding the justice of an entitlement system if most of the transfers under it are done for reasons*". He goes further to say, that "*it means only that there is a purpose or point to someone's transferring a holding to one person rather than to another; that usually we can see what the transferrer thinks he is gaining, what cause he thinks he is serving, what goals he thinks he is helping to achieve*". Without this key requirement, it would difficult to justify the pay setting process, regardless of the outcome.

¹¹⁶ King et al (n110). Also see, Equilar Press Release, '*SEC Regulations and Shareholder Scrutiny Lead to Longer Pay Disclosures*' < <http://www.equilar.com/press-releases/43-sec-regulations.html>>.

¹¹⁷ Charlotte Villiers '*Executive Pay Beyond Control?*' [1995] Legal Studies, Vol.15, Issue 260, 265.

3.5. Benchmarking in Executive pay setting: Does this Accord with Nozick's Legitimate Process?

Given the performance related bent of Nozick's thesis, it then becomes relevant to determine how the use of comparator averages in the setting of executive pay, factors within his justice perspective. Utilising comparator averages in the determination of executive pay, is a widely regarded practice amongst compensation committees of some of the largest Anglo-American firms¹¹⁸. To determine whether the practice falls within Nozick's postulation of a legitimate process, is to first understand the implication of basing executive pay on peer averages instead of performance, from a justice perspective.

Benchmarking involves the use of industry averages in the setting of executive compensation. Compensation packages are determined by the going rate within a select group of peers-usually firms with similar core characteristics-and to which the movement of the CEOs pay would be pegged. In practice, compensation is usually set at or above the median pay within a given peer group. Figures from the year 2015 show, that of the firms within the American S&P 500 index, 96% used peer groups in setting CEO pay, while over 56 per cent set pay based on the earnings of 80-100 per cent of the firms within the same industries¹¹⁹.

¹¹⁸ Charles Elson and Craig K. Ferrere "Executive Superstars, Peer Groups and Over Compensation—Cause, Effect and Solution" at p.105. Available at <<http://ssrn.com/abstract=2125979>> (accessed on 25/07/2018).

¹¹⁹ Mercedes Erickson 'Peer Benchmarking and Trends in Executive Compensation'. Available at <https://www.auditanalytics.com/blog/peer-benchmarking-and-trends-in-executive-compensation/>.

Proponents of the standard view of compensation, would argue that the pay setting process is above reproach in the majority of cases, this argument fails to factor the exacerbating effect benchmarking has on pay levels. Benchmarking could ensure that compromised pay packets become frames of reference in the setting of pay, becoming a standard for executive compensation, known as the mimetic effect of benchmarking¹²⁰. Given the pervasiveness of the practice, it is important to a discussion on the purity of the process, to determine whether benchmarking in practice, meets Nozick's standard of a legitimate process.

3.5.1. Does Benchmarking Meet the Standard of a Legitimate Process?

Shin critiqued the efficacy of basing the pay of CEOs on those of their more successful peers¹²¹. While Ezzamel and Watson note, that the upward adjustment of CEO pay is the more common reaction to peer reports which show an inequity, when considering his pay in relation to the industry average¹²². The fact that peer grouping predominantly leads to higher wages for the affected CEOs, could suggest some form of managerial interference in the pay setting process. Shin, notes that the ability of the CEO to restore equity-that is get his wages to match or better the peer average-is

¹²⁰ Donald C. Hambrick and Sydney Finkelstein *'the Effects of Ownership Structure on Conditions at the Top: The Case of CEO Pay Raises'* Strategic Management Journal, [March 1995] Vol. 16, No.3, pp. 175-193 at 179.

¹²¹ Taekjin Shin *'Fair Pay or Power Play? Pay Equity, Managerial Power, and Compensation Adjustments for CEOs'*. Journal of Management, Vol.20, No.10, pp.1-30, 2.

¹²² Mahmoud Ezzamel and Robert Watson, *'Market Comparison Earnings and the Bidding-Up of Executive Cash Compensation: Evidence from the United Kingdom'* The Academy of Management Journal [April 1998] Vol. 41, No.2, pp. 221-231.

stronger when he wields greater influence over the board, and would be far less able to do so, where he does not¹²³.

There are several reasons why firms would want to base pay on the going rate rather than performance: it could stem from a desire to make the CEO feel appreciated or valued, to retain his services or ensure the firm remains competitive on all fronts including the compensation for its head¹²⁴. It could also be argued that benchmarking CEO pay could help facilitate the equitable distribution of wealth amongst CEOs of a similar standing¹²⁵. As supported by evidence, which shows that CEOs who earn below the peer average, usually benefit from an upward revision of said pay in the following year¹²⁶. This assertion however ignores the balancing effect of the theory.

Equity theory is based on the need to restore parity when inequity in distribution becomes evident. A restoration of this nature may require upward adjustments of the subject's earnings as well as deductions to bring it in line with the stated average. Therefore, the use of equity theory to justify benchmarking is worrisome, the reason being that the practice is more frequently utilised for pay raises rather than contractions. On this point Ezzamel and Watson, using a sample of firms trading in the UK, show the prevalence of peer average inspired upward adjustments in executive compensation as against the lowering of salaries for overpaid executives¹²⁷. They do state however, that the trend should not be taken as evidence of "*collusion between compensation committee members and the executives whose pay they are setting, nor*

¹²³ Shin (n121) 9.

¹²⁴ *ibid* 4, Ezzamel and Watson (122) 223.

¹²⁵ *Ibid*.

¹²⁶ Shin (n121) 4.

¹²⁷ Ezzamel and Watson (n122) 230.

*does it necessarily imply indifference to shareholder demands to render pay more dependent upon firm performance measures*¹²⁸. It however, remains difficult not to draw such a conclusion. As Shin mentions, strict adherence to compensation benchmarking is as much determined by whether the CEO is overpaid or than the need to restore equity¹²⁹.

He draws a clear link between managerial influence and benchmarking inspired pay increases. Stating that upward adjustments are rarer in the case of overpaid CEOs, than when they are underpaid in comparison. Accordingly, when underpaid CEOs unduly influence the board, compensation committees are more willing to incorporate external evaluations of peer average in their pay considerations, than they perhaps would, where such deference does not exist. In the latter instance, pay considerations would take a more inward direction, in adherence to the pay for performance mantra. Similarly, powerful CEOs who are overpaid, might use said influence to limit the use of comparator groups in pay setting, while encouraging appraisals that are almost entirely performance based. While overpaid CEOs with little or no influence over the board may find themselves unable to prevent a downward adjustment to align pay with the peer average¹³⁰. The former is most pronounced when the CEO dually acts as chairman of the board¹³¹.

Furthermore, Hambrick and Finkelstein, found mimicry of industry averages to be more likely in manager-controlled firms, than in firms controlled by a single majority

¹²⁸ Ibid.

¹²⁹ Shin (n121) 9.

¹³⁰ Ibid, 3.

¹³¹ Ibid, 23.

owner¹³². Common sense would suggest that the latter scenario would be the least frequent, calling to question the usefulness of benchmarking as practiced, if not to justify high or excessive CEO wages.

Even optimal contracting enthusiasts recurring contentions that current pay levels result from optimal and efficient processes, would concede that it would not be completely implausible to contemplate the possibility of managerial influence over the pay setting process, albeit in a limited number of instances. Whatever the nomenclature, basing compensation on peer performance does not evidence prudent contracting by company boards. The most important fact here, is not the frequency of such instances or how widespread the practice is, but rather the effect even a handful of manager influenced pay packages could have on overall pay levels.

For example, statistics from the U.S show that in 2013 the top ten most benchmarked companies within the S&P 1500, were referenced a total of 580 times, with the most being manufacturing conglomerate 3M, which had 62 companies reference its compensation policy in setting executive pay. It is worthy of note, that 3M paid its CEO \$16.4 million in total compensation for that year¹³³. The least referenced company was food manufacturing giant Kellogg, which had 43 references to its name, along with Illinois Tool Works and Colgate Palmolive¹³⁴. If any of these firms had their compensation policies drafted by captive boards then you have a situation whereby a minimum of 43 other firm's base compensation practices on flawed standards.

¹³² Hambrick and Finkelstein (n120) 179.

¹³³ James R. Haggerty '3M CEO's 2013 Pay Rose 11% to \$16.4 Million' March 26, 2014, WSJ.com (accessed on 25/04/2015).

¹³⁴ S&P 1500 Peer Group Report 2014, *C-Suite Insight by Equilar*, Issue 14, 2014, p.35.

Having noted the above, it then becomes difficult to argue that benchmarked pay packages are the outcome of Nozick's postulation of a legitimate process. The centrality of the concept of desert to his entitlement theory, requires that every pay package should have a direct correlation to the service provided. Only when pay is given in exchange for the CEO's value proposition, can the requirement for justice in distribution be said to have been met.

It is fair to say, that even the most ardent proponent of peer averaging in compensation setting would struggle to defend the practice on the basis of Nozick's theory. The already stated widespread use of peer averages, increases the potential for compromise pay packages, to be the basis upon which others may be set. Given the importance of the pay setting process to the question of the justice of high pay, this latter fact suggests that executive pay, in its current form, falls short of the justice standard upon which Nozick's thesis is based.

3.6. Conclusion

The most salient objection to executive pay in its currency is the issue of desert. Do CEOs deserve their current wages? In the present socio-political climate, economic arguments in favour of current pay levels have become insufficient and has become necessary for proponents of high pay to prove the justice in the current wage disparity between company heads and the ordinary earners within society. Causing unprecedented attention to be given to the determinative process of pay and the pivotal role played by company boards.

The enthronement of shareholders as the focus of the Anglo-American corporate objective required that their interests be protected by a board consisting of “*autonomous fiduciaries*”¹³⁵, who, in this opinion are the primal authority¹³⁶. But this view, just like the shareholder primacy argument, before it fails to capture the practicalities of corporate governance in Anglo-American. It is thought to be that neither the shareholding body nor the board of directors are the central authority within the firm, but that managers hold sway, using their influence to control the board and extract rents. Enabled by a governance infrastructure which perpetuates managerial excesses.

The highlighted governance failures could be attributed to board ineffectiveness, with the reasons for these already discussed earlier in the chapter. It is fair to conclude, all things considered, that the form and mode of the Anglo-American system of corporate governance, effectively guarantees the failure of corporate boards in the monitoring of managers, which affects consequentially, the setting of managerial compensation.

As such, the growth in executive pay, appears to have less to do with managerial or firm performance, but rather the rent extractive tendencies of the latter. Wherein the interlocking and mutually interdependent relationships which form the governance and monitoring framework of these large enterprises, create the supple environment for managerial excess.

The importance of the sanctity of the pay setting process to the justifiability of high pay, is highlighted by Nozick’s theory of entitlement. As noted within the Chapter,

¹³⁵ Stephen M. Bainbridge ‘*Director v. Shareholder Primacy in the Convergence Debate*’ UCLA, School of Law Research Paper No. 02-04, <http://papers.ssrn.com>.

¹³⁶ Ibid at 2.

Nozick argues that income is only just and deserved, when it arises through the justice regarding means of acquisition and transfer, implying that when it does not, said income is inherently unjust. It is fair to say that the current governance structure allows for managerial influence over the pay setting process as board capture theory would suggest. Even if this is only true for in a handful of companies and pay packages, the use of peer averages in the pay setting exacerbates the impact of these compromised situations, further worsened by the fact that this is more likely tool in firms with weak governance infrastructures¹³⁷ Which would call into question the justness of the current regime of executive pay.

¹³⁷ Shin (n121) 9.

Chapter Four

CEO Pay and the Income Distribution Conundrum: Putting

High Pay into Context

4.1. Introduction

The problem with the high executive pay culture cannot be limited to the sheer magnitude of the quantum of the disclosed figures alone. For such an observation, would be isolationist and perhaps reductionist, but more so bearing the fundamental weakness of having the observer's initial reservations about the trend easily justified, with valid reasons.

This is so, because the pervasive attitudes toward CEO pay could be summed up expressively as having a 'means justifies the ends' approach. Whereby the focus on the process and the justice thereof outlines the importance of the 'means'. But just as important, is the 'end' portion of that construct. Nozick best signifies this mind-set with the statement "*Any set of holdings that results from a legitimate process is just*"¹.

Earlier portions of the thesis had focused on the process of executive compensation setting, highlighting some of the practices that could potentially compromise its integrity². The previous Chapter discussed the pay setting process, using Nozick's theory of entitlement as a litmus test of its integrity. Highlighting Nozick's argument that the justice of 'ends' could only be met by the legitimacy of the process. Legitimacy

¹ Robert Nozick '*Anarchy, State and Utopia*' (Blackwell, 1974) p.207.

² Chapter 3, 3.15.

in this context would refer to practices which do not fall afoul of commonly regarded ethical considerations. But viewing legitimacy in this context, strictly from the view point of ethics or legality, could prove myopic in the long term. For there exists a substantial gap between behaviours which are legal and those which are ethical or just³.

The point being made here is that the justice of high executive compensation cannot be determined simply by an evaluation of the means of attaining the disputed outcome but must also contemplate the wider impact of the trend, before making an accurate and informed judgement regarding its fairness. In this case the legitimacy of the process, would not sufficiently justify the end.

Discussed in Chapter Three was Nozick's Wilt Chamberlain example, which was intended to highlight the core principle of voluntariness which underpinned his justice theory. There it did not matter that Mr Chamberlain received substantially more than the average income due to receiving a portion of the ticket prices. Here Nozick concluded that Chamberlain was entitled to his income, as his fans had willingly paid to watch him play, fully aware of the distributional consequences. Nozick effectively concludes that the justice of a distribution can only be determined by the process through which it is received, regardless of the inequalities which result⁴.

³ For practices, such as benchmarking for instance, might not fall out of the bounds of legality, but can hardly be termed just either. For can basing the compensation of one executive on that of a contemporary with greater performance, with the intent to secure a pay rise be just under any given circumstance? Particularly when the said executive presides over individuals who enjoy no such privilege? Or belongs to a wider community whose members do not enjoy such wage-related privileges? Benchmarking in and of itself is legal, maybe even ethical, but the equity of such a practice is however debatable.

⁴ Nozick (n1) 161.

In direct contrast to Nozick's process-oriented argument, is the Rawlsian view of justice as fairness. Rawls rejects the notion of a process-based justification of inequalities, arguing instead that a system of income distribution which creates sizeable wealth disparities can only be justified where; those inequalities benefit the least within society and provides true equality of opportunity⁵. With regards to executive pay, the Rawlsian focus would be quantum-based-how much executives earn and the social impact of the latter-regardless of the integrity of the pay-setting process. Indicating that a comprehensive evaluation of high executive pay, must extend beyond the pay-setting process, and consider its externalities. The externalities of high executive pay, are most relevant to the issue of income inequality.

Thomas Piketty attributed the rise in income inequality to the advent of the "*super manager*"⁶. He blamed the infiltration of the superstar mind-set in American corporations-and to a lesser degree, British firms-in the late 70's and 1980's on the rise in pay levels which began at about the same period. However, he is quick to note that the income gap between the top earners and the rest has more to do with the salaries paid to company executives than to other "*superstars*" with the latter consisting of just 5 per cent of the top 1 per cent of earners⁷. Whether managerial or sporting talent Anglo-American society pedestals outstanding individuals and pays accordingly. This is the reality Nozick captures and endorses in the Wilt chamberlain scenario.

⁵ John Rawls: *A Theory of Justice* (HUP, 1971) at 54.

⁶ Thomas Piketty '*Capital in the 21st Century*' (HUP, 2014), 273.

⁷ *Ibid* 262.

The zeitgeist is, highly talented individuals are a valuable economic asset, deserving huge rewards⁸. While the nobility of just deserts cannot be overstated, issues arise when the marginal output of one, is priced multiple times above the average. We could endlessly debate the value of talent in general and it is not only within corporations that we are confronted with seemingly outrageous sums in salaries and wages. Sportsmen, entertainers and other highly talented individuals have for decades being very well remunerated. With these high sums not enjoying the same level of scrutiny, granted to company executives.

Several reasons could be proffered in explanation but could simply be put down to conceptions of desert and worth. Sporting talent is obvious; we observe are enthralled and immediately evaluate its worth. Seven-figure pay packets juxtaposed against talent of intangible but euphoric value, would seem trivial. But the notion of the hardworking executive stashed behind the corporate veil, toiling for the sake of corporate performance would provoke far less magnanimity in the casual observer. The reason could be quite simple, said observer works with or for the executive, has first-hand knowledge of what most of the job entails and most importantly has watched his wages stagnate, as the latter swelled. The consequences of such an evaluation are multi-faceted, with the effect on morale, not being the least of these⁹.

⁸ On this see, Roger Martin and Mihnea C. Moldoveanu '*Capital Versus Talent: The Battle That's Reshaping Business*'. Harvard Business Review (July 2003). As well for arguments on how knowledge as an imperative economic resource has been exploited by its holders. See Roger Martin '*the Rise (and Likely Fall) of the Talent Economy*' Harvard Business Review (October 2014).

⁹ Research shows that pay differentials lose their initial incentivizing effect, once the difference between the highest and least paid exceeds 24 times. See, High pay Centre Report '*The High Cost of High Pay: An Analysis of Pay Inequalities Within Firms*'. Available at (http://highpaycentre.org/files/High_Cost_of_High_Pay1.pdf).

The question of excess when it comes to compensation for services in general and for executives like most things is relative and often biased. Opinions of the current levels would vary, from the public sector to high finance. But regardless of the individual's station, certain levels of compensation sufficiently evoke feelings of unfairness and inequity. The controversy surrounding executive compensation has not just to do with the figures alone, as issues of finance transcends merely the wage and lifestyle differentials but have wider effects on society. The most unequal societies would by implication, have higher rates of poverty than the more egalitarian ones and have been shown to be less productive also¹⁰.

The aim of this Chapter is not to embark on a vast philosophical discourse on the negatives of income inequality, but quite simply an attempt to answer or at least contemplate the justice of a pay ratio of 129:1 in the UK, in favour of the CEO, as against the average wage earner in the organisation he leads. Or for CEO wages which have risen between 439-513 per cent since 1978 in the U.S, while the average private sector salary rose just 1.4 per cent in the same time¹¹. Libertarians like Nozick, could suggest several reasons why this could be fair, but the most pressing question which neither the proponents nor the agitators have could answer convincingly, is whether the current pay levels have been arrived at organically or are they the product of a synthetically constructed process, advanced by a cabal of rentiers, utilising a legitimate process, to justify illegitimate gains?

¹⁰ Joseph E. Stiglitz *'The Price of Inequality'* (Penguin, 2012) 143.

¹¹ Lawrence Mishal and Alyssa Davies, *'CEO Pay Continues to Rise as Typical Workers Are Paid Less'* Economic Policy Institute, Issue Brief No.380 (June 2014) p.4.

Nozick's suggestion that the process is everything, fulfil the process and the ends must be just, fails to fly in a post-crisis world coming to terms with the realities of a meltdown powered by greed and regulatory oversight, where citizens are becoming more socially aware of the inequalities that pervade and the reasons for those inequalities. This Chapter seeks to answer the second research question utilising Rawls' justice theory. The thesis argues here, that even if high executive pay fulfils its procedural justice requirements, it must be viewed in terms of its impact in wider society for it to pass the test of fairness or justice.

The rest of this Chapter is outlined as follows; the following section would look further into the glorification of talented and highly-skilled individuals and its effect on income inequality in general, and particularly into the celebration of managerial talent within Anglo-America and the tectonic effects this has had on executive pay within the region. The Chapter will analyse the effectiveness of celebrated CEOs especially as it impacts firm performance. Trying to answer the question of whether celebrity CEOs and all the exposure they elicit are good for business. Next, this thesis will attempt to answer the question of the justice of executive compensation, by examining some of the foremost theories of justice as they pertain to executive compensation, comparing Nozick's entitlement theory with the Rawlsian principles of justice.

To give these arguments real world context, the thesis will analyse these principles against modern phenomenon such as globalisation and innovation and adoption of technologies in business operations. Both are believed to have played a part in the growth of executive pay and widening the income gap in Anglo-American societies¹².

¹² It is thought amongst some economists that globalization aided by advancement in technology and increasing export opportunities has aided the growth in executive pay and by implication the income

Globalisation and technology appear to have a co-enabling effect on each other, a combination of which has maximized the productivity of the modern corporation allowing them to function in ways that could never have been anticipated in the past. It could be argued, that the workings of the corporation have ensured that the profitability gains from a globalised and techno-advanced world, have positively impacted managerial remuneration.

As such the thesis seeks to show how the quest for greater compensation by executives underpins the increasing globalisation of firm operations and how the latter has led to a global convergence towards Anglo-American compensatory methods and levels.

4.2. Executive pay and Inequality in Income Distribution

Income inequality in American and British societies has risen dramatically since the 1970's¹³. An issue described by former U.S president Barack Obama as "*the defining Challenge of our time*"¹⁴. This statement itself encapsulates the concerns of the widening gap between the very wealthy and the rest of society. A wealth gap precipitated by a small but powerful class of rentiers, whose interest in wealth acquisition does not appear to have worked to the benefit of all, contrary to conventional economics¹⁵

divide. Also, by providing opportunities for executives to capture rents on a larger scale. Wolfgang Keller and Olney Wills '*Globalization and Executive Compensation*' IDEAS Working Paper Series from RePEc, 2017.

¹³ Piketty (n6) 242.

¹⁴ Jim Newell '*Obama: Income Inequality is the Defining Challenge of our time*' The Guardian.com 14 December 2013 (accessed 04/08/2015).

¹⁵ Stiglitz (n10) 41.

Piketty estimates that by 2030, the top decile of earners in the U.S would earn twice as much as the bottom 50 percent of income distribution scale¹⁶. While in the UK the proportion of the national income filtering to the top 1 percent has risen to just about 14 percent, and they have about as much wealth as the bottom, 60 percent¹⁷. There are a few reasons for the growing income and wealth gap, globalisation and-somewhat ironically-technological advancement topping that list. It is no surprise that income inequality is on the rise amongst the OECD countries, and measurable in traditionally more egalitarian societies¹⁸. However, on the income distribution scale, the top four most unequal societies have the U.S and U.K in 2nd and 4th respectively.

Piketty notes **two** ways a society might attain and sustain high levels of inequality; having a predominance of rentiers and what he describes as a “*hyper-meritocracy*”. While the former largely belongs to a fading era of inherited wealth, the latter, which is more relevant to the discourse, involves an unequal distribution of income, due to a concentration of wages in the hands of a few talented or revered individuals or ‘superstars’. Piketty’s focus in this case being on superstar CEOs or ‘*super managers*’- corporate managers celebrated for their perceived managerial nous. He states however that it would be naïve to assume that a society could not be rentier-oriented and hyper-meritocratic all at the same time and cites the U.S and Britain as examples¹⁹. Suffice to note however that the current spate of unequal distribution of income, coincided with managerial wealth gains²⁰.

¹⁶ Piketty (n6) 246.

¹⁷ High Pay Centre Report ‘*the shocking rise of inequality in Britain*’ Available at <<http://highpaycentre.org/blog/New-film-the-shocking-rise-of-inequality-in-britain>>

¹⁸ Ibid.

¹⁹ Piketty (n6) 265.

²⁰ Mishal and Davies (n11) at 3.

A combination of technological advancements and globalisation has ensured productivity gains and higher CEO wages, but average earners have yet to receive any of the benefits. Advancements in technology have de-skilled the productive process, heightening the dispensability of the average blue-collar wage earner, while outsourcing to low-wage countries has only worked to exacerbate the problem. Thus, the Anglo-American corporation is more profitable, even though the economy less productive and its workers worse off financially²¹.

The Chancellor of the Exchequer in 2015 outlined a plan for a £9 per hour minimum wage by 2020²². It is noteworthy that the average FTSE 100 CEO earns that much every 30 seconds. Similar wage recommendations in the U.S faced significant push back from large corporations, arguing a loss in profitability might threaten the job security of existing employees²³.

At the core of the executive pay debate are the questions of desert it raises. Do executives deserve very high wages? Do less skilled and qualified workers deserve less than a fair wage? These questions raise a few endlessly debatable philosophical issues- for instance, how we define skill or what could be regarded as fair in wage setting? Fairness from the viewpoint of economics is pay that reflects the value of the marginal

²¹ The strengthened ties between company performance and pay for executives, ensures they stand to directly profit from every gain performance wise. This practice prescribed to solve the agency problem-the divergence that is a product of the conflicting interests between managers and shareholders-apart from causing an exponential growth in pay, could be linked to the decreasing productivity and stagnant wages within both economies.

²² BBC News 'The Chancellor of the Exchequer, in 2015 outlined a plan for a £9 per hour minimum wage by 2020' <http://www.bbc.co.uk/news/uk-politics-33437115> (accessed 01/06/2016).

²³ Even though in 2013, the CEOs of both companies earned an estimated \$6,898 and \$9,247 per hour. McDonalds could effectively pay approximately 924.7 of their 90,000 strong U.S workforce, with the wage its CEO earns per month. Given that the wage increases when implemented would only affect less than 1 percent of their workforce makes it more troubling. See, Hayley Peterson, 'McDonald's and Starbucks' CEOs Make More Than \$9,200 An Hour' Business Insider, Dec 10, 2013 (accessed 06/08/2015) and Clare O' Connor, 'McDonald's Workers Slam \$1 Raise 'Stunt' Ahead of Planned Mass Walkout' Forbes.com, April 3, 2015 (accessed 19/08/2015).

product²⁴. This notion takes into consideration the time and effort required for skill acquisition and task performance. Whereas managerial expertise gained over years of educational and practical training, compared to lower-level roles which require less time and training.

Inversely the adopted belief in the rarity of true managerial talent, is at the core of its economic value²⁵. This economic value is celebrated and this celebration precipitates outsized rewards²⁶.

As we know the celebration of talent within Anglo-America culture transcends the co-existing worlds of entertainment, sports, politics etc. These individuals fall within a broad classification of Entertainers, Athletes and other Superstars (hereinafter EAOS) revered for the abilities they possess, which the market prices well above the average and whose product is almost always readily consumed by interested parts of society. The dynamics of demand and supply helps ensure the perpetuity of a high reward system for rare talent, and it is to these individuals that corporate managers are being likened.

²⁴ Piketty (n6) 330.

²⁵ Roger Martin '*the Rise (and Likely Fall) of the Talent Economy*' Harvard Business Review (October 2014 Issue).

²⁶ Piketty (n6) 315.

4.3. Justifying High Executive Pay: Making an Argument for Talent

Nozick's Wilt Chamberlain example briefly illustrates the value Anglo-American society places on skill and talent.

In sports for instance, multi-million pound pay deals were non-existent or rare in Europe four decades ago. But such agreements were not quite as foreign in America within the same period. The culture of high salaries for American sports people officially began in the 1970s²⁷. Similar levels existed for entertainers²⁸.

However, forty years later the trend has significantly altered, as participants in team sports in Euro-Asia are more likely to be far better compensated than their American counterparts. Per a global salary survey for sports teams done in 2015, seven of the top ten best paid teams are based in Europe with Paris St-Germain, a French football team leading the pack, with an average salary of £5.3m annually²⁹. The culture for paying excessively for sporting talent has metastasized beyond continental Europe to places like Russia (where the highest paid salary was £35.9m in 2012)³⁰ and China (with the average salary in the Chinese Super league in 2011, in the region of £1m)³¹, as well as Japan³². The trend is not limited to football alone as other team sports have joined in the high pay bandwagon. For instance, of the top forty highest paying teams in the world, four are members of the elite Indian Cricket league, each paying their players'

²⁷ Debbie Stephenson 'When Did Athletes Start Getting Rich?' The Deal Room. Available at (<https://www.firmex.com/thedealroom/when-did-athletes-start-getting-rich/>) .

²⁸ Martin 'the Rise and Likely Fall of the Talent Economy' (n25).

²⁹ Sports Intelligence, Global Sports Salaries Survey 2015, p.12.

³⁰ Samuel Eto'o set to become world top earning player with Anzhi deal' The Daily Mail 22, August 2011 (accessed on 27/07/2015).

³¹ Conca Smashes Chinese Transfer Record, ESPNFC.com, July 3, 2011 (accessed on 25/07/2015).

³² In the Japanese football league, known as the J-League, the top paying club the Urawa Red Diamonds, pays an average annual wage of just under £250,000.

salaries more than £2m on average³³. The same goes for film stars in India and some of Asia³⁴.

The fact that none of the above-mentioned countries are known to be particularly inegalitarian makes the trend more puzzling. With Russia and China having very strict socialist backgrounds, with the latter still widely regarded as being a communist country in designation at least, if not in practice. It shows how the celebrity status afforded certain highly skilled individuals in certain professions, could alter the dynamics of income distribution. With this same reverence being afforded to company CEOs in the last few decades.

In 1981, Sherwin Rosen described a superstar system as one in which *“there is a concentration of output by a few individuals, marked skewness in the associated distribution of income and very large distributions at the top”*³⁵. Noting further that *“there is a strong tendency for both market size and reward to be skewed towards the most talented individuals”*. Although this mind-set had been pervasive in popular culture, it is perhaps odd that this media-driven popularity has found a place within corporate governance culture³⁶.

³³ Sports Intelligence (n29) 13. Even though India, per the World Bank, is believed to have a third of the world’s poor. See World Bank Report *‘The State of the Poor: Where are the Poor and where are they Poorest?’*.

http://www.worldbank.org/content/dam/Worldbank/document/State_of_the_poor_paper_April17.pdf

³⁴ A Forbes survey of the highest paid actors in the world featured four Bollywood superstars-the Indian versions of Hollywood-each making a minimum of \$15 million. Natalie Robehmed *‘Bollywood’s Highest-Paid: Meet the Indian Actors Making More Than U.S. Stars.’*

<http://www.forbes.com/sites/natalierobehmed/2015/08/04/bollywoods-highest-paid-meet-the-indian-actors-making-more-than-u-s-stars/> (accessed on 04/11/15).

³⁵ Sherwin Rosen *‘the Economics of Superstars’*. The American Economic Review, Vol. 71, No. 5. (Dec. 1981), pp. 845-858.

³⁶ Martin, (n25).

This sort of exposure is perhaps not always unmerited. With there being a multiplicity of examples of pioneer CEOs whose innovations have vastly improved our quality of life. Others having no hand in the inception, have however, overseen the growth and prosperity of the firms they managed³⁷. And these managers are subsequently recognised for their efforts, and rightly so. Research has shown managers of successful firms usually witness a spike in their monetary rewards as well as perks and other like benefits³⁸. There are two identifiable and yet inevitable problems with a superstar mentality in rewarding executives; the concentration of wealth that would unavoidably occur and inevitable consequence of underperforming CEOs benefitting from such a system.

Starting with the latter problem. Having earlier on addressed the practice of benchmarking³⁹, the thesis wish not to dwell any further on it. However, paying high performing executive's celebrity like wages would help set the going rate for CEOs in general, even for those whose performances fail to reach the requisite level. Just like the proverbial tide that lifts all boats, benchmarking in executive compensation helps level a playing field with varied talent levels. In a system, where it could be argued that even the most deserving managers are overcompensated, such a trend could only ever have undesirable consequences for the firm first, as well as the economy and society.

³⁷ A foremost example of a successful manager who was not an entrepreneur, is GE's Jack Welch. Who spent 20 years as the CEO/Chairman which coincided with its most successful period, in which time the company's market capitalization rose from \$14 billion in 1981 to \$400 billion. Known for his authoritative and decisive leadership style, he oversaw the streamlining of GE's operations which saw revenues rise from \$26.8 billion in 1980 to \$130 billion at the time of his retirement. Revered for his attainments Welch has been celebrated in the media and in the corporate world, being recognised as one of the top 25 most influential business leaders. CNBC25: *Rebels, Icons and Leaders* <http://www.cnbc.com/2014/04/29/25-jack-welch.htm>.

³⁸ Ulrike Malmender and Geoffrey Tate 'Superstar CEOs' Quarterly Journal of Economics (Nov. 2009) 1593.

³⁹ See Chapter 3, 3.5.

It could be said that a key argument for high pay could be that the market generates the prices that are to be paid for services on all levels, and if the market does not *“transfer holdings.... on an irrational and arbitrary basis”*⁴⁰, then the sums must be right. Nozick’s contention that marginal product determines earnings and that distributions are the product of the *“party’s voluntary exchanges”* is steeped in the joint notions of entitlement and desert. Party A gives voluntarily to party B, to incentivize and reward the latter for his talent and effort. In critiquing Rawls’s ideal of inequalities being just, only when they are to the benefit of all, Nozick states:

“the serviceable inequalities stem, at least in part, from the necessity to provide incentives to certain people to perform various activities or fill various roles that not everyone can do equally well”

On this note he goes on to rhetorically ask, *“to whom are these incentives to be paid, to which performers of what activities?”* Nozick’s answer to these questions are fairly obvious, given the general direction of his thesis—those with the higher marginal product. Incentivizing marginal product by inversion excludes or should exclude an incentive structure rewarding anything other than apt performance. Basing pay on the industry average, is not an incentive structure that rewards performance, but one that rewards an individual for the performance of others. That would take most benchmarked pay packages out of the purview of Nozick’s notion of entitlement, and the question of justice, would be a forgone conclusion.

Flowing from the earlier point is the second problem precipitated by a celebrity-like reward system for corporate executives, the problem of wealth concentration at the

⁴⁰ Nozick (n1) 188.

upper end of the income distribution scale. Celebrity-like status enables executives and CEO's capture a larger portion of the wealth distribution than they would have had they not been so regarded⁴¹. Research shows that most executives who have been the recipients of awards or been recognised for performance enjoy a significant rise in pay afterwards⁴². The reasons behind the trend would be addressed later, however it would be safe to conclude at this point that celebrity-like status does have perceivable positive effects on executive pay⁴³. Which in turn further skews the distribution of income.

As Rosen noted there are three characteristics of a superstar system; a concentration of output amongst a small number of persons, which results in skewness in income distribution and the emergence of a top-heavy wealth concentration framework. All three characteristics could be said to be evident within the current executive compensation culture. Since the 1970's and 80's executives have increasingly had their fortunes tied almost inextricably with that of the firms they managed and have increasingly demanded that they be credited as well for the successes these firms have enjoyed⁴⁴. It may be down to pure happenstance that the recognisability of managers coincided with the rise in CEO pay or a direct consequence of said recognition. Leading to a situation where-just as Rosen evinced-a few individuals reap the largest rewards.

⁴¹ Malmender and Tate (n38) 1594.

⁴² Ibid.

⁴³ Ibid, 1596.

⁴⁴ Martin, (n25).

4.3.1. The Falsehood of Transferable (Generic) Managerial Talent

Elson and Ferrere blame the celebration of CEO talent on a false notion of the transferability of managerial skills. A notion which fails to recognise that CEO success is often attained by investing a significant amount of time working within a firm or industry. Skills acquired thus are not always transferable being more specific to the firm in question. Unsubstantiated claims about their transferability may have stemmed from misguided comparisons between CEOs and star athletes⁴⁵.

Rosen noted that advancements in technology had provided the platform for talented individuals to develop valuable skills, which enhance their earning potential⁴⁶. Advancements in and utilisation of technology had caused Anglo-American firms to dominate markets and consequently grow the size of their operations, with some of the gains going to larger pay packages for executives. There are however notable flaws in making such comparisons: one is the fluidity of movement across industry and genre that athletes and entertainers have, allowing them to find success in areas outside their natural artistic/athletic inclinations. For instance, recording artists could delve into film making and succeed or athletes could move across teams-or sports-and flourish, the firm or industry-specificity of CEO talent may inhibit such fluidity⁴⁷.

A second limitation has more to do with the discernibility of executive talent as well as those for athletes and other like professionals, discernibility impacts the way they are subsequently priced. Compensation for athletes and entertainers is purely market

⁴⁵ Charles Elson and Craig K. Ferrere, 'Executive Superstars, Peer Groups and Over---Compensation – Cause, Effect and Solution' 18 <http://ssrn.com/abstract=2125979> (downloaded 01/08/15).

⁴⁶ Rosen (n35) 849.

⁴⁷ Monika Hamori and Maria Kakarika, 'External Labour Market Strategy and Career Success: CEO Careers in Europe and the United States' Human Resource Management, (May-June) Vol. 48 No.3, pp. 355-378.

driven, simply put, demand determines the price paid for supply⁴⁸. Barring the outlying instance where reputation could be artificially enhanced to advance productivity, generally star entertainers and athletes are perceived by the buying public to be worth the value of their product, which in this case is the athlete or entertainer himself or at least the persona he exudes. But the pricing of CEO talent varies markedly, despite the contentions of high pay advocates, the pricing for executives is not entirely market-driven, contrary to conventional thinking⁴⁹.

Further on the issue of discernibility, CEO ability as well as contribution to firm growth and success tends not to stand out as much as that of the average EAOS. With the talent of the average superstar being on display for the casual observer to make a value judgement on his marginal product. Value judgements of CEO talent and ability are based on second-hand information as their activities are rarely witnessed on a first-hand basis by those outside the upper-echelons of management. As noted by Elson and Ferrer, executives are tasked more with the formulation and organization of the corporate policy and operations, as such *“rather than being a factor of production an executive directs and organizes other factors”*⁵⁰.

Pouring further scorn on the comparisons between CEOs and EAOSs is the pay for performance aspect which is substantially more apparent in compensation for EAOSs than with CEOs. With EAOSs a dip in performance levels-a downward surge in the value of the product-would necessarily cause earnings to follow a similar path. With CEO pay however, a flailing firm would not always have as negative an impact on managerial

⁴⁸ Robert Gordon *‘Has the Rise in American Inequality Been Exaggerated?’* Challenge 52, Issue 3 p.92, 104-105.

⁴⁹ Elson and Ferrer (n45) 19.

⁵⁰ Ibid.

pay, as evidenced by the much documented 'reward for failure' instances pre-and post-recession⁵¹. The bottom line as Elson concludes, is that managerial expertise within a firm or industry is acquired by experience gathered only by functioning within that firm or industry, hence CEO skills are not so easily transferable⁵².

Those who argue for transferable CEO skills, believe in the existence of core knowledge-based skills, which are applicable regardless of industry⁵³. Murphy and Zaborjnik correlate the unprecedented rise in CEO pay levels to the increasing generalisation of managerial skills and state that *"over the past three decades, the society has steadily accumulated a body of knowledge in economics, management science, accounting, finance, and other disciplines, which, if mastered by a CEO, can substantially improve his ability to manage any modern corporation successfully"*. As well they put forward the impact technology has had in enhancing CEO talent. Stating that the digitization of company operations can allow CEOs transition more fluidly between sectors, allowing them to learn the nature of the firm's operations easily, with the aid of available interactive technologies. They cite the increase in the number of external hires as evidence of a shift towards generalisation in management, to alternatively explain the rise in CEO pay, as external hires tend to earn higher than those promoted from within the organisation⁵⁴. The theory is the demand for

⁵¹ It is said that performance only accounts for less than 5 percent of pay, certainly not as much as firm size, which is of significantly larger consideration in pay decisions. see Elson and Fererre (n45) 19.

⁵² Ibid, 20. See also, Carl T. Bogus 'Excessive Executive Compensation and the Failure of Corporate Democracy' Buffalo Law Review Vol.41 1 1993, at 29.

⁵³ Kevin J. Murphy and Ján Zaborjnik, '*Managerial Capital and the Market for CEOs*'. Queens Economic Department Working Paper No.1110.

⁵⁴ Ibid, 27.

generalised managers has led to competition amongst prospective employers in the market for managerial talent, causing prices to increase.

However, this view is unsupported statistically. Ang and Nagel, found it to be more beneficial economically to promote from within than hire from outside. Using a sample of firms gathered over two decades, their results show that firms hiring from outside should have expected to make a loss 86.2 percent of the time⁵⁵. That one could mention a few other instances of outside failures, is not conclusive of the futility of the generalisation argument. Corporate management like any other skill-based endeavour requires, time in a methodical process of skill acquisition and dissemination, just as the best dramatists and athletes learn their craft for extended periods of time so would successful management require an in-depth knowledge of the workings of the specific market. It is no surprise that some of the most successful managers, spent an incredible amount of time at the firms they managed⁵⁶. It is on this note that arguments for transferability fail to convince.

⁵⁵ James S. Ang and Gregory L. Nagel, *The Financial Outcome of Hiring a CEO from Outside the Firm*, (Working Paper 2011) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1657027 (accessed 27/07/2015). Also, Bogus (n52) at 29.

⁵⁶ Former GE CEO Jack Welch, had spent a total of 21 years at the company before assuming the role of CEO/Chairman in 1981. Other examples, like Xerox's Ursula Burns, Rex Tillerson of Exxon-Mobil and Samuel Palmisano of IBM represent a number of employees who worked their way from entry level positions to the helm. See, Nicole Hardesty 'Entry-Level to CEO: 11 Corporate Titans Who Started at The Bottom' theHuffingtonPost.com 10/22/2010 (accessed on 09/11/2015).

4.3.1. CEO Celebrities: good for performance?

Having already mentioned the debate about the efficacy of externally hired CEOs, as determined by the effect on performance, it is perhaps proper as well to focus briefly on CEO performance in the aftermath of firm and personal success.

Malmender and Tate enthuse a steeper likelihood of a dip in firm performance following recognition for its CEO. However, this retardation in performance often coincides with an increase in managerial pay⁵⁷. The reasons for the latter are not so farfetched, least of these is the heightened reputation following success, coupled with increased bargaining powers of successful CEOs. It is however not quite as clear cut with regards to the performance issue. Malmender and Tate on this note proffer a few reasons of their own. They argue that CEOs become distracted following recognition, especially by the media. They claim award winning managers become taken with the trappings of celebrity, subsequently neglect their managerial responsibilities and the focus instead becomes less about managing firm success as it is about personal business. An over-indulgence in extra-corporate activities usually follows a la external board memberships, writing biographies, philanthropy, undertaking expensive pet projects i.e. investments in sports teams etc. are just some of the manifestations of the tendency⁵⁸.

Similarly, Samuelson's studied observation within academia notes a decline in output of Nobel laureates in contrast to performance before the award and the recognition that came with it. In this case, recipients become enthralled with and overwhelmed by

⁵⁷ Malmender and Tate (n38) 1594.

⁵⁸ Jayne Barnard *'Narcissism, Over-Optimism, Fear, Anger, and Depression: The Interior Lives of Corporate Leaders'* University of Cincinnati Law Review, Vol.77 2008, 405, 406.

the prize money and the media attention, leading in some instances to a meltdown within professional and personal circumstances⁵⁹. Barnard notes certain pathological traits exhibited by successful CEOs namely; fear, depression and anger. As well as a need to consolidate their current positions and place in history, by empire building often leading to ill-advised acquisitions and loss of value⁶⁰. These characteristics evidence a deviation from the corporate focus of value maximization, to a more personal and perhaps narcissistic need for recognition.

Behaviourists term this the “*hot-hand effect*”, derived from basketball, it is a term used to describe a performance streak⁶¹. The hot-hand streak is a hubris trap, where a person coming off a string of successes, begins to view themselves as infallible, becoming assumptive in their behaviour towards present and future endeavours. Taking steps premised on the conclusion that past successes would translate into present or future ones. It “*represents a pattern of behaviour where initial success inhibits an individual from making adaptive strategic decisions*”⁶². Researchers on organizational settings believe that successful and celebrated CEOs could become rigid, eschewing experimentation in favour of tried and tested methodology. This rigidity could lead to decline “*as the firm will not have gained the necessary knowledge by undergoing the experimentation needed to adapt to environmental change*”⁶³. This view is supported by research by Miller, which showed that although CEOs usually start

⁵⁹ Paul Samuelson ‘*Is there Life after a Nobel Prize?*’ <http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1970/samuelson-article.html> (accessed on 24/08/2015).

⁶⁰ Barnard (n58) 409.

⁶¹ Shelby J. Solomon and Joshua Bendickson ‘*Generating Press, Bold Ideas and Stubbornness: The Impact of Celebrity CEOs*’ *Journal of Business Strategies* Vol.32, No.2, 73 at 85.

⁶² *Ibid* at 86.

⁶³ *Ibid*.

by adopting a comprehensive range of strategies, over time they tend to favour those which proved effective in the past⁶⁴

Malmender and Tate confirm that powerful and distracted CEOs are more common in firms with a weak monitoring apparatus. As such “*CEOs extract more rents and consume more perks*” engage in extra-corporate activities, take more leisure time than they should, focus less on managing the firms and often oversee a downturn in performance thus. In summary, celebrating CEOs could in fact have a negative impact on firm performance⁶⁵.

On a concluding note, Bogus evinces the waste of paying CEOs vast sums for any reason other than that the payments equate to the value created. He mentions the futility of paying for talent or CEO mobility and skill transferability. Stating that, it was needlessly excessive to make incentive payments that exceed the value of the production it stimulates⁶⁶.

⁶⁴ D. Miller “*Stale in the Saddle: CEO Tenure and the Match Between Organization and Environment*”. *Management Science*, [1991] Vol.37, pp.34-52.

⁶⁵ Malmender and Tate (n38) 1595.

⁶⁶ Bogus (n52) 28.

Part II

4.4. Justifying High Compensation in the face of Growing

Income inequality

As mentioned it would be an inchoate exercise for an evaluation of executive pay to be based on quantum only, without any relevant context. A context-based analysis would inter alia involve comparisons with average earnings across the income distribution spectrum. This approach to the subject-matter must be taken cautiously however, given its sensational nature and populist inclinations. As Harris notes, pay ratio evaluations could be complicated and become an easily manipulated exercise⁶⁷.

Executive pay ratio disclosures, are useful in so far as they aid discussions regarding the equitability of executive pay. workers generally desire to be treated fairly, and there is no greater indication of this, than the way they are compensated. Even though, it has been suggested that definitions of fairness differ and are determined by hierarchical positioning within organisations or society⁶⁸. However, for all people, the *'fair wage, for fair work'* standard is imperative.

⁶⁷ Jared Harris, *'What's Wrong with Executive Compensation'* Journal of Business Ethics [2009] 85: 147, 150.

⁶⁸ Ibid.

4.4.1. What then is a Fair Wage? Conceptions of Desert as Postulated by Nozick and the Rawlsian principles of justice

Nozick's definition of a fair wage as one which came about by legitimate means⁶⁹. Having a process-oriented approach to conceiving justice, he postulates that outcomes are only just, if they were acquired by means which are in tandem with either the principles of justice in acquisition or transfer⁷⁰. Simply put "*whatever arises from a just situation by just steps is itself just*". Adopting this argument in favour or against high executive pay, ignores one of the major arguments against high pay; its effect on income inequality.

Income and wealth Inequalities appear to be intricately intertwined with the notion of free markets and ownership in capitalist societies, whereby outcomes are determined by effort, and thus just. But such a narrow-minded view assumes all play by the rules and that all economic activity is regulated by an '*invisible hand*' which ensures that outcomes are commensurate with input, while self-serving antics are dealt with appropriately by natural processes. But recent economic history has shown that to not always be the case, it would cause one to question the solidity of Nozick's process-oriented thesis.

However, assuming executive compensation accorded with all the demands of justice in acquisition and pay levels are attained by "*justice preserving means*", accepting high pay as fair would in turn justify the differentials between CEO pay and average earnings within organisational settings and wider society. The use of CEO pay ratios

⁶⁹ Nozick (n1) 152.

⁷⁰ Ibid, 151.

has been criticised by Harris for being overtly political and that they fail to legitimately control for the complexities in pay and pay differentials⁷¹. CEO-worker's pay ratio analysis requires, the juxtaposition of the wages of highly skilled managers against a group of average workers with varying skill levels. When regarded from that view point it could perhaps suggest a hastiness in pay differential analysis. Harris argues that calculations of differentials between CEO pay and average workers, factoring salaries of top level managers (i.e. CFO and COO's) would invariably bridge the gap between CEO pay and the average. That the often non-inclusion of the salaries of these highly paid managers in the average pool, leaves the motive behind the utilisation of pay differentials in CEO pay analysis, somewhat suspect⁷².

That said, if we adopt the libertarian conception of a fair wage, the issues surrounding pay differentials become irrelevant, due to its focus on the pay-setting process⁷³. Although both Nozick and Rawls have procedural justice at the heart of their respective justice perspectives, they however diverge on the issue of outcome. While Nozick concludes that the fairness of the outcome is assumed once the justice of the process is proven, Rawls on the other hand makes no such assumptions. The Rawlsian perspective argues instead that; outcomes are only just when they are to the benefit of all.

The second Rawlsian principle, which involves wealth distribution and social and economic inequalities, states in sum; that the inequalities that would arise from just

⁷¹ Harris (n67) 149.

⁷² Ibid, 148, 149.

⁷³ Jared Harris "How Much is Too Much? A Theoretical Analysis of Executive Compensation from the Standpoint of Distributive Justice" in the 'Ethics of Executive Compensation' (Blackwell) R.Kolb ed., 67-86, 80.

processes, should be arranged in such a way that they are to the benefit of the least privileged; and *“are attached to offices open to all”*⁷⁴. Whereas Nozick leaves the justice of the outcome to be determined by the process, i.e. wealth acquired through justice preserving means would be fair, regardless of the inequalities that result. Rawls’ contemplation of a just distribution would ideally be an equal one, but, unequal distributions could be tolerated if they eventually worked to the benefit of all within the spectrum. A contemplation of justice in distribution which is not limited to the procedure resulting in the outcome, but of the outcome itself. An unjust outcome in that case, would be one that produces *“inequalities that are not to the benefit of all”*⁷⁵.

To determine the justice of current pay levels would be to question, how inequalities produced by executive compensation work to the benefit all. Rawls provided the template for answering this question. Although he admits that the conceptions of justice do not recommend a threshold for permissible inequalities, however they do require everyone be left better off by said inequalities. That every individual within the spectrum *“prefer his prospects with the inequality to his prospects without it”*⁷⁶

Rawls’ conception of justice does not differ much from the *Lockean* proviso, whereby an appropriation of a previously unowned thing is only justified if there is enough and as good left for others. Locke believing acquisition was complete upon the mixing of one’s labour (effort and skill) with an unappropriated resource, however caveated this by his insistence on the effects said appropriation would have on the welfare of the next man. Which if when negative, would place the acquisition on the wrong side of

⁷⁴ Rawls (n5) 53.

⁷⁵ Ibid, 54.

⁷⁶ Ibid, 56.

the proviso. These arguments highlight the importance of exploring the impact of executive pay in a wider social context.

As well, the second arm of Rawls second principle suggests that for an unequal distribution to be fair, the opportunities afforded to the most well off must be open to all. The right to equality of opportunity - *“positions are not to be only open in a formal sense but that all should have a fair chance to attain them”*- as Rawls himself admits is somewhat stymied by the limitations of natural abilities and talents. Bearing this in mind he then goes further to clarify, what is meant by a fair chance at attainment;

“but we might say that those with similar abilities and skills should have similar life chances. More specifically, assuming that there is a distribution of natural assets, those who are at the same level of talent and ability, and have the same willingness to use them, should have the same prospects of success regardless of their initial place in the social system”⁷⁷

The question here is the attainability of managerial positions, are they truly positions open to all, or exclusive to a certain social stratum? Rawls theory would suggest that for high pay to be justifiable, the answer would need to lie closer to the former. If not, then high pay and the resulting inequalities would not be. The issue is how much of a weighting education and social positioning have on one’s ability to attain these positions. More importantly, the impact social positioning has on one’s ability to attain the requisite educational qualifications. The increasing competitiveness of the market for managerial talent requires that often the best qualified individuals only, are

⁷⁷ Ibid, 63.

considered for these coveted positions. With these individuals drawn mainly from a quorum of elite institutions.

A 2014 report by the governments *Social Mobility and Child Poverty Commission*, found that 22 per cent of FTSE 350 CEOs were privately educated, even though just 7 per cent of the UK population were thus trained. Also, 18 per cent of FTSE 350 CEOs were 'Oxbridge' alumni, compared to just 1 in 100 of the total UK population⁷⁸. The figures are worse when you exclude those educated outside of the UK, where 41 per cent of British educated FTSE 350 CEOs were privately educated and 43 per cent attended a Russell group university. Only 7 per cent of the entire sample did not have any university education. Although these figures are admittedly not as overwhelming, as similar trends in politics and the wider public sector, which show much higher levels of representation of those with privileged educational backgrounds⁷⁹. They could however support suggestions of elitism and social engineering in the CEO selection process.

Given that increase in mobility is meant to compensate for income differentials for these differentials to be just, it goes without saying that the absence of said mobility becomes then a serious indictment on an unequal distribution. On this, Piketty notes that if every individual were to spend a year in the "*upper centile of the income hierarchy*" then increases in the wages of high earners would not automatically imply an increase in wage inequality⁸⁰. There is a similar situation in France, where most

⁷⁸ Social Mobility and Child Poverty Commission Report '*Elitist Britain*' August 28, 2014. Available at (www.gov.uk/government/publications/elitist-britain).

⁷⁹ The report shows an overrepresentation of the elite trained, in the upper reaches of governance senior judges (71%), senior Armed forces officers (62%) as well as 33% of MPs, 36 and 22 per cent of the Cabinet and shadow cabinet respectively. For more on this see report (ibid at 10).

⁸⁰ Piketty (n6) 299.

corporate executives are alumni of the country's prestigious *Grand Ecoles*⁸¹. They could however support suggestions of elitism and social engineering in the CEO selection process.

4.5. Does High Executive Pay Work to the Benefit of All?

The first part of Rawls' second principle would require high CEO wages to ultimately work to the benefit of all within society. A libertarian response to this requirement would probably touch on the success inducing force which is high and the fact that an overwhelming majority of CEO pay packages have a performance related element to them. However, such an argument could be easily rebutted in the face of modern realities. The fact is high pay and pay for performance has placed an unprecedented emphasis on firm profitability, for which CEOs are required to increase returns to shareholders often at the expense of genuine value creation.

Much has been made of the increasingly short-sighted outlook of the Anglo-American corporation, the endemic profit-oriented attitudes and the apparent willingness to sacrifice future value for immediate wealth. It could be argued that some of the more laudable achievements perhaps function to the detriment of true value creation and help perpetuate inequalities. Take for instance the opinion-splitting concept of globalization, which has been facilitated and accelerated by advancements in productive and communicative abilities, that have helped improve the quality and productive pace of goods and service provision. As well as, increasing our abilities to

⁸¹ Bang Dang Nguyen 'Does the Rolodex Matter? Corporate Elite's Small World and the Effectiveness of Boards of Directors' *Management Science* Vol.58 Issue 2, pp.236-252, 236.

communicate and transport these from place to place, more quickly and efficiently than in the past. Making the globe smaller as distances have narrowed and erstwhile barriers more easily breached.

Globalization, as driven by advancements in technology has been immensely beneficial to firm growth, however the benefits to firm productivity do not appear to have always worked to better the lot of the least in society. Having had a simultaneously negative impact on middle to low income wages⁸². By achieving the previously unthinkable proposition of placing labour from the developed world in direct competition with their counterparts from low-wage countries. With this having a suppressive effect on wage levels for the ordinary low-skilled worker, while the wages of highly-skilled, managerial level earners have grown⁸³. In the following portion of the Chapter the thesis argues that, globalisation and technological advancement have been utilised by self-interested managers to improve the corporate bottom line and extract rents, causing executive pay to rise. Thus, this chapter argues that there exists a causal link between high pay and wage stagnation for ordinary workers.

4.5.1. Firm Profitability and Wage Suppression: adoption of new technologies

Piketty described education and technology as “*the decisive determinants of wage levels*”⁸⁴. A statement which buttressed the importance of education and technology—particularly the latter—in wage and earnings distribution. Technological innovation and

⁸² Era Dabla-Norris et al ‘*Causes and Consequences of Income Inequality: A Global Perspective*’ International Monetary Fund Discussion Note. Available at (<https://www.imf.org/external/pubs/ft/sdn/2015/sdn1513.pdf>) at 18.

⁸³ Ibid, 19, 20.

⁸⁴ Piketty (n6) 305.

its adoption impacts wage distribution in two broad ways; first, it determines the skill-level needed to perform the required tasks and how this skill acquisition is priced⁸⁵. Secondly, it has revolutionised firm operations in the production of goods and provision of service, also functioning as a determinant in the way these supplanted roles are priced. On the one hand, technological innovation has helped drive wages up for those possessing the requisite skill-levels, having the opposite effect with regards to the latter⁸⁶.

Piketty noted a race between education and technology, stating that inequalities exacerbate, when the latter fails to keep pace with the former. He concludes that best way to “*reduce inequalities..... is to invest in education*”⁸⁷. His assertions are based on statistical evidence from Europe and America which showed inequality increased as access to quality education at secondary and tertiary levels declined⁸⁸. He states that, the wage gap began to grow in the 1980s coincided with the decade in which university graduation rates began to stall in America. Comparing this to the more egalitarian Scandinavian societies, which have comparatively moderate levels of inequality, which accordingly, is partly due to the inclusiveness of their educational system⁸⁹.

The role of education as a major contributor to earnings disparities is in relation to its position in the development and operation of technology as an indicator of individual marginal productivity⁹⁰.

⁸⁵ Daron Acemoglu, ‘*Technology and Inequality*’ NBER Reporter (Winter 2003) www.nber.org.

⁸⁶ Martin (n25).

⁸⁷ Piketty (n6) 265.

⁸⁸ Milton Friedman, ‘*Capitalism and Freedom*’ (CUP 1962) 161.

⁸⁹ Piketty (n6) 307.

⁹⁰ A study on the impact of education on lifetime earnings, shows those with He degree on average earn a return of 27 per cent, as against those who do not. As well, the study found that the stages of education completed seem to matter more in the UK, than the number of years spent. This latter

Marginal productivity theory; the free market basis for income distribution and justification for the inequalities that could result, could best be described in the words of Milton Friedman as a system that gives “*to each according to what he and the instruments he owns produces*”. A pattern of distribution that bases allocations on its perception of the worth and value of the individual’s skill and labour. This accordingly is the true equality of outcome i.e. *pay based on preferences in sum*⁹¹. Advances in technology have invariably impacted such perceptions. It is believed, that the diverging movements in wages at the top and lower ends of the scale, have been greatly influenced by “*endogenous technical change*”⁹².

That technological advancement has been endogenous, suggests that the adoption of new technologies by firms has not simply been a response to external impositions, but rather an outcome of deliberate attempts to improve productivity, profitability and perhaps managerial rewards⁹³. As Acemoglu notes, while history shows technological adoption to have had a downward effect on the wages of skilled artisans, the present-day complementarity between technological advancement and skill acquisition has ensured higher wages for those with the requisite skills. He mentions further, that the demand for skill-biased technology was in recognition of the impact innovation and utilisation of technology would have in increasing profit potential. On this note Acemoglu states:

finding contrast with results from the U.S. See Richard Blundell, Lorraine Dearden and Barbara Sianesi ‘*Evaluating the Impact of Education on Earnings in the UK. Models, methods and Results from the NCDS*’ <http://www.ucl.ac.uk/~uctp39a/BlundellDeardenSianesiJRSS.pdf> (accessed 01/11/15).

⁹¹ Friedman (n87) 162.

⁹² Acemoglu (n84).

⁹³ Ibid.

“Put simply and extremely, it can be argued that the increased skill bias of technology throughout the 20th century and its acceleration during the past 30 years resulted from the changes in profit opportunities which were, in turn, a consequence of the steady increase in the supply of skilled workers over the past century and its surge starting in the early 1970s”.

This bias manifest itself more glaringly in widespread automation, which is most evident in service provision. With the biggest argument against automation being, its ability to makes labour replaceable⁹⁴. The application of a “downward pressure” on the cost of labour, coupled with factors like neutered collective bargaining, severely limits unskilled labour’s ability to make demands⁹⁵. Karl Marx observed this potential vulnerability over a 100 years ago, noting that the application of technology during the industrial revolution in Britain had allowed capitalists to wield greater power over labour, *“believing that the introduction of machinery during the industrial revolution had completed the domination of the employers over the employed”*⁹⁶.

Modern British service provision is largely automated, from banking halls and supermarket checkout stalls to warehouses across the nation. This threat is not limited to low-skilled occupations alone. Previously untouchable professions, have begun experimenting with machines and software as a cost-effective alternative⁹⁷. In 1983, Nobel Laureate Wassily Leontief stated, *“the role of humans as the most important*

⁹⁴ William Lazonick *‘Business organizations and the Myth of the Market Economy’* (Cambridge University Press 1991) p.120.

⁹⁵ Brown and Campbell (n76) at p.5.

⁹⁶ Lazonick (n93) 121.

⁹⁷ John Lanchester *‘The Robots Are Coming’* London Review of Books Vol.37 No.5, 5/03/2015, pp.3-8. See also, Carl Benedikt Frey and Michael A. Osborne, *‘The Future of Employment: How Susceptible are jobs to Computerisation?’* September 17, 2013 at 17.

factor of production is bound to diminish in the same way that the role of horses in agricultural production was first diminished and then eliminated by the introduction of tractors"⁹⁸. Three decades later this statement may not seem so far-fetched.

To emphasise the point, none have benefitted more from the advancements in technology and their adoption and utilisation in business operations than CEOs. As already stated technology allows firms to attain greater productivity, which in turn translates to increased profits, thus impacting CEO pay. As larger portions of CEO pay become equity-based, firm success becomes a personal undertaking. It could be argued that this personal stake has helped drive the increasing focus on the short-term⁹⁹. Profits are generated by keeping costs as low as possible, while maintaining or increasing productivity. Where there are productivity shortfalls, measures are soon taken to reverse the trend, which would often include work-force reductions, site closures etc.¹⁰⁰. These measures hardly ever include CEO pay cuts, to the contrary, examples exist of bonus payments to CEOs and executives in the face of a downturn¹⁰¹. Puzzling indeed, given that CEO pay as well as those of other executives continue to claim increasing portions of company revenue¹⁰².

⁹⁸ Ibid.

⁹⁹ Lucian A. Bebchuk, Alma Cohen, and Holger Spamann *'The Wages for Failure: Executive Compensation at Bear Stearns and Lehmann Brothers'* <http://papers.ssrn.com/abstract=1513522> (accessed 16/04/2015).

¹⁰⁰ In October 2015, British company Tata Steel announced it would be cutting over 1,200 jobs at its UK plants, due to failing market conditions and increasing production costs. Having to compete with cheap Chinese imports, the steel industry in the UK has taken a major hit. Leading to over 4,000 job redundancies within the sector. Michael Pooler *'Steel sector demands urgent action to survive'* FT.com (accessed 27/10/15).

¹⁰¹ In 2015, CEO of RBS Ross McEwan, saw his pay double to £3.8m, despite the state-owned bank reporting a loss of over £2bn. Similarly, BP shareholders voted down a £14m pay package for its CEO, in a year the company declared a record loss of £6.45bn and proposed to 7,000 jobs and froze employee salaries. *'BP shareholders revolt against CEO's £14m pay package'* The Guardian, 14 April 2016.

¹⁰² Lucien Bebchuk and Yaniv Grinstein, *'The Growth in Executive Pay'* Oxford Review of Economic Policy, Vol.21 Issue 2, p.283, 284.

The profit-oriented motivations of automation, are as obvious as the undeniability of its efficiency gains. For example, Apple generated a profit of \$18bn in 2015, with 1/6th of the total workforce General Motors had 50 years earlier, a time which the latter company posted profits of about \$7.64bn in today's currency and was considered then, to be the most valuable¹⁰³.

Lanchester notes the benefits of increased productivity are too restrained being mainly to its owners and managers, to sufficiently impact the wider economy. Stating on this note that "*capital isn't just winning against labour: there's no contest*"¹⁰⁴.

4.5.2. Firm profitability and Wage Suppression: Globalisation

In 2011, an OECD report on the growth of income inequality amongst its member states, identified globalisation and trade integration as one of the main drivers of inequality¹⁰⁵. As mentioned, globalisation allowed companies to circumvent the geographical barriers and allowed them to cut costs by creating competition between workers in the developed world and the peers in low-wage countries. Buoyed by advancements in information technology and transportation, it became cost-effective to relocate and produce goods and services at offshore locations, at a fraction of the costs of producing same in the developed world¹⁰⁶.

¹⁰³ Lanchester (n96).

¹⁰⁴ Ibid.

¹⁰⁵ OECD Report, 'An Overview of Growing Income Inequalities in OECD Countries: Main Findings' <http://www.oecd.org/social/inequality-and-poverty.htm> at 24.

¹⁰⁶ William Lazonick 'How Stock Buybacks Make Americans Vulnerable to Globalization' Air Industry Research Network, Working Paper #16-0301, at 5.

It is important to note, that even though globalisation may have been a natural occurring phenomenon, its pace and acceleration was largely man-made¹⁰⁷. Lazonick draws a line between the acceleration of globalisation which began in the 2000s and share buy-backs which boost share prices in the short-term and are of immense benefit to managers¹⁰⁸. Buy-backs are representative of the shift from a value-creating focus, to value-extraction. As companies have increasingly scaled back the pursuit of innovation and growth, in favour of dividend pay-outs and stock repurchases, committing significant portions of its resources that may otherwise have been earmarked for research and innovation¹⁰⁹.

The point being made here is, that the alignment of managerial wealth to shareholder value creation, ensures that self-interested managers would take the needed steps to ensure the creation of value, but only as it would precipitate short-term spikes in the share price. Globalisation provided an opportunity to grow the business, create value and minimise costs all at the same time.

4.5.2.1 Outsourcing and Offshoring as Manifestations of Globalisation

The latter stages of the 20th century, leading up to the 2000s witnessed a surge in production relocation and outsourcing¹¹⁰. Larger portions of the manufacturing and

¹⁰⁷Ibid, 2.

¹⁰⁸ Ibid, 7, 8 and 9.

¹⁰⁹Ibid, 9.

¹¹⁰ Ibid, 5.

production-based industries have been outsourced to low wage countries by some of the largest and most profitable Anglo-American corporations¹¹¹.

Outsourcing has had a suppressive effect on middle and low-income wages¹¹², and this works well for the corporate bottom line and executive pay, given that wages could be a particularly steep business expense. Given the minimum wage requisites and the need to provide costly employee benefits in the UK and most of the developed world, outsourcing these roles to low wage countries, provides the advantage of having these tasks performed at much lower costs. The implication being that companies maintain or even increase their level of productivity, without being burdened by the financial obligations within their home country.

It is important to mention that the economic benefits of globalisation in general and offshore outsourcing to the developing world have not come without costs to the host communities, as revealed following the recent spate of factory collapses in Bangladesh and Cambodia¹¹³. These incidents are in no way isolated, as other examples exist of human rights violations in third party work environments, utilised in the production of goods by major Anglo-American corporations¹¹⁴. What these incidents however suggest, is a callous indifference to the basic labour rights and international labour

¹¹¹ Companies like Apple, GM, IBM and Walmart amongst others, are believed to have relocated a total 2.4m jobs outside the states in recent years Zaid Jilani '*Top 'U.S.' Corporations Outsourced More Than 2.4 Million American Jobs Over the Last Decade*' Thinkprogress.com (accessed 15/10/2015). Increasingly UK companies like BT plc and EE since the 2000's have relocated significant portions of the technical and customer service roles to locations in South Asia. Daniel Thomas '*BT pledges to bring call centre jobs back to the UK*' ft.com, 18 September 2015 (accessed 16/10/15).

¹¹² Stiglitz (n10) 75.

¹¹³ One which housed the factory used by British retailer Primark. Despite revelations of the below par working conditions in these factories, the retailer, amongst others, restated their intent to continue production within the country Bangladeshi factories are notorious for their dire working conditions, which activists estimate cost the lives of more than 500 garment workers in the period 2006-2012. See, Puck Lo '*H&M Responds Slowly to Bangladesh Factory Collapse Killing 1,100*'. Available at (<http://corpwatch.org/article.php?id=1584>, accessed 16/10/2015).

¹¹⁴ Ibid.

standards. Perhaps, companies do not feel any social responsibility to third party employees and host communities, they are being merely collateral to the primary objective of shareholder wealth maximization. This indifference, is at the core of the mutual dependence that underpins the relationship between corporations and low wage countries.

The benefits of globalisation to corporate profits are exponential, but these benefits are not enjoyed by all. Stiglitz mentions that, the gains from globalisation are enjoyed mainly by the owners of capital¹¹⁵. Presumably under corporate influence, governments pass laws which actively encouraged the globalisation of corporate activity. A prime example would be the *North American Free Trade Agreement (NAFTA)*, which provided protections for companies that relocated operations to Mexico, as well as a tax-payer funded compensations scheme to cover resultant losses¹¹⁶-or the EU-U.S *Transatlantic Trade and Investment Partnership* - of which the UK was signatory pre-Brexit - was negotiated heavily in favour of multi-national corporations. The justification for trade agreements of this nature is almost always the economic benefits they present in the form of cheaper goods and greater job creation¹¹⁷. As Stiglitz mentions corporations have managed to purvey these two questionable assumptions about globalisation as fact; that globalisation helps increase

¹¹⁵ Stiglitz (n10) 77.

¹¹⁶ Chapter 11 of NAFTA. This agreement has been credited with job losses and wage suppression for middle to lower classes in the three countries who are signatories to it. See, *Lessons From NAFTA: The High Cost of Free Trade*. Available at (https://www.policyalternatives.ca/sites/default/files/uploads/publications/National_Office_Pubs/lessons_from_nافتa.pdf) accessed 22/06/2018.

¹¹⁷ Lori Wallach 'NAFTA's Corporate Goodies Are Its Biggest Problem' The New York Times, January 30, 2017.

GDP and that the benefits of increased GDP would “*trickle down to*” to all levels of society¹¹⁸.

In sharp contrast to these projections, the middle-class has been besieged by wage reductions, underemployment and even unemployment¹¹⁹. In a world pervaded by corporate short-termism the margins may prove too attractive for companies to prioritise the social benefits of local job creation, against siting these jobs abroad. Especially considering the immense impact on firm profitability and direct benefits in bonuses and other forms of monetary compensation for CEOs and other managers. It has become a classic case of ‘*heads I win; tails you lose*’.

4.5.3. Share Buy-Backs as means of Increasing Profitability in a Globalised World

Share buy-backs have steadily been utilised by the largest corporations as a mechanism to increase firm value in the short-term. What was once considered to be a form of market manipulation, has due to policy changes, gradually exploded into widespread use, with the percentage of corporate profits ploughed back into share repurchases, having grown exponentially over the past two decades¹²⁰.

Share buy-backs or repurchases, as the term implies, involves the use of corporate funds to repurchase shares previously sold to investors on the various exchanges, with

¹¹⁸ Stiglitz (n10) 78.

¹¹⁹ Ibid, 79.

¹²⁰ Lazonick shows that while average annual repurchases by the largest U.S firms, represented about 3.6 per cent of net earnings, between 1981-82, this figure grew to 89 per cent by 2007, about \$500B of net income. William Lazonick ‘*The Financialization of the U.S Corporation: What Has Been Lost, and How Can It Be Regained*’ Seattle University Law Review Vol.37, 857 at 881, 882.

a view to increasing the share price and firm value in the shorter-term. The practice functions on the standard economic theory of demand/supply, whereby the more funds committed to repurchases, the less of the firm's stock becomes available in the open market, causing a demand, with the invariable rise in the share price being the consequence.

Prior to 1982, buy-backs were faux pas, a way to manipulate the market and frowned upon. However, following the wave of deregulation of the financial sector which began in the 1980's, a change in policy ensured that buy backs were rebirthed as a way to "confer a material benefit on shareholders"¹²¹. With the latter providing the ideological cum economic justification, the utilisation of share repurchases increased greatly. On this note, Lazonick reports that between 2003-2012, the largest firms dedicated 91 per cent of their earnings towards share repurchases, leaving just 9 per cent for other corporate activity¹²². Going beyond profits, even when firms have been granted a windfall due to government legislation, the figures show that a larger portion has been used to buy-back shares, with far less being dedicated towards job creation and wage increases, which is the intent of such measures¹²³.

¹²¹ This changed with the passing of *Rule 10b-18*, which provided companies with a 'safe harbour'. The so-called safe harbour protected companies from manipulation charges so long as their open market purchases did not exceed "25 per cent of the stock's average daily trading volume over the previous four weeks and if the company refrained from doing buybacks at the beginning and end of the trading day". Ibid at 880.

¹²² William Lazonick 'Profits Without Prosperity'. Harvard Business Review, September 2014 Issue. (accessed on 22/07/2018).

¹²³ Two instances of these; in 2004, as part of the American Job Creation Act, the U.S congress allowed eligible firms repatriate \$312B worth of overseas profits back into the country, granting them a tax holiday as an incentive to do so. The intent was for that money to be utilised in job creation and wage increases. However, the statistics show that 91 cents of every dollar were spent on share repurchases, while tens of thousands of jobs, were slashed by participating companies. A similar amnesty granted in December 2017 via the Tax Cuts and Jobs Act, has led to over \$500B in share repurchases, with only \$6.9B spent on wages and job creation. see, Jeff Cox 'The last time companies got a break on overseas profits, it didn't work out well' CNBC.com <<https://www.cnbc.com/2017/04/26/what-happened-the-last-time-companies-got-a-break-on-overseas-profits.html>> (accessed 11/07/2018). Also see, Cory

Share buy-backs evidence a current dispensation, where firms habitually eschew investments in employees and communities they inhabit, in favour of increasing shareholder value. Furthermore, the methodology of managerial compensation- wherein managerial wealth is intricately tied to shareholder value creation-ensures personal wealth increases as well. Hence, an argument could be made that share buy-backs are as much about CEO rent extraction than they are about shareholder wealth maximization.

As Lazonick highlights, firms that engage in share buy-backs attempt to justify the practice on the need to foster confidence in the firm's future prospects, as measured by share price performance¹²⁴. By repurchasing stock, executives intend to signal to the market that their stock is undervalued. However, as Lazonick argues, if the latter were the case, there would be a "*massive sell-off of corporate stock*" to take advantage of "*the speculative boom*" to raise funds to either "*pay off corporate debt or bolster corporate treasuries*". But rather, he stated that during the speculative boom of the 1990's, CEOs began selling off their own stakes in the company, following price hikes which had been triggered following massive repurchase schemes¹²⁵.

He argues that share buy-backs are a value extracting exercise and goes on to mention a plethora of industries and sectors which have been inhibited by the corporate focus on investing its profits and returns in repurchasing its shares, to detriment of

Booker '*The American Dream Deferred*'. The Brookings Institute (June 2018)
https://www.brookings.edu/essay/senator-booker-american-dream-deferred/?utm_campaign=brookingscomm&utm_source=hs_email&utm_medium=email&utm_content=64076453.

¹²⁴ Lazonick (n121) 886.

¹²⁵ *ibid*

innovation and long-term growth¹²⁶. Undoubtedly, the prime beneficiaries of the practice of repurchasing shares, are the investors and executives, particularly the CEO. Given the argument that the utilisation of buy-backs boosts executive pay to the detriment of longer-term firm value, it becomes then difficult to argue that the practice in its guise as a stimulant for executive pay, meets the requirements of the Rawlsian difference principle¹²⁷.

While CEO pay has grown, research has shown a linear connection between buy backs and cost cutting measures within firms, like wage stagnation, job cuts and relocations etc. all factors contributing to the wealth gap between CEOs and ordinary workers. Considering Rawls' requirement that the least must prefer their prospects with the inequality than without, the adverse effects of the buy-backs to the well-being of the ordinary worker, ensures that this cannot be the case. Therefore, the significant benefits of buy-backs juxtaposed against the adversity to other workers as a result, further indicts the justice of executive pay in its currency.

¹²⁶ Lazonick argues that industries from the Energy sector to ICT have failed to attain their full growth potential, due to the focus on share repurchases. Lazonick (n121) 890.

¹²⁷ The UK Government in January 2018, commissioned research into share repurchase schemes, to investigate whether buy-backs are in fact being utilised to increase executive pay. The research is being carried out by PwC, supported by Professor Alex Edman, with the results to be made available towards the end of 2018. Highlighting the *raison d'être* behind the research, the Business secretary Greg Clark stated, that "*there are concerns that some companies may be trying to artificially inflate executive pay by buying back their own shares. This review will examine how share buyback schemes are used and whether any action is required to prevent them from being abused*". Department for Business, Energy and Industrial Strategy, "*Government to research whether companies buy back their own shares to inflate executive pay*" January 2018. Available at <<https://www.gov.uk/government/news/government-to-research-whether-companies-buy-back-their-own-shares-to-inflate-executive-pay>> (accessed on 05/08/2018).

4.6. Globalization: The Convergence of Corporate Governance Systems as a Driver of Executive Compensation

Having already discussed the effect of globalisation on wages of low-skilled workers- as exerting downward pressure on wages- in sharp contrast to the latter, globalisation is argued to be one of the greater drivers of executive pay, particularly within companies outside of the U.S¹²⁸. As already established over the course of the thesis, the interdependency of the UK and U.S markets, has led to inherent similarities in the respective modes of corporate governance, particularly with respect to executive compensation. This section would argue that executive pay levels are less susceptible to performance, than they are to external influences and market trends.

U.S-based CEOs are better paid on average than those based outside of the States. UK CEOs come a close second, with overall levels closer to the U.S levels than what could be obtained in most of the developed world¹²⁹. Proper place to start would be to examine some of the reasons put forward for this in the literature.

Gerakos et al, cite globalisation as one of the core drivers for CEO pay in the UK. Increasing globalisation has led to higher levels of interaction between the UK and U.S markets and they posit that this increased interaction, places UK firms in direct

¹²⁸ Joseph Gerakos, Joseph Piotroski and Suraj Srinivasan 'Do US Market Interactions affect CEO Pay? Evidence from UK Companies' Working Paper 11-075 (<http://ssrn.com/abstract=1738083>).

¹²⁹ Piketty (n6) 318.

competition with their U.S counterparts¹³⁰. A competition which is not only product-based, but which extends to CEO talent. Their position is supported by Marin, who argues that the popular explanations for the continued surge in pay are unsupported by data and blame the rise in pay on globalisation and the “*changing nature of the corporation and the integration of rich economies into the world economy*”¹³¹. Citing long-run data from 1936-2005, Marin argues that Bebchuk’s theory of managerial power due to the inadequacies of internal governance mechanisms, falls short as a comprehensive explanation for the rise in pay levels. She mentioned that although corporate governance was significantly weaker half a century ago, pay levels in the 1950’s and 60’s was much lower than they have been more recently. Stating that the rise in pay levels in the 1970’s coincided with the acceleration of international trade and the focus on performance -sensitivity in pay determination¹³².

Arguing further that the increase in trade exposure for firms has led to a “*war for managerial talent*”. Making managers assets to the firms they serve, as such pay is artificially ratcheted up resulting from a bidding war firms must engage in to prevent their best talent, being poached by foreign or international competitors. This threat is higher in firms outside of the U.S, whose exposure to U.S markets, places their managerial talent in full view of their American competitors¹³³. This argument finds

¹³⁰ Ibid at 2.

¹³¹ Dalia Marin ‘*The Battle for Talent: Globalisation and the Rise of Executive Pay*’ IDEAS Working Paper Series RePEc 2009, at 2 (<http://ideas.repec.org.ezproxy.lancs.ac.uk/p/bre/wpaper/236.html>).

¹³² Ibid at 4.

¹³³ Ibid at 5.

support in a study by Cunat and Guadalupe, who also find that executive pay levels were driven by a sensitivity to international trade exposure¹³⁴.

They surmise that the increase in pay levels was catalysed by an increase in *“foreign competition which results from a reduction in trade barriers and globalization of economic activity”*. They find that greater foreign exposure leads to more *“incentive provision in a variety of ways”*. Amongst the reasons for these are; the fact that competition leads to greater performance sensitivity and higher competition also leads to greater CEO mobility¹³⁵. To the first point, their research showed that increasing foreign competition led to a reduction in the levels of fixed compensation. Showing a focus on the utilisation of incentives in a bid to spur a competitive edge, hence the greater performance sensitivity, which also impacts *“the steepness of pay inequality within the firm”*¹³⁶.

The integration and internalisation of trade, has inadvertently led to the globalisation of labour markets, for all levels on the skill rung, having a particularly positive effect on the pay of highly-skilled workers in general. Whereas the levelling of geographical barriers has negatively impacted, low-skilled wages, CEO wages on the other hand have risen exponentially. Cheffins notes that the internationalisation of the managerial labour market, and the cross-border hiring which results, has had an ‘Americanising’ effect on executive pay in firms outside the U.S, particularly in the UK. Echoing Marin’s argument, that the *“fear of losing top people”*, would compel firms to adopt American

¹³⁴ Vincente Cunat and Maria Guadalupe ‘Globalization and the provision of Incentives Inside the Firm’. Available at (<http://www.law.columbia.edu/sites/default/files/microsites/contract-economic-organization/files/working-papers/mcglob1006.pdf>).

¹³⁵ Ibid at 2.

¹³⁶ Ibid at 4.

compensatory practices-with its focus on variable pay-which could effectively drive pay upwards in countries like the UK¹³⁷. Mentioning also that the hiring of U.S CEOs could also have swelling effect on pay levels. Arguing that American executives would be reluctant to take up positions outside of the U.S, unless they were guaranteed to earn similar levels of pay as they would in the states¹³⁸.

Similarly, Gerakos et al find that UK firms with local directors with U.S board service or who have American directors serving on their boards, have a greater tendency to pay higher wages. This is because directors with U.S based experience, would be more likely to adopt U.S style compensatory practices, opting for a mix of fixed and variable pay, with the latter consisting of a number of incentivized arrangements. Hence, they are more likely to offer larger cash bonuses and option grants, than firms without U.S based directors serving on their boards¹³⁹.

Furthermore, Gerakos et al posit that compensation is higher amongst UK firms listed on U.S exchanges. They find this fact to be true amongst non-UK firms, whom are similarly listed. They suggest however that the higher remuneration levels are in effect a reward for the heightened risks associated with a foreign listing¹⁴⁰.

In sum, these authors argue that the shift to American style compensation is part of a larger convergence to the U.S corporate governance model, of which the erstwhile mentioned forces of globalisation, represent the primary conduits through which that is attained. The following section would briefly discuss the theoretical postulations of

¹³⁷ Brian R. Cheffins 'Will Executive Pay Globalise Along American Lines?' Corporate Governance, [2003] Vol.11 No.1 pp.8-24 at 13.

¹³⁸ Ibid.

¹³⁹ Gerakos et al (n128) 12.

¹⁴⁰ Ibid at 22.

a global convergence towards the Anglo-American governance model and how these impacts executive compensation levels in the UK amongst other countries.

4.6.1. Global Corporate Governance Convergence and its Effect on Executive Pay

At the turn of the century, Harvard academics Hansmann and Kraakman declared an end of the history of corporate governance, declaring that Anglo-American governance model had proven to be the most likely to foster peak efficiency. Thus, there would be the inevitable convergence towards this model globally, in recognition of its superiority and in a bid to emulate the U.S economic success¹⁴¹. They claim that the forces of competition brought about by increasing globalisation would compel convergence to the shareholder model¹⁴². To create a backdrop for their arguments, it perhaps fair to mention that their research was published while the American economy was experiencing unprecedented boom and U.S firms were at the pinnacle of international trade and commerce.

Bebchuk and Roe had previously rejected the notion of a global convergence towards the Anglo-American governance model, arguing that the path dependence of corporate governance models, would force a persistence that would deter a wholesale adoption of the Anglo-American model¹⁴³. Accordingly, these forces of persistence are both structural-as represented by the complementary and formal structures that

¹⁴¹ H. Hansmann and R. Kraakmann, *"The End of History of Corporate Law"* Harvard Law School Discussion Paper No. 280 January 2000.

¹⁴² Ibid at 13.

¹⁴³ Lucian Bebchuk and Mark Roe, *"Path Dependence in Ownership and Governance"*. Working Paper No.131 [November 1999] at 7.

support the existing governance model-as well as the legal and regulatory frameworks that are derived to legitimise the entrenched structures¹⁴⁴. This argument recognises that corporate governance systems are reflective of the inherent cultural peculiarities of a given jurisdiction, therefore the wholesale transplantation of the American model may not be feasible.

The arguments for convergence are not without an evidentiary basis however, convergence enthusiasts cite the expansion of capital markets in countries not previously known for great levels of shareholder dispersion, as evidence of this. Furthermore, they site increasing shareholder activism, increasing levels of corporate acquisitions, the cross-listing of firms in continental Europe due to internationalisation and the adoption of Anglo-American compensation methods, to support this argument¹⁴⁵. Gilson on the other hand posits that these examples iterate a convergence in function rather than form. Whereas formal convergence would require a complete revamp of the existing governance system, ideologically and administratively, convergence in function only requires a shift in the methodology of attaining the corporate objective¹⁴⁶. This functional convergence is most evident in executive compensation.

The last decade bore witness to the increasing adoption of Anglo-American methods of executive compensation in jurisdictions outside the U.S. the UK has traditionally

¹⁴⁴ Ibid at 10.

¹⁴⁵ Marc Goergen Miguel C. Manjon Luc Renneboog, "*Is the German System of Corporate Governance Converging Towards the Anglo-American Model?*" *Journal of management Governance* [2008] 12; 37-71.

¹⁴⁶ Ronald Gilson, "*Globalizing Corporate Governance: Convergence of Form or Function, in Convergence and Persistence in Corporate Governance*" edited by J. Gordon and M. Roe (CUP 2004, Cambridge) at 137.

borne similarities to the U.S both in function and form, and generally began adopting U.S style compensation practices in the 1980's¹⁴⁷. However, functional convergence in compensation is most evident in jurisdictions in continental Europe, with Germany as a prime example. Although German corporate governance model has remained largely unchanged, with its co-determinative structure of dual boards and employee representation in all aspects of corporate governance including executive pay setting. There have however been changes in the way corporations reward executives, like the use of cash bonuses and the establishment of equity participation schemes for CEOs and other executives. Thus, German executives whose pay historically lagged their UK contemporaries, exceeded the latter for the first time recently¹⁴⁸. This functional shift towards the Anglo-American pay levels and methodology is also evident in countries like France and Switzerland¹⁴⁹.

All of this is evidence of a wider trend which Cheffins referred to as the '*Americanization*' of executive compensation in jurisdictions outside the U.S. he posits that there would be a convergence towards American compensatory practices, when high CEO wages are accompanied by sustained growth in corporate performance¹⁵⁰. However, he did note that a slump in economic performance-like the 2007 financial crises-might raise a barrier to the potential shift to the Anglo-American model of executive compensation.

¹⁴⁷ Martin Conyon et al 'The Executive Compensation Controversy: A Transatlantic Analysis'. Available at <<https://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1004&context=ics>> at 62.

¹⁴⁸ Alex Barker and Chris Bryant '*Germany overtakes UK in corporate executive pay stakes*' Financial Times, January 5, 2015.

¹⁴⁹ Ibid.

¹⁵⁰ Cheffins (n137) 11.

It is important to mention on a final note that the persistence noted by Bebchuk and Roe as an obstacle to convergence, could also apply to executive compensation. There are few nations outside the U.S and UK, with the requisite tolerance for the levels of pay inequality found within Anglo-American companies and wider society. As such the socio-cultural tendencies towards egalitarianism, might have a suppressive effect on the growth of executive pay, such that despite the adoption of Anglo-American methods of compensation, the levels of pay would remain below the average levels in UK and U.S. Such is the case in jurisdictions in continental Europe, where except for countries like Switzerland and Germany, which have pay levels similar to the UK, the rest of Europe while largely converging towards the methodology of compensation i.e. utilising equity-based compensation, cash bonuses etc. pay levels have remained comparatively low.

The preceding discussion is germane to the theme of desert in discussing the justice of high executive compensation, in the context of society with rapidly growing income inequality. The notion of an artificial convergence towards a compensatory ideology to maintain a competitive edge belies the arguments of desert, based on marginal productivity. Averaging pay at levels beyond reason, on the justification of a scarcity of managerial talent-which is unsupported by evidence-appears beyond the pale, given that the present culture of high executive pay does not appear to work to the benefit of the least in society, or any beyond the actual recipients of the awards.

Also, of relevance to the wider discussion on the antecedents of high executive pay, is the fact that there has been a notable rise in inequality levels in jurisdictions, not normally known for unconscionable levels of inequality, where executive

compensation is on the rise. Countries like Germany, Sweden as well as other Nordic countries, witnessed unprecedented increases in income inequality levels in the last decade¹⁵¹. The growth in inequality in these countries outpaced the growth elsewhere, although they remain largely egalitarian at least in comparison to the UK and U.S. It would be unfair to attribute this entirely to the rise in executive pay, however it could be argued that the growth in inequality mirrors the latter.

4.7. In Conclusion

The thesis has sought in the preceding to engage the subject of the justice of high executive pay, by analysing it in context and considering its externalities. *In other words, is high executive pay avarice or just desert?* Having examined both Nozick's and Rawls's thoughts on the concept of justice in distribution, against a real-world context, it could lead only to the conclusion that high executive pay is neither justified nor could it be justifiable given the status quo.

The main argument that could be made against high executive pay is its role as a contributor to income inequality, which does not render it unjust-as excessiveness of a reward is not prima facie proof of its injustice-largely because questions of excess are subjective by their very nature. In this case, high executive pay is rendered unjust by the presence of two key factors; the way it is ultimately determined and the

¹⁵¹ OECD Report 'An Overview of Growing Income Inequalities in OECD Countries: Main Findings'. Available at (<https://www.oecd.org/els/soc/49499779.pdf>)

absence of key redistributive mechanisms that would allow the benefits filter to the least.

With regards to the first instance, the pay determination process goes beyond the deliberation of an independent remuneration committee. The latter instead, adhere to an accepted regime forged by a culture of excess. Pay is less sensitive to individual performance as it is to the status quo, a standardised level determined more by firm size and cults of personality, than by actual performance. Furthermore, the prioritisation of shareholders' interests, ensures that measures taken to the maximize value are often to the detriment of the constituencies, mainly the firm's other employees and the host environment. That the legacy of increased productivity and a more prosperous economy is outlandish pay packages for the executives and wage stagnation, underemployment and job insecurity for the almost everyone else, speaks of a system rigged to benefit a few at the expense of the most. Such a system would be incapable of producing just outcomes.

The absence of a viable system of redistribution acts as a further indictment on high executive pay. Rawls theorises inequalities in income could only be justified when they work to the benefit of the poorest in society. That could only work when proper redistributive policies are in place to ensure that the excess filters down to the rest of society. However, the willingness of the elite classes to share the benefits of their wealth, is at historic lows and has been aided by the gradual but consistent erosion of the redistributive qualities of tax policies in recent times. Such that wealthy corporations and individuals are required to pay less than they would perhaps been required to 50 years ago, when tax limits were much higher for the very wealthy.

This very fact may be evidence of the efforts by the wealthy-popularly referred to as the “1 percent”-using their influence and reach to limit their financial obligations to the state. It would be fair to state that any effort to tackle income inequality, would not only require making executive pay fairer, but would need to ensure that when the inevitable disparities in income distribution occurs, the appropriate redistributive mechanisms are in place to maximize the benefits to the least privileged sections of society.

Chapter Five

The Issue of High Executive Pay in Anglo-America: The Judiciary and other Solutions

5.1. Introduction

Rising executive pay levels have in recent years become a major topic of public debate. Helped in no small way by the recent global financial meltdown, which triggered losses of jobs and homes, vanishing personal wealth and stagnated wages globally with the pinch felt hardest by ordinary people. Raising questions on the appropriateness of high pay and its role as a catalyst of corporate short-termism¹. The debate on the justice of high executive pay, could be linked to similar debates in the inter war years².

The executive pay issue could be traced back to 1930's America, the age of the 'million-dollar executive'³. What was thought at that time to be excessive compensation packages being handed out to executives led to radical enforcement procedures put in place in a bid to stymie the rise in executive pay. Procedures such as the then novel practice of disclosure of pay packages, enforcement of which was the mandate of a newly established Securities and Exchange Commission, given powers under the *Securities and Exchange Commission Act of 1934*. The populist opinion was that executive compensation needed to be reined in and vehicles to that effect like the SEC Act 1934, were thus welcome.

Executive pay was largely unaffected by the economic downturn and increased as corporate revenues recovered and then soared to pre-crises levels in some cases. As discussed in the previous chapters, executive pay amongst the largest Anglo-American

firms, continues its upward trajectory. With recent figures showing the median CEO pay within the FTSE 100, standing at £3.93m, while average CEO pay stands a lot higher at £5.65m⁴. Average executive compensation for U.S based CEOs currently stands at £18.9m, according to 2017 figures⁵. With the three top earners receiving a combined \$300m in compensation⁶.

In the UK, the ratio between average FTSE 100 CEO pay and the average wage is 147:1, while CEO pay to average total pay is 129:1⁷. It has been the mainstream argument that executive pay is the endpoint of an efficient market system and the interactions therein⁸. However, the aim here is not to examine the validity of that argument but rather the justice of high or perhaps high executive pay, through the lens of the judiciary.

For long, prescribed solutions to excessive pay rises have darted between market-oriented solutions and increased government regulation of pay issues, but there has not been as much of a call for judicial review of executive pay levels.

¹ Charlotte Villiers, "Controlling Executive Pay: Institutional Investors or Distributive Justice?" *Journal of Corporate Law Studies*, Vol. 10 Part II Oct 2010 309. For an exposition on the link between the short-term corporate focus and the financial crises, see: Alfred Rappaport, *Saving Capitalism from Short-termism: how to Build Long Term Value and Take Back Our Financial Future* (McGraw Hill, 2011) 19.

² Randall S. Thomas and Harwell Wells, "Executive Compensation in the Courts: Board Capture, Optimal Contracting and officer's Fiduciary Duty" *Minnesota Law Review*, Vol.95 2010-2011, pp.846-905 at 905

³ *Ibid* at 866.

⁴ High Pay Centre Report 'Executive Pay: Review of the FTSE 100 executive pay'. Available at <http://highpaycentre.org/files/CEO_pay_report.pdf> (accessed 19/08/2018).

⁵ David Gelles 'Want to Make Money Like a C.E.O.? Work for 275 Years'. *The New York Times*, (May 25, 2018).

⁶ Jana Kasperkevic 'America's top CEOs pocket 340 times more than average workers' *The Guardian*, 17 May 2016.

⁷ This is lower than the current U.S ratio of 312:1. HPC report (n4).

⁸ Daniel R. Fischel, "The Corporate Governance Movement", *Vanderbilt Law Review*, Vol.35 1982, 1259.

This chapter is intended to discuss the solutions to the issues surrounding executive pay which have been examined via the two research questions. Having highlighted the corporate governance failures which allow a culture of excess in Chapter Three and the wider implications of said culture in Chapter Four, the present chapter will look to explore prescriptions to the highlighted problems. Given the nature of the issue, in terms of its justice implications, the judiciary would be an obvious place to begin. However, this Chapter argues that the courts cannot be relied upon to provide said solution, due to its historical reluctance to engage in an *ex-post* examination of business decisions, in the absence of compelling evidence of managerial foul play.

This attitude of non-interference has been recognised as the Business Judgement Rule in some jurisdictions, and codified in countries including the U.S. Although there currently is no formal recognition of the Rule as a legal doctrine in the UK, the attitude of non-intervention in business decisions-with the exception of instances of gross misconduct by directors-prevails. This attitude impacts the courts approach to the issue of high executive compensation.

As would be discussed in this Chapter, despite several opportunities-most of these arising in the U.S-the Anglo-American courts have refrained from lending a voice to the executive pay debate. Manifested mainly by its strict adherence to the inordinate procedural complexities involved in executive pay litigation, regardless of the justice demands of the individual cases.

This failure suggests the judiciary, perhaps cannot be relied upon as an instrument in making executive pay fairer. Leaving a vacuum which could possibly be filled by legislation.

The Chapter is outlined thus; the following section will briefly recap some of the arguments surrounding the executive pay debate and highlight prior attempts to make pay fairer. The following section will examine some of the difficulties in litigating executive compensation cases and why the courts cannot be relied upon in the effort to make executive pay fairer. Following this, the chapter would analyse the non-interventionist approach of the Anglo-American judiciary to pay issues, as manifested through the Business Judgement Rule in some jurisdiction. The final section would discuss existing measures put in place to enhance the fairness of executive pay, in a bid to highlight their efficacy thus far. The section would also discuss further reforms to the current governance framework in terms of their potential to heighten the fairness of executive pay.

5.2. Current CEO Pay levels: A Manifestation of Managerial Rent-

Seeking?

Reasons have been proffered to explain the growth in executive pay. Some of those reasons have been mentioned in Chapter 3, however to provide context, I would briefly highlight some of these arguments.

Discussed in Chapter Three was Bebchuk and Fried's theory managerial influence over the management board. They argue, that the role CEOs play in the nomination of board members, works to compromise the latter's effectiveness. Creating a situation

where board members are sufficiently beholden to the CEO, allowing her to exert undue influence on matters including compensation⁹.

In contemplating the efficacy of the independent board as a prophylactic to managerial overreach and rent-seeking behaviours, Brudney underlined a number of factors which could impede board effectiveness. Like Bebchuk et al, he posits that the psychological and social factors at play in the boardroom-the collegiality amongst co-directors, arising due to prior relationships and similar social background-could make directors biased towards the CEO's needs¹⁰.

Taking these theories at face value could precipitate the conclusion that current executive pay levels do not result from symmetrical transactions between the CEO and the board. The process by which board members are elected and the circumstances under which the board is meant to function, evinces some of the flaws inherent within Anglo-American corporate governance and this is representative of some of the areas in need of reform.

Benchmarking pay to the industry average has been cited as a reason for rising pay levels¹¹. This practice has become pervasive and widely used by compensation committees in pay setting¹². It however goes against the grain of the pay for

⁹ Chapter 3, 3.3.

¹⁰ Ibid, p.62.

¹¹ Charles Elson and Craig K. Ferrere "*Executive Superstars, Peer Groups and Over Compensation—Cause, Effect and Solution*". 105 Available at <<http://ssrn.com/abstract=2125979>> (accessed on 25/07/2018).

¹² Mahmoud Ezzamel and Robert Watson, '*Market Comparison Earnings and the Bidding-Up of Executive Cash Compensation: Evidence from the United Kingdom*' The Academy of Management Journal [April 1998] Vol. 41, No.2, at 230.

performance justification for high pay and in a sense, exposes the weak link between executive pay and corporate performance.

Concerns and outrage about executive pay levels led to calls for reform in a bid to make pay fairer. This has led to legislative attempts to improve the transparency and accountability of the pay setting process. Steps have been taken in the U.S to improve the disclosure of pay packages i.e. the figures and metrics through which they were realised and the company's policy on executive compensation, could be found in the *Public Company Accounting Reform and Investor Protection Act* of 2002, known colloquially as the Sarbanes-Oxley Act , which provided for stricter disclosure requirements¹³, and the passing of the *Wall Street Reform and Consumer Protection Act* (hereinafter the Dodd-Frank Act) in 2010, which had extensive say on pay provisions, exceeding previous provisions of a similar tenor¹⁴.

In the United Kingdom, the Greenbury Report plus recent amendments to the *Companies Act 2006* via the S.79 of the *Enterprise and Regulatory Reform Act 2013* and the *Financial Reporting Council's Corporate Governance Code* all have, in varying degrees, provisions urging for full pay disclosure¹⁵. Recent research shows a failure of these disclosure requirements to stymie the growth of pay as well as the income

¹³ The Act was a legislative response to the accounting scandals that occurred in the early 2000's and provides in sections 302,401 & 404 for stricter internal controls and accountability in the proffering of financial statements.

¹⁴ Designated, *the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010*, went further than previous disclosure provisions by containing requirements that companies disclose the ratio of top executive compensation to those of the median earners. (See S.953).

¹⁵ The director's remuneration report regulation introduced in 2002, was the first say on pay provision in the UK, it required that the remuneration committee put the remuneration report to a non-binding shareholder vote every business year. Mild improvements were made to this provision in the E.R.R Act 2013. As well the FRC released a revised version of the corporate governance code in April 2016, which had clear provisions on transparency in compensation policy development. See, UK Corporate Governance Code 2016, p.21.

divide. Evidenced by the continued rise in pay even for those executives whose pay had been voted against by shareholders¹⁶. As a matter of fact, heightened disclosure may have the inadvertent effect of aiding the growth of total compensation¹⁷.

Proposed solutions to the pay conundrum have been centred around better shareholder engagement and increasing pressure from institutional investors¹⁸. Neither of these options appear to be viable in practice. For one, institutional investors are primarily concerned with the return on their investments and while they may occasionally raise concerns on the size of executive pay, they could be expected to side with management as long as the company remains profitable. Furthermore, institutional investors are often plagued by the same agency and short-termist problems, much like the firms they monitor¹⁹. Some even lay the blame for rising compensation levels at the feet of institutional shareholders²⁰. Since “*shareholders did not adequately constrain executive compensation that was set by managers with little outside control*”²¹. Furthermore, the fickle nature of share ownership, and the ease with which diversified investors could liquidate their interests, makes the prospect of a shareholder led intervention as a stop gap to executive and corporate excess unlikely.

¹⁶ Aditi Gupta, Jenny Chu and Xing Che “*Form Over Substance? An Investigation of Recent Remuneration Disclosure Changes in the UK*”. Available at (http://papers.ssrn.com.ezproxy.lancs.ac.uk/sol3/papers.cfm?abstract_id=2798001).

¹⁷ Heightened disclosure may lead to the artificial ratcheting up of executive pay, whereby lower paid CEOs, get pay rises, to bring their earnings in line with the comparator average. See, Alexandre Mas ‘*Does Disclosure affect CEO Pay Setting?*’ March 2016. Available at (<https://www.princeton.edu/~amas/papers/CEODisclosureMandate.pdf>).

Evidence from the Passage of the 1934 Securities and Exchange Act

¹⁸ Villiers (n1) 325, 326.

¹⁹ Villiers, (n1) 331.

²⁰ R.S Karmel, “*Should a Duty to the Corporation Be Imposed on Institutional Investors*” Business Lawyer, Vol.60 Nov. 2004, 1.

²¹ Ibid, at 8.

5.3 Adjudicating Executive Pay Issues

5.3.1 Executive Pay Litigation in the U.S: The Business Judgement Rule

The Business Judgment Rule, as codified in the U.S amongst other jurisdictions i.e. Australia, requires that judges when faced with matters that may involve a review of business decisions, defer to the decision of the board of directors in the absence of clear evidence of fraud or that the directors had failed to exercise its common-law duties of care, loyalty and to act in good faith when taking the decision²². It must be stated that the Rule applies solely to business decisions, i.e. “*decisions to take or not to take action in respect of a matter relevant to the business operations of the company*”²³. Therefore, the rule can only be applied when the disputed decisions were a product of a valid exercise of director’s discretionary business judgement and not a responsibility imposed by statute²⁴. The Delaware courts in *Aronson v Lewis*²⁵, held that provided the directors, acted in good faith, were duly informed on the of the stated transaction, acted not out of self-interest but reasonably believed the decision at the point of making it, to be in the best interest of the company, they could not be personally liable if the decision turned out not to be in the company’s best interest²⁶.

This restraint on the courts ability to adjudicate business decisions that qualify for protection under the Business Judgement Rule, has limited the court’s capacity to

²² *Shlensky v Wrigley* [1968] 237 N.E 2d 776.

²³ S.180 (3) of the *Australian Corporations Law Act*.

²⁴ *ASIC v Healey* (No 2) [2011] FCA 1003.

²⁵ 473 A.2d. 805.

²⁶ *Ibid*, similar to provisions set out in S. 180(2) of the *Australian Corporations Law Act 2001*.

intervene in executive compensation matters. While also severely limiting the ability of shareholders aggrieved by executive pay awards, to challenge these through the courts.

The direct consequence of applying the Business Judgement Rule to executive compensation cases, is that the courts cannot be relied upon to curb the growth in executive pay. The indirect consequence of rule is that the courts are inhibited in their role as a bastion of justice and fairness and unable to make a meaningful impact, despite the growing public agitation to make executive pay fairer. As a result, the income inequalities to which high executive pay contributes, continue to persist. This reality perhaps opens the door to a discussion of a wholesale exemption of executive compensation matters from within the purview of the rule.

The law does provide exceptions to the overarching rule in cases where the egregiousness of the challenged compensation, in a sense unmasks the underlining intent. The requirements for qualifying for exception from the rule are steep and difficult to meet. Two of these exceptions, namely; the corporate waste doctrine devised by the U.S courts and the broadly defined unfairly prejudicial relief, which the English courts have regarded as an exception to its principle of non-interference in business decisions.

5.4. The Exceptions to the Application of the Business Judgment Rule.

5.4.1. The Corporate Waste Doctrine.

The reluctance of U.S courts to review business decisions has generally been extended to executive compensation cases²⁷. However, the rule is excused when compensation awards are so egregious as to necessitate a judicial review of such decisions. This happens in corporate waste cases, where the plaintiffs allege there has been a gifting of corporate assets. In these instances, the onus is on the claimants, usually a shareholder(s) to prove that the compensation paid out to the CEO and or other serving executives was so out of proportion with the contemporaneous performance as to constitute making a gift of corporate assets.

The court in the old American case of *Rogers v Hill*²⁸ held that if compensation paid to executives was out of touch with the performance for which they were given they could be considered a gift of corporate assets which directors had no right to do. The case involved a million-dollar award made to a tobacco company's CEO at the height of the great depression and the court decided that even in the absence of fraud or clear evidence of self-dealing, that compensation could be so high as to be regarded as unreasonable. The onus once again is placed firmly on the shoulders of the one supposing such an irregularity or unreasonableness of the sum awarded.

However, before the courts would entertain a claim, the claimants would need to overcome a litany of procedural hurdles. Firstly, due to the old common law doctrine

²⁷ *Heller v Boylan*, 29 N.Y. S.2d 653.

²⁸ 289 U.S. 582 (1933).

laid down in *Foss v Harbottle*²⁹, which states that only the company can remedy wrongs done to it. This doctrine was explained further in *Prudential Assurance Co Ltd v Newman (No 2)*³⁰, that “an individual shareholder cannot bring an action in the courts to complain of an irregularity in the conduct of a company’s internal affairs if the irregularity is one that can be cured by a vote of the company in general meeting”³¹. Such an “irregularity” would stand so long as it’s ratified by the majority³². However, S.261 of the UK Companies Act 2006, gives the court the right to grant permission to a shareholder who institutes a derivative action, if it believes there is a prima facie case to answer³³. This provision has effectively replaced the common-law position in England³⁴.

Similar provisions allowing derivative actions to exist in America³⁵, but in executive compensation matters the claimants must unravel an extra layer, known as the demand requirement³⁶. This is the requirement by the courts that a shareholder intending to challenge an executive pay decision because the award constituted a waste of corporate assets, must first prove that he had placed a demand that the board remedy the wrong or otherwise prove the futility of such a demand being

²⁹ [1843] 2 Hare 461.

³⁰ [1982] Ch.204.

³¹ *Ibid*, 210.

³² *Edwards v Halliwell* [1950] 2 All E.R 1064.

³³ Andrew Keay and Joan Loughrey ‘Derivative Proceedings in a Brave New World for Company Management and Shareholders’ *Journal of Business Law* [2010] Issue 3, 151 at 153.

³⁴ *Ibid*.

³⁵ The shareholders right to bring a derivative action could be found in S.7.41 of the MBCA.

³⁶ *Ibid*, S. 7.42. For more on the subject, see Randall Thomas and Kenneth Martins, “Litigation Challenges to Executive Pay: An Exercise in Futility” *Washington University Law Quarterly*, Vol.79, 569, at 576.

made³⁷. The hardships this additional requirement poses to claimants in the litigation of compensation cases would be discussed in the following section.

5.4.1.1. The Demand Requirement: An Impediment to Successful Excessive Remuneration Litigation?

The Delaware Supreme Court in *Brehm v Eisner*³⁸ stated the benefits of the demand requirement, as: allowing the board of directors the chance to settle the matter within the company, thus avoiding potentially damaging litigation and giving the board the chance to determine between frivolous and meritorious suits. However, this requirement may be excused if the court, on the urging of the plaintiff has reason to believe that the making of such a demand would in the end be fruitless. The responsibility for proving the futility of a demand would invariably be on the plaintiff, to do this he must first satisfy what is known as the *Aronson's Test*³⁹.

The first part of the two-pronged test requires the plaintiff to provide evidence that the board was beholden to the CEO. Precedent has shown this requirement difficult to prove as *Aronson* would suggest. In that case, despite the presentation of evidence that the embattled CEO had handpicked the board members and owned large portions of the company's shares, the court refused to consider this proof of potential foul play.

³⁷ S. 7.42 of the Model Business Corporation Act, states the procedure to be followed when making a formal demand on the board. It is important to add that, failure to make the demand as required, would except for a few instances, inevitably lead to an outright dismissal of the case following an application by the defence. An exception would be where the plaintiff can prove the futility of making a demand on the board. See, Steven Caywood, 'Wasting the Corporate Waste Doctrine: how the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation' *Michigan Law Review*, Vol.109 111, 121.

³⁸ 746 A.2d 244, 260 (Del. 2000).

³⁹ The test was developed in *Aronson v Lewis* (supra).

Holding in effect, that in the absence of evidential proof that the close relational ties between the CEO and board members had influenced their pay decisions, the directors could not be said to have failed to meet the demand requirement.

Secondly, the plaintiff must prove that the disputed pay package was not subject to the Business Judgement rule. As noted, the requirements for a business decision to qualify for protection under the Business Judgement Rule-the stated payments must have been an exercise of a valid business judgement, must have made an informed decision, acted in good faith and in the honest belief that the said transaction was in the company's best interest⁴⁰. Unless the plaintiff can prove that the directors in deciding to make the disputed payments failed to meet the above requirements, the plaintiff would have failed the second test. This as illustrated by the Delaware courts in the *Aronson* decision. Where it stated:

*"In sum, we conclude that the plaintiff has failed to allege facts with particularity indicating that the Meyers directors were tainted by interest, lacked independence, or took action contrary to Meyers' best interests in order to create a reasonable doubt as to the applicability of the Business Judgment rule"*⁴¹

The second requirement, was considered in the more recent *Brehm v Eisner*, there the plaintiff challenged the decision of a lower court absolving the board of entertainment firm Disney of a breach of their duty of care and loyalty and of committing a waste of corporate assets, by making certain payments to its disgraced former CEO Michael Ovitz to an employment agreement entered prior to his employment. Per the court in

⁴⁰ *Kaplan v Centex Corp*, Del Ch. 284 A.2d 119, [1971].

⁴¹ *Aronson v Lewis* (supra).

Aronson's case, for any board decision to be protected by the Business Judgement Rule, including compensation-based decisions, the directors inter alia must have met the information requirement i.e. they must have informed themselves of all aspects of the disputed transaction before acceding to it⁴². This issue was raised in *Brehm*, as the plaintiff tried to create reasonable doubt that the board had met this requirement and the trial judge in dismissing the claim stated that the requirement was that the directors be "*reasonably informed*", rather than that they be informed of every fact in considering the transaction⁴³. On appeal, the court of chancery stated that the 'reasonably informed' requirement as stated at first instance was more of an abbreviated

*"attempt to paraphrase the Delaware jurisprudence that, in making business decisions, directors must consider all material information reasonably available, and that the directors' process is actionable only if grossly negligent"*⁴⁴.

The Appeal Court stated that the '*reasonably informed*' standard did not require that the directors in exercising their judgement consider every piece of information regarding the transaction, but only those which were readily available to them, certainly not information that was beyond their reach of which there could have been no reasonable expectation that they would be made aware of⁴⁵. The court declared that the plaintiff had failed to provide sufficient evidence so as to rebut the presumption that the directors had duly informed themselves, the court had heard

⁴² Also, contained in S.180 (2) of the *Australian Corporation Law Act 2001*, S.8.30 of the Model Business Corporations Act and S.76 (4) of the *South African Companies Act 71 of 2008*.

⁴³ *Brehm v Eisner* (supra) at 258.

⁴⁴ *Ibid*, 259.

⁴⁵ *Ibid*.

evidence by the plaintiff, that the board had no knowledge of what the financial exposure of the company would be, as none of the directors had taken the time to total the sums as laid out in Mr Ovitz contract of employment, a fact which was admitted to by the compensation expert hired by the board in his witness testimony. The claimants argued this was proof that they had failed to meet the requirements for the decision to ratify the contract, to be considered a valid business judgement, warranting protection under the rule.

However, the Delaware Court of Chancery saw it differently and the court in describing these allegations as insufficient proof of directorial negligence, declared:

“I think it a correct statement of law that the duty of care is still fulfilled even if a Board does not know the exact amount of a severance pay-out but nonetheless is fully informed about the manner in which such a pay-out would be calculated”⁴⁶. A strange decision considering the absurdity of the particularized facts surrounding the case. But the objective at this point is not an analysis of the merits of the court’s decision, but rather to emphasise what an uphill task it is for plaintiffs bringing waste claims even at the preliminary stages.

Statistics show the success rates at this stage of proceedings to be about 41 per cent on average, adjudged by a sample of cases which included those decided within and outside Delaware⁴⁷. Perhaps this single fact could be the reason for the relative shortage of executive compensation litigation stemming from publicly held companies in America. Such cases are more likely to initiate from private companies than they are

⁴⁶ Veasey C.J, quoting the judge at first instance in *Brehm v Eisner* (supra) at 260.

⁴⁷ Thomas and Martins, (n37) at 580.

the latter as the success rates tend to be higher⁴⁸. However, the overwhelming ubiquity of compensation-based litigation originating from privately held companies when pitted against publicly traded firms, as viewed by Thomas et al could be down to the fact that there is more susceptibility in the former to improprieties in the pay fixing process⁴⁹. Stating the dual positions held by officials in these closely held entities as indicative of a self-interest by the manager in fixing his own pay, where they are often able to vote on proposed pay packets. Scenarios of this nature are less likely to occur in public companies, with their better-defined management structures and hierarchies. Besides compensation related issues are usually left to the compensation committees, which in some jurisdictions, is to be comprised mostly of ‘*disinterested*’ non-executive directors⁵⁰. This and the other procedural intricacies in public companies grossly limit the possibility of a potential conflict of interest.

Further reasons could be the innate professionalism with which corporate boards of traded companies are run, being mainly comprised of seasoned and experienced business managers. Also, a greater allotment of the holdings in public companies are controlled institutionally, resources helping them wield considerable influence on the board⁵¹. Furthermore, the lack of a personal involvement by public shareholders in the governance of the firm-only too willing to sell at the first sign of trouble-and the higher compensation to profit differential in traded companies, could be further reasons why

⁴⁸ Ibid, at 585.

⁴⁹ Ibid.

⁵⁰ The UK Corporate Governance Code 2014, requires that the board of listed companies establish remuneration committees to be comprised of at least three (two in the case of smaller companies) independent directors. The committee is only to include the chairman of the board if he could have been independent at the time of his appointment, see p.22.

⁵¹ Brenda Hannigan: *Company Law* 2nd Edition (OUP, 2009) 414.

there is less of an outrage than in their smaller, closely held counterparts⁵². In general, there is a higher conflict potential in private companies, due to the nature and composition, this could be attested to by the higher success rates in compensation-based litigation arising from these types of companies⁵³.

5.5. Why have Corporate Waste Claims been largely Unsuccessful in the U.S?

As stated already the protections offered by the Business Judgement Rule greatly limit the chances for success by aggrieved claimants and these limitations are nowhere more obvious than in corporate waste cases. As one American jurists succinctly put it, successful waste claims are a rarity that could only be likened to sightings of the Loch Ness monster⁵⁴.

The difficulty could be with the way corporate waste is defined⁵⁵. The earliest decided waste claims starting with *Rogers v Hill*, seemed to set the standard for waste at the blatant gifting of corporate assets by directors. The issue at hand in these early cases was the consideration or lack thereof in exchange for the payments made. Therefore, compensation policies that encouraged spousal payments⁵⁶, and bonus payments that could be taken to be retroactive salary reimbursements, as was the case in *Hurt v*

⁵² Thomas and Martins, (n37) 586.

⁵³ Stated that duty of loyalty claims arising from challenged executive pay decisions, the success rates in closely held corporations in America stands at about 51 per cent, as against 15 per cent in public companies. Thomas and Wells, at 585.

⁵⁴ *Steiner v Meyerson*, No. 13139, 1995 WL 441999, at *5 (Del. Ch. July 19, 1995).

⁵⁵ Lawrence A. Cunningham, "A New Legal Theory to test Executive Pay: Contractual Unconscionability" Iowa Law Review Vol. 96 1177 at 1212.

⁵⁶ *Adams v. Smith*, 153 so. 2d 221, (Ala. 1963).

*Cotton States Fertilizer Co*⁵⁷, or stock options which could be exercised instantaneously and did not require continued employment were easily determined as falling within the scope of “*corporate gifts*” defined in *Rogers v Hill*. But it becomes less straightforward when the disputed payments were made pursuant to an employment contract and in ‘reward’ for services rendered.

As previously mentioned so long as the procedure adopted in arriving at the challenged pay matched the standard laid out by statute and case law, the rebuttable presumption of due care and diligence lies in favour of directors. The courts would be averse to review pay related decisions or policies in the absence of facts that suggest fraud or underhand dealings between the parties involved. This regardless of the stated sum or the level of disproportion between the pay-out and company performance. This approach would appear to be validated by the standard in *Rogers*, which is that there must be “*a relation between what the corporation gives and gets*”⁵⁸.

Thus, due to its *quid pro quo* nature this standard has aided in effectively excluding cases that involve compensation for services rendered from within the purview of the waste doctrine. In *Brehm v Eisner*, the first instance court in reiterating the standard, as a transaction so one sided that no business person of sound mind would believe that the company had received adequate consideration, dismissed the plaintiff’s application as failing to meet that standard. The ruling was upheld on appeal, to which the Delaware Supreme Court stated, again reaffirming the view of the lower court that

⁵⁷ 159 F.2d 52, 58 (5th Cir. 1947).

⁵⁸ *Rogers v Hill*, quoted in Cunningham, (n56) at 1212.

executive compensation cases were subject to “*great deference*” stating that it was up to the directors to determine whether a person was worth a lot of money and such issues should not be open to judicial review⁵⁹. Chief Justice Veasey, Quoted Chancellor Allen, in *Lewis v Volgestein*,⁶⁰ when he stated:

“The judicial standard for determination of corporate waste is well developed. Roughly, a waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade. Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift”.

On what the approach for the court should be in these instances, the chancellor in that case went further to state that:

*“if there is a good faith judgment that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude ex post that the **transaction was unreasonably risky**”* [emphasis mine].

The court in affirming the lower court on the waste issue, did however concede that there was an outer limit to the waste doctrine, but these were limited to individual cases where the facts showed an irrational squander of corporate assets⁶¹. A similar decision was reached in *Re Walt Disney Company Derivative litigation*⁶², which was one of several cases that dealt with the Walt Disney compensation saga. Here the

⁵⁹ *Brehm*, [262].

⁶⁰ 699 A.2d 327 (Ch. Of Delaware 1997), 336.

⁶¹ *Brehm* [263].

⁶² 906 A.2d 27, 57 (Del. 2006).

court refuted the plaintiff's allegations of waste because the contract was entered in pursuit of a rational business purpose, since the agreed sums were intended to incentivize the recipient to take up employment with the company and payments made consequent to that agreement could not be considered wasteful⁶³.

The above decisions seemed to leave the corporate waste doctrine in a stalemate⁶⁴. However, the preliminary ruling in the *Re Citigroup* case, is said to have reaffirmed the doctrine⁶⁵. A case heard before the Delaware Court of Chancery that arose in the wake of the 2008 mortgage crisis, instituted by shareholders aggrieved by the erstwhile CEO's multi-million-dollar retirement package, *inter alia*. The court dismissed all the claims save the compensation claim. Stating that the director's discretion to make compensation awards, albeit protected by the Business Judgement Rule, was not unlimited and that where an agreed compensation award was so disproportionate when juxtaposed with the concurrent services, would not cause a reasonable person to believe that there had been adequate consideration given in exchange for the said payments. Hence such a decision could not be regarded as a valid exercise of the director's business judgement, restricting interference by the courts.

⁶³ Ibid, 73-75.

⁶⁴ Caywood, (n38) at 118.

⁶⁵ Ibid.

5.6. Excessive Remuneration Litigation in the United Kingdom:
'the Unfairly Prejudicial Remedy'.

Despite the absence of a statutorily defined Business Judgement Rule, the British courts have generally abstained from a review of business decisions. As a result, compensation-based litigation in the UK has been relatively scarce, especially those involving quoted companies. with the vast majority of excessive remuneration cases involving privately owned companies⁶⁶. Not surprising given that the nature and governance makes them more prone to litigation of the sort. Where the more modest earnings ensure that large pay-outs constitute a larger portion of the profits, than in the much larger quoted companies. Here, excessive remuneration could substantially lead to bankruptcy or failure to pay dividends⁶⁷. Therefore, the outrage potential in response to such levels of compensation would understandably be higher in these types of institutions. This fact could perhaps explain the disparity in decided cases between private and quoted firms, in favour of the former⁶⁸.

This fact could not be demonstrated any more clearly than in the English case of *Smith v Croft (No.3)*⁶⁹, here three minority shareholders challenged payments made to executives to cover expenses as *ultra vires* gifts and a fraud on the minority. Here the court noted that the excessive payments might well have been an abuse of powers by the executive, it stated however “*the uncontradicted evidence of the very special field in which the company operates and the very high level of remuneration which obtains*

⁶⁶ Villiers, (n1) at 333.

⁶⁷ As was the case in *Irvine v Irvine* [2006] EWHC 406 (Ch.).

⁶⁸ Villiers, (n1) at 333.

⁶⁹ [1987] BCC 218.

in that field” put forward by the defendant, as contradictory of that notion⁷⁰. The *dictum* on this point is very much in contrast to the reasoning of the court in the more recent *Irvine v Irvine* decision, and the “*objective commercial criteria*” standard of excessiveness which would be considered later.

The ability of a minority shareholder, who alleges misconduct by the majority or management that impinge on his rights as a shareholder, to bring a claim pursuant to that right have been greatly limited by the *Foss v Harbottle* rule which as earlier mentioned declares the proper plaintiff in such matters to be the company. However, both case law and statute allow a shareholder, to bring a derivative claim on behalf of the company, subject of course to a grant of permission by the court⁷¹. Furthermore, *s.994 of the Companies Act 2006* allows a petitioner who is a shareholder in a private company, who believes his interests have been greatly prejudiced by the way the company’s affairs have and are being conducted to seek relief from the courts.

But before delving into the constituents of the Unfairly Prejudicial Remedy for minority shareholders, it is perhaps important to lay a proper foundation for such a discussion by first highlighting the English Laws position on the process of determining executive pay, as derived from case law. Highlighting the historical reluctance to delve in matters of corporate strategy and decision making in general⁷², as well as the remuneration of those of whom it is their responsibility to make these⁷³.

⁷⁰ Ibid at 236.

⁷¹ See s.261 of the Companies Act 2006.

⁷² *Carlen v Drury* [1812] 35 ER 61.

⁷³ *Guinness v Saunders* [1990] 2 A.C. 663 H.L.

5.6.2. The English Courts General Attitude Towards Adjudicating

Compensation Matters

In the UK, there is an established principle that company directors are not entitled to remuneration while acting within their capacity as fiduciaries⁷⁴. The principle persists with exceptions of course, which include: when remuneration for directors was authorised by contract, authorised by a meeting of the members, or by the company's constitution⁷⁵.

It was held in *Guinness v Saunders*⁷⁶, that the authority to set directors pay was to be determined in accordance with the articles of association. Which in turn creates a potential snag with regards to a possible legal challenge. Where on the one hand, it could create a vehicle for members to challenge compensation deemed to be excessive and without the limits of the company's constitution, it could on the other hand make it difficult to challenge pay decisions or policies which fall within the purview of the company's articles, even when those policies spawn remuneration packages which could be regarded as excessive.

S.171 of the *Companies Act 2006*, outlines a duty for directors to act in accordance with the company's constitution. Directors are required by statute, to develop remuneration policies when the latter duty is carried pursuant to statutory provisions.

Any member challenging the fairness of the policy or remuneration package itself,

⁷⁴ *Hutton v Western Railway Corp* [1883] 23 Ch. D. 654 CA. Also, see *Aberdeen Railway v Blaikie Bros* [1854] 17. D. (H.L.) 20 and *Molineaux v London, Birmingham & Manchester Insurance Co* [1909] 2 KB 589.

⁷⁵ Ernestine Ndzi 'Shareholders Dilemma Regarding Excessive Directors Pay and Unfair Prejudicial Conduct' *Company Lawyer* [2016] Vol.37 (1), pp.3-7. Held also in *Re George Newman & Co* [1895] 1 Ch 674 at 686, per Lindley LJ that directors were not entitled to remuneration, except as authorised by a regulating instrument or a properly convened instrument of the shareholders.

⁷⁶ *Supra* (n74).

would need to establish that the directors acted dishonestly in setting the disputed pay⁷⁷. However, that is where the difficulty begins.

In general, the setting of director's remuneration, particularly in large quoted companies, is the responsibility of the remuneration committee. Remuneration committees have become widely utilised by quoted companies in the UK, following recommendations made by the Greenbury committee in its report published in 1995⁷⁸. Remuneration committees have become a mainstay of the different iterations of the UK Corporate Governance Code, including the 2016 version. The 2016 code requires company boards to establish a remuneration committee consisting of two to three independent directors. The committee should be tasked with setting compensation and benefits for all executive directors including the board chairman. Furthermore, the Code recommends that "*the committee should also recommend and monitor the level and structure of remuneration for senior management*"⁷⁹. In accordance with s.420 of the Act, the committee is tasked with preparing a remuneration report for directors, which must be presented to the board for approval, under s.422. Given the sensitive role of the remuneration committee, the key therefore to its effectiveness is its independence.

The committee by intent and composition is contrived to be completely independent of the CEO. The obvious reason being the need to, at the very least, eschew any appearance of managerial influence over the pay setting process. Therefore, a

⁷⁷ Chrispas Nyombi 'Corporate Personality: The Achilles' Heel of Executive Remuneration Policy' International Journal of Law and Management [2014] Vol.56 No.3, pp.184-196 at 187.

⁷⁸ Director's Remuneration: *The Report of a Study Group Chaired by Sir Phillip Greenbury*, Published 17 July 1995 at 21.

⁷⁹ UK Corporate Governance Code 2016, D.22 at 21.

successful challenge to excessive compensation, must go beyond its excessiveness, but prove that by awarding compensation at such a level, the board via the remuneration committee, had acted dishonestly and as such breached its duty to promote the company's success, outlined under s.172 of the Act⁸⁰. Which is difficult to prove, particularly when decisions were taken in unison by committee members in accordance with the articles of association, as held in *Guinness v Saunders*.

Therefore, a successful challenge must show that the decision regarding the compensation award, was not taken collectively and the pay decision ultimately contravened the provisions of the company's articles, as was the case in *Guinness*. With regards to the former, the court had to determine if a bonus payment made to a director following the completion of an acquisition was ultra vires the company's constitution. The court determined that the responsibility to make decisions with regards to an award of special remuneration must be the board's, in accordance with the company's articles. That the decision could not be delegated to a committee, even less one of which the recipient was a member. However, it is not uncommon for the English courts to decide that a director is entitled to remuneration in equity, even when the directors' actions or the circumstances surrounding the pay award fall short of the requisites in the company's articles. In *Re J Franklin & Son Ltd*⁸¹, a resolution made by directors to award remuneration to one of their own, was challenged having had certain irregularities which would have voided it. In that case, the court decidedly relieved the affected director of his obligation to repay the sum owed.

⁸⁰ Ndzi (n76) at 2.

⁸¹ [1937] 4 All ER 43.

In *Guinness*, there was an obvious conflict of interest in the pay setting process, tainted the award, making the court's decision inevitable. It raises questions as to what happens when the facts do not lead to such an inevitable consequence?

The non-interventionist position of the English courts was restated in *Guinness v Saunders*. With the presiding judge stating that the courts "*are in no position to determine equitable allowance or remuneration*"⁸². The court decided similarly in *Smith v Croft (No.2)*⁸³.

Be that as it may, there are instances where the court has delved directly into the remuneration issue and made decisions regarding pay awards. One of those instances was in the earlier mentioned case of *Re J Franklin & Son Ltd* and in *Re Barry and Staines Linoleum Ltd*⁸⁴. In both cases the court did not deny jurisdiction to decide on the issue of remuneration. In the latter case, *Maugham J* while admitting jurisdictional competence, however decided "*that the views of the shareholders (solvent company) or creditors (insolvent company) must first be heard*"⁸⁵.

Furthermore, in 2013 the *Enterprise and Regulatory Reform Act* was passed to make executive pay fairer. Section 79 of the Act provided for shareholder approval of director's remuneration report, accordingly, members would be allowed an advisory vote on said remuneration policy annually and a binding vote every three years. Although the Act has the stated intent of making pay fairer by requiring shareholders approve the proposed remuneration, this could perhaps have the unintended effect

⁸² Nyombi (n78) 187.

⁸³ [1987] 3 W.L.R. 405.

⁸⁴ [1934] Ch 227.

⁸⁵ Gerard McCormack '*The Guinness Saga: In Tom, We Trust*' *Company Lawyer* [1991] Issue 12, 90 at 97.

of creating barriers to a legal challenge. As it would be difficult to argue against something which had been approved by a majority of the members. Even though we know that a large portion of traded stock is held by large institutions, who perhaps fail to share the concerns of ordinary shareholders, with regards to pay⁸⁶. It must be noted that, any reasonable defence to a legal challenge would be built on the approval of the majority.

However, considering the overall paucity of remuneration-based litigation arising from large quoted companies in the UK, prior even to the passing of the Act, S.79 therefore, is unlikely to make any considerable difference. The reasons for this could range from shareholder apathy to the relative cost to a minority, of sustaining a legal challenge-when it could perhaps be less costly to divest one's interests. However, it is likely to be that executive remuneration does not represent a significant enough cost to large corporations, for to be taken seriously enough by institutional shareholders or worthy of the costs to the minority⁸⁷. This explains the greater likelihood of remuneration-based cases arising from privately-held companies.

As would be discussed in the following section, when members of small privately held companies are aggrieved by the actions of the majority-including matters having to do with compensation-the *Companies Act*, through S.994 allows minority members to bring an action for relief.

⁸⁶ Just under 30 per cent of UK company stock is institutionally held. ONS Bulletin '*Ownership of UK Quoted Shares: 2016*'. Available at <https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2016#holdings-of-uk-quoted-shares-by-sector-of-beneficial-owner>

⁸⁷ Executive pay is said to constitute only about 0.6 per cent of corporate expenditure in the FTSE 100. See, *House of Commons BEIS committee Report on Corporate Governance* (30 March 2017) at 35.

5.6.3 The 'Unfairly Prejudicial' Relief Under S.994 Companies Act 2006: An Exception to the Principle of Non-Interference

S.994 allows a minority shareholder who believes an act or omission being committed either by the company or on its behalf, would be unfairly prejudicial to the rights of the members in general or in part. This provision could be regarded as an exception to the English courts reluctance to delve into company matters and question directors' business judgement.

A reading of S.994 would show two requirements to qualify for the relief i.e. one the wrong must be suffered in the petitioner's capacity as a shareholder⁸⁸ and the acts or omission complained of must potentially endanger his position as such. However, the petitioner is not required to show that the injurious acts were done in bad faith or intentionally⁸⁹. In *O'Neill v Phillips*⁹⁰, Lord Hoffmann put forward a two-fold test of unfairness. First, the majority exercises its legal power contrary to good faith and engages in an act or acts that put an end to the basis upon which the members entered association with each other⁹¹. On the second arm of the Hoffmann test, it goes without saying that the basis for a shareholder agreement, much like any other agreement, would be based on mutually held trust. Which must be backed by properly articulated terms entitling either party to relief, in the event of a breach. A breach therefore of these terms would significantly alter the trust dynamic of this association,

⁸⁸ Robert Goddard, "The Unfair Prejudice Remedy" *Edinburgh Law Review* 2008, Vol. 12 Issue (1), 93, 94.

⁸⁹ Hannigan (n52) 422.

⁹⁰ [1999] 1 WLR 1092.

⁹¹ Goddard, (n89) at 94.

severely limiting its ability to engage meaningfully in the purpose for which it was initially established. S.994 allows the court to offer relief at this point, to the injured party, which would require an ex-post evaluation of the actions of the majority.

Additionally, where the grievance involves remuneration deemed by the minority to be excessive, an evaluation would involve an inquiry into the decision to pay the challenged sum and the effects or potential effects said payments would have on the minority. Prior to this, it must be made clear that where the disputed payments were made consequent to a prior agreement and duly authorized by the shareholders in sum, the contending minority must plead evidence of the adversity such payments would wreak in terms of their strict legal rights as beneficiaries of the company as a going concern. Therefore, regarding the contractual agreement between shareholders, an unfairly prejudicial claim for excessive remuneration would only succeed when a prior agreement existed between parties regarding their financial entitlements i.e. dividends and the challenged compensation was likely to jeopardise the director's ability to meet these obligations as required⁹². In *Irvine v Irvine*, where a director's remuneration package jeopardised the firm's ability to meet profit sharing obligations under the member's agreement, it was held that the director had violated said agreement.

What is significant about *Irvine* is that in deciding that the defendant's compensation was unfair, the court adopted the approach taken in *Re a Company (No 004415 of 1996)*⁹³, where compensation was deemed unfair, because it was "outwith the

⁹² Robert Goddard, "Fowler v Gruber: Excessive Remuneration and the Unfair Prejudice Remedy" *Edinburgh Law Review*, 2009, Vol. 13 Issue (3), 517, 518

⁹³ [1997] 1 BCLC 479

objective commercial criteria” for CEO’s within the defendant’s commercial bracket in terms of company size, responsibilities etc. In this case, the salary package had weakened the financial position of the minority it was held to be unfairly prejudicial. In summary compensation, would be deemed unfair, where it is comparatively excessive i.e. the objective comparative criteria referenced in *Irvine* etc. must have been agreed to in bad faith and diminished the financial position of the minority.

5.6.3.1. The Objective Commercial Criteria Test

The Scottish courts in *Fowler v Gruber*⁹⁴, recently considered a petition for unfairly prejudicial conduct by the majority shareholder in a privately held company. Amongst the grounds for the petition, included remuneration received by the sole director of the company. Here, the court in granting the petition held that the respondent’s remuneration had been unjustified, when upon an evaluation of the earnings of directors of a similar peer group or objective commercial criteria. This decision echoed the dictum entered more than a decade earlier in *Re a Company (No 004415 of 1996)* where Sir Richard Scott V-C stated that:

“If the respondents are unable to justify by objective commercial criteria that the companies’ dividend policy was a reasonable one and that the remuneration the ...directors were paid by the companies was within the bracket that executives carrying the sort of responsibility and discharging the sort of duties that they were carrying and

⁹⁴ [2009] CSOH 36 (OH).

discharging would expect to receive, the petitioners will, in my opinion, have succeeded in establishing their s.459 case.”

To determine unfairness in excessive compensation, we would need to understand what these objective commercial criteria are.

The objective commercial criteria standard for determining excessiveness had been previously used in *Re a Company ex p Burr*⁹⁵, where Vinelott J. in dismissing an excessive remuneration claim stated,

“There is no evidence that the directors are paid in the aggregate... more than the company would have had to pay to secure suitable replacements or that the remuneration is out of line with that paid to directors of other companies with similar size and turnover”

Here the court iterated that compensation exceeding the peer average was not of itself conclusive of its unfairness. In *Lloyd v Casey*⁹⁶, the court reached a similar conclusion. The above mentioned suggest that, a proper evaluation of the excessiveness of director’s remuneration, should go beyond a mere contemplation of the quantum of the disputed pay package. Therefore, to be successful, petitioners would need to establish the unreasonableness of the challenged payments. The test for reasonableness of remuneration was stated in *Irvine* as whether *“an intelligent and honest person”* having knowledge of the relevant facts, would consider what was paid to the director to be reasonable⁹⁷.

⁹⁵ [1991] BCLC 724.

⁹⁶ [2002] Pens. L.R. 185, 195.

⁹⁷ *Irvine v Irvine* (supra).

On the issue of reasonability, Ferris J. stated in *Lloyd*, a petitioner trying to establish that the salary received by the defendant were prejudicial to his interests would need to “*invoke some general concept that remuneration received shall not exceed what is reasonable*” [emphasis mine]. Though the judge admitted that the courts have no “*yardstick*” for determining the reasonableness of such payments, he went further to state that such an inquiry would have to be subjective, stating that, “*the amount involved was so large in relation to a company’s trading that, perhaps with the assistance of expert evidence it would be possible to reach a conclusion that what was paid was, by any standard, unreasonable*”⁹⁸.

This approach was adopted in *Irvine*, where to prove the defendant’s remuneration was without his peer bracket, the court relied on the testimony of an expert witness, called on the petitioner’s behalf. Wherein the witness, who was described by the judge as “*an extremely impressive witness with a wide knowledge on remuneration issues*” gave evidence outlining his research which involved a survey of data involving the compensation paid to CEOs within the defendant’s industry (insurance brokerage). Taking into consideration the size of the firm, its turnover and the intrinsic entrepreneurial qualities of the defendant in terms of his capacity to acquire and grow a company and the salaries he would be likely to earn if he were to take up employment in another firm within or outside the sector. As such the witness concluded that a reasonable pay package would have seen the CEO’s takings range anywhere from £100,000 at the lower end peaking at no more than £300,000 per annum. Stating that only exceptional circumstances would justify a raise above these

⁹⁸ Ibid.

levels and that such circumstances (should they arise) would have the effect only of taking the defendants compensation to the higher end of the spectrum and not beyond. Although the judge disagreed with this analysis, he still decided that the decision to compensate himself exorbitantly was prejudicial to the interests of the members. Especially as he had consistently been excessively paid in the years preceding the petition.

5.6.3.2 Additional Factors in Determining Unfairness

Ferris J. in *Lloyd* seemed to imply in his dismissal of the excessive remuneration head of the petition, that to be successful, the petitioner must not only show that the payment was overly generous in that it exceeded a prior agreement, but also there was an element of bad faith in authorising and making such payments⁹⁹.

Since we know that high pay does not of itself connote unfairness a successful claimant must show that the payments were. Not only more than what the directors were entitled to but were made in bad faith also. Payments agreed to or ratified by the shareholders, would not fall under the above heading¹⁰⁰. In *Croly v Good*¹⁰¹, large payments made to a director were upheld as it appeared to be the norm between directors, having each received an amount more than their legal entitlements in the past. In contrast, the court in *Hequet v McCarthy*¹⁰², held that agreements made between directors to award a significant portion of the profits from a road resurfacing

⁹⁹ Supra (n175).

¹⁰⁰ Goddard, '*Fowler v Gruber*' (n93) 519.

¹⁰¹ [2010] 2 BCLC 70.

¹⁰² [2009] 1 BCLC 622.

contract to themselves, despite the protestations of the minority to be unfairly prejudicial and a breach of their fiduciary duty.

Payments received in excess of an existing compensation agreement, could potentially breach the director's duty to promote the success of the company, in the event that they endanger the financial future of the company¹⁰³.

Subsequently, the failure to pay dividends, as a direct result of excessive remuneration must breach a prior agreement between shareholders¹⁰⁴. In *O'Neill v Phillips*¹⁰⁵, the court considered the '*legitimate expectations*', which flow from such agreements. In rejecting the concept, however conceded that despite the advent of circumstances that would ordinarily necessitate a breach of an agreement between equity partners, either party was precluded via the agreement to act in a way that the court would consider to be "prejudicial and unfair" to the other's rights as secured by the agreement¹⁰⁶.

5.7. Anglo-American Judicial Non-Intervention in Compensation Matters.

5.7.1 The Doctrinal Essence behind the Non-interventionist Approach

The current attitude of non-interference, was first introduced in common law in the English case of *Overend & Gurney Co v Gibb*¹⁰⁷, where the court, stated that only in

¹⁰³ Goddard, (n89) at 519.

¹⁰⁴ Ibid.

¹⁰⁵ [1995] BCC 405.

¹⁰⁶ Ibid at 412.

¹⁰⁷ [1871–72] LR 5 HL 480.

cases were there had been gross negligence on the parts of directors in the performance of their duties would the courts be justified in reviewing decisions made by men presumably accustomed to business, having the knowledge required to act on behalf of the owners.

The rationale behind the non-interventionist approach under the common law, was stated most clearly in *Shuttleworth v Cox Bros & Co Maidenhead Ltd*. Here, Scrutton J opined that when a decision was honestly reached and believed by management to be in the company's best interest, provided reasonable men would come to a similar decision, it should be allowed to stand regardless of any disagreements the court would have with the path taken. It concluded that it was not the business of the courts to manage companies¹⁰⁸.

As a result, provided and unless a plaintiff challenging a business decision with dire consequences can prove negligence on the part of the directors in making the decision the court would disregard his claim. The burden of proof lies on the person(s) making the allegation of impropriety¹⁰⁹.

With regards to the U.S., where there is a codified Business Judgement Rule, it has been decided that, to waive the rule's application, the plaintiff must sufficiently prove the directors in performing their duties breached one or more of their fiduciary duties.

¹⁰⁸ [1927] 2 KB 9, 23.

¹⁰⁹ Ibid.

Particularly the duty of care, although the court would treat as seriously a breach of any of their fiduciary duties¹¹⁰.

5.7.1.1 The Reason for the Attitude of Non-Interference

There are two schools of thought regarding the general approach of non-interference and the Business Judgement Rule-in the U.S. on the one hand argues the Rule was intended to shield company directors from liability, the other states the company is the intended beneficiary. Jeremy Telman argues in favour the latter¹¹¹ stating that the American Business Judgement Rule was not formulated to protect the directors from personal liability for the consequences of their business decisions, but rather the rule operates essentially for the benefit of the company and by implication the shareholders. Bainbridge posits that, the rule as established holds within it the advantage of encouraging managing boards to take the risks which would generate shareholder value¹¹².

5.7.1.2. The Courts Choose Non-interference to Encourage Risk Taking

Bainbridge believes the potential for personal liability for the poor decision making, would evoke the kind of risk averse behaviours that shareholder value and agency theories would be too quick to denounce. He mentions the “*basic corporate law principle of limited liability*”, the diversified portfolios of shareholders and the

¹¹⁰ As held in *Cede & Co v Technicolor*, 634 A.2d 345, *Shlensky v Wrigley* (supra), see also, Douglas M. Branson, *Intra-corporate Process and the Avoidance of Director Liability*, Wake Forest Law, Vol. 24, 1989 at p.97.

¹¹¹Jeremy Telman ‘*The Business Judgment Rule, Disclosure and Executive Compensation*’. Tulane Law Review [2007] Vol. 81, at 833.

¹¹² Stephen M. Bainbridge ‘*The Business Judgement Rule as Abstention Doctrine*’ Vanderbilt Law Review [2004] Vol.57, p.83 at 110.

hindsight bias involved in an *ex post* judicial review of business decisions as supportive of the rule's existence and implementation¹¹³. He states that a combination of the limited liability protections offered to shareholders of quoted companies and their unenviable position as residual owners was sufficient reasons for shareholders to require that managers be highly risk inclined.

Arguing further that, because it is impossible to recreate the exact circumstances which preceded the decision in question, therefore, an *ex post* review would be had, with full knowledge of the outcome of the decision, which raises questions as to the efficacy of such a process.¹¹⁴ He states further, that a hindsight review would blur the foreseeability of the outcome of a decision, rendering it punishable, regardless of the "*ex ante quality of the decision or the decision-making process*"¹¹⁵. Creating a situation whereby managers are punished for bad outcomes rather than a failure to exercise due care in decision making.

The question of hindsight bias in judicial review of business decisions was briefly addressed in *Weaving Capital (UK) Ltd v Dabha*¹¹⁶, a case involving a violation of S.174 of the *UK Companies Act 2006*, where the defendant insisted he had not failed in his duty of care by relying on information given by a senior colleague, with disastrous consequences. The court in disregarding this argument, held that, performance of his duty required that he investigated the claims of his superior, and had he done so the deficiencies in his answers which were so glaringly obvious would have been visible to

¹¹³ *Ibid*, 111-115.

¹¹⁴ *ibid* at 114.

¹¹⁵ *Ibid* at 115.

¹¹⁶ [2013] EWCA Civ. 71.

him, by him taking his colleague at his word without any further investigation was a breach of the duties stated in S.174.

Furthermore, the absence of personal liability could be justified by the need to encourage the best and brightest to take on board role, as well as the need to encourage bold management by company directors¹¹⁷. On this point, Telman argues that the rule could present a potential moral hazard, when directors can take risks with funds belonging to shareholders, without any personal liability, when decisions taken later prove to negatively impact shareholder value¹¹⁸.

5.7.1.3 The Courts Lack the Required Expertise to Review Business Judgments and the Director Primacy Argument

A second justification for the rule and a frequent excuse for judicial deference to board decisions, is that “judges are not business managers”¹¹⁹. In *Dodge v Ford* the court decided it lacked the necessary expertise to engage in an analysis of the merits of the decision taken. Here the rule was applied on the grounds of a lack of expertise. The eagerness with which judges refuse to examine business decisions on those grounds have been questioned¹²⁰. Bainbridge challenged this argument citing as its limitation, its generic suppositions as to the corporate expertise or lack thereof, of jurists. Stating further and using Delaware as an example of jurisdictions were members of the bench

¹¹⁷ In *Joy v North*, (2nd Circuit, 1982) 692, E2d 880, 886, the court stated that it would not be in the shareholders’ best interest if the law created further incentives for risk aversion amongst directors, bearing in mind the fact that the potential for gain almost always creates a potential for loss.

¹¹⁸ *Ibid*, 846.

¹¹⁹ Bainbridge, (n113) 117.

¹²⁰ *Ibid* at 119-122.

frequently come from within the corporate sector¹²¹. That Delaware accounts for a large portion of the corporate law litigation in America, would mean judges in such a jurisdiction, would have the expertise and experience needed to adjudicate thoroughly on these issues¹²².

The lack of expertise argument fails the credibility test, considering judges are frequently required to examine the consequences of expert judgements. For instance, in examining medical negligence cases, judges do not plead a lack of requisite expertise and thus defer to the professional's expertise. raising questions about the tendency to defer to business judgments¹²³. If anything, the previously mentioned qualifications of judges in jurisdictions like Delaware, where there are several judges with sufficient knowledge of the corporate sector should qualify them to engage in an analysis of challenged business decisions¹²⁴.

Also, corporate boards themselves rely on expert opinions in arriving at certain decisions. A useable example would be executive compensation decisions, where compensation committees frequently utilise the services of expert pay consulting firms in making pay decisions. It could be argued that when courts decide to defer to directors on executive pay, they in fact defer to the opinions of paid consultants, who lack the requisite fiduciary responsibility. Given that boards refer to consultants when making pay decisions-as they are required to do in some situations¹²⁵-would the

¹²¹ Bainbridge, (n113) at 120, 121.

¹²² Ibid.

¹²³ Ibid, also see, Telman (n112) 841, 842.

¹²⁴ Ibid.

¹²⁵ Directors must have informed themselves on the intricacies of the disputed transaction before they can avail themselves of the protections of the rule, in *Brehm v Eisner* 746 A 2d 244, the Delaware Court implied that meeting this requirement might require that directors employ the services of expert consultants.

application of the rule be justified in such an instance? The purport of the rule and the basis for its application would seem to imply that the answer to the question would be no¹²⁶.

Furthermore, the director sovereignty or primacy model, provides a further justification for the rule's application¹²⁷. This model as opposed to the shareholder value and managerialist model, places directors at the top of the corporate pyramid. The director primacy model is derived from contractarian view of the corporation, i.e. the firm as a "*nexus through which all the contracts making up the corporation, and whose powers flow not from shareholders alone, but from the complete set of contracts constituting the firm*"¹²⁸.

Director primacy refutes the commonly held view of the shareholders as the central authority, for the simple reason that besides exceptional circumstances-i.e. mergers and acquisitions where shareholder consent is required by law-board decisions are usually not subject to any form of judicial review. It devolves that the one who makes the decisions has the control. Citing Arrow's authority-based theory, that the corporation because of its size and make up, needs to have a hierarchical management structure with the decision making done by a central authority familiar with the business. Bainbridge states that if the alternate consensus-based theory were adopted, the modern corporation would lose its organizational advantage.

¹²⁶ Telman, (n112) 843.

¹²⁷ Telman, (n112) 854.

¹²⁸ Ibid, 855.

5.8. Qualifying for Protection under the Principle of Non-interference:

The Rational Actor Requirement

For the courts to decide against adjudicating on a business decision, the director(s) involved must meet the foundational requirement of reasonableness¹²⁹. That is, the decision must have been the outcome of a reasonable exercise of his business judgement. To determine whether a decision was rational or not, the arbiter must first make plain the granules of a rational decision-making process, asking and answering the question of what a rational decision entails?

The Australian case of *ASIC v Rich*¹³⁰ provides the perfect place to begin such an inquiry. Here, the Australian Securities and Investment Commission, brought an action against the directors of a troubled company. Stating a breach of their duties to exercise reasonable skill and judgment as codified under, S.180 of the *Australian Companies Act 2001*. The court dismissed their claim and declared that the defendants could have invoked the Business Judgement Rule as provided for under S.180 (2) of the same Act, had it not.

In determining the applicability of S.180 (2), the court determined that a defendant seeking to rely thus, must meet the standard of reasonableness stated therein. The Act provides in S.180 (2), that the business decision in dispute must have been made in good faith, without any conflict of interest and on an informed basis, in (2)(d), that the directors must “*rationally believe the action to be in the best interest of the*

¹²⁹ Similar provisions on the requirement of ‘reasonableness’ could be found in the Australian, South African and the UK Company’s Acts and the American Law Institutes’ Principle of Corporate Governance. Also, see, Jean Du Plessis, “*Open Sea or Safe Harbour? American, Australian and South African business, Judgment Rules Compared*” *Company Lawyer*, Vol. 32 Issue 11 [2011] 347 at 380.

¹³⁰ 75 ACSR 1.

*corporation*¹³¹. The sub-section goes further to define a rational decision, in stating that a business decision would be deemed to be a rational one, unless it was such that no reasonable person would ever make. This requires an objective test of what a rational decision might be, so long as it seemed reasonable at the time to make the decision, the decision by implication could be said to be rational. It seems like a fair but low standard to measure up to.

Speaking of low standards, the standard of care set by the *UK Companies Act 2006*, does not appear to be any higher. S.174, sets the standard as a reasonable exercise of care, skill and judgement. However, subsection (2) attempts to define what a reasonable exercise of one's care, skill and judgement could imply, by first limiting the object of such an exercise to be a "*reasonably diligent person*". Sub-paragraph (a) goes on to enunciate the qualities this reasonably diligent person is expected to possess, which are;

"(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company"

This is a broad generic standard without much specificity and leaves the reader wanting with regards to the skills and knowledge to be had by the director and if they are they to be firm specific or meant to be part of a broad range of skills? Sub-paragraph (b) goes on to answer the first question by limiting this seemingly broad range of skills, knowledge and experience to;

¹³¹ S. 180(2) goes further to define a rational belief by stating, "*the director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold*".

“(b) The general knowledge, skill and experience that the director has”

In other words, directors cannot be held liable for lapses in business judgement in the absence of proof they possessed the ability to do a better job. This second paragraph dashed any hopes of a reasonably high standard of care that the first paragraph may have held, by making the standard subject to the intrinsic qualities of the errant director and not some objectively desirable standard with requisite qualities which he must have. The section echoes the sentiments of the common law on the issue, stated by Romer J, in *Re City Equitable Fire Insurance Co Ltd*¹³² when he declared:

“A director need not, in the performance of his duties, exhibit a greater degree of skill than may reasonably be expected from a person of his knowledge and experience”.

This decision followed a judgement entered a decade earlier in *Re Brazilian Rubber Plantation and Estates Ltd*¹³³ where Neville J, decided against holding three evidently incompetent directors liable for the disastrous consequences of their decisions, holding instead that if the company, while being fully aware of their professional shortcomings thought them fit to be directors, then they should be prepared as well to live with the consequences of that choice.

However, more than half a century later, the Australian courts decided in *Daniels v Anderson*¹³⁴, that *“the tort of negligence and the modern duty of care formed an acceptable basis of [personal] liability for director’s breach of their duty of care”*¹³⁵, the decision is said to have objectified the duty of care, skill and diligence to be exercised

¹³² [1930] 2 Ch. 293.

¹³³ [1911] 1 Ch. 425.

¹³⁴ [1995] A.C.S.R 607 CA (NSW).

¹³⁵ Du Plessis, (n130) at 351.

by serving directors in Australia. Terminating the hitherto subjective approach of a lateral analysis of perceived negligence, which juxtaposed the director's skill and knowledge against the requirements of his role¹³⁶. This objectification of director's duty of care was echoed in S.180 (2) of the Act, the Australian statutory equivalent of the American Business Judgement Rule. Du Plessis believed the enactment which was ironically a legislative response to the decision in *Daniels v Anderson*, was intended to provide a "safe harbour"¹³⁷ for directors from the minefields of personal liability that resulted from the *Daniels'* decision.

The reasons for this are as much a subject of debate as the protection provided thereunder, however the explanatory memorandum to the act stated that the rule under S.180 (2) was intended both as a standard of liability and a doctrine of review. It is not difficult to comprehend how the drafters could have intended the rule to be all of the above, given that the doctrinal perception of the rule has been a source of debate even within its jurisdiction of origin among jurists and commentators on the subject. The following section would briefly examine these varied theories on the function of the rule.

5.9. The Nature of the Principle of Non-interference: is it intended as an Absolute Preclusion of Judicial Review?

It has been argued that by the decision of the Delaware Supreme Court in *Cede & Co v Technicolor, Inc.*¹³⁸ that the American Business Judgement Rule was therefore to be

¹³⁶ Ibid.

¹³⁷ Ibid, 352.

¹³⁸ 634 A.2d 345.

regarded as a standard of liability. A means by which the courts were to review business decisions taken by company directors to determine whether they had met their required duty to exercise due care, loyalty and skill¹³⁹. On a similar note, Du Plessis argues just as well, that the English Appeal Court's decision in *Overend & Gurney Co v Gibbs*¹⁴⁰ "was them expressing their view of the Business Judgement Rule as a standard of conduct and personal liability"¹⁴¹. However, this conception of the rule has been challenged in the literature.

Bainbridge amongst others, stated the standard of liability/review doctrine of the nature of the rule as going against the original intent of the rule¹⁴². Positing that business decisions were never intended to be the subject of judicial review or an *ex post* review of any kind, stating the earlier mentioned justifications for the rule as a defence of his thesis. In contrast, he conceives the rule in what he believes to be its original intent, as a doctrine of abstention. He cites the Delaware court's decision in *Shlensky v Wrigley*¹⁴³ to buffer his argument. In that case when faced with an issue that would require an assessment of a business decision made by a manager, which he believed to be in furtherance of the corporation's core goals, the courts declined to engage in such an assessment choosing instead to defer to the decision taken, stating that:

"The response which courts make to such applications is that it is not their function to resolve corporation's questions of policy and business management. The directors are

¹³⁹ Bainbridge, (n113) at 91.

¹⁴⁰ [1871-72] L.R. 5 H.L. 480 HL.

¹⁴¹ Du Plessis, (n130) 348.

¹⁴² Bainbridge, (n113) at 87.

¹⁴³ 237 N.E.2d 776 (Ill. App. Ct. 1968).

*chosen to pass upon such questions and their decision unless shown to be tainted with fraud is accepted as final*¹⁴⁴

A similar tone was taken in *Howard Smith v Ampol Ltd*¹⁴⁵, where the Privy Council declared that the courts had no standing to substitute its opinion for those of management in matters concerning the best interest of the corporation and that there was “*no appeal on the merits from management decisions to courts of law*”. It is perhaps important to state at this point that the *Howard Smith* decision was indeed an accurate reflection of the common-law perception of the nature of the rule. Which appeared to be more as a doctrine of non-review than anything else¹⁴⁶. Similar positions were adopted in *Harlowe’s Nominees Pty Ltd v Woodside (Lake Entrance) Oil Ltd*¹⁴⁷, where the court held:

*“Directors in whom are vested the right and the duty of deciding where the Company’s interests lie and how they are to be served may be concerned with a wide range of practical considerations, and their judgment, if exercised in good faith and not for irrelevant purposes, is not open to review in the courts”*¹⁴⁸

In addition, Telman mentions that the courts have also regarded the American rule as an evidentiary presumption of proper conduct in favour of directors. In *Aronson v Lewis*, the Delaware court held that absent any evidence that the directors had failed to act in good faith, it shall be presumed that they did so and the burden of proving otherwise shall be upon the person seeking to establish facts to the contrary. The

¹⁴⁴ Ibid at 779.

¹⁴⁵ [1981] AC 821.

¹⁴⁶ Du Plessis, (n130) 348.

¹⁴⁷ [1968] 121 CLR 483.

¹⁴⁸ Ibid at 493.

evidentiary presumption view seems to be the more popular with the American courts. As could be gleaned from more recent decisions in the *Disney litigation* cases for example¹⁴⁹.

Given the perception of the Business Judgement Rule as one of judicial non-review, it is somewhat surprising the attempts at codification in common law jurisdictions have tended to view the rule instead as a standard of review. S.180 (2) of the *Australian Corporations Law Act*, mentions also the requirements for qualification for its protections. Requirements which closely resemble the American judicial position, adopted in *Aronson v Lewis inter alia*. The section requires a juridical review of the disputed business decision, before deference to the board's decision may occur, if no impropriety was found.

Similarly, the South African version of the rule, set out in S. 76 (4) of the *South African Companies Act 71 2008*, states the usual requirements that he must have; acted on an informed basis, not from self-interest and had a rational basis for making or supporting the decision made¹⁵⁰. The statute also appears to view the rule as a standard of review¹⁵¹. Another example of a codified Business Judgement Rule, which shifted ideologically from the original common law position adopted in *Harlowe's Nominees*.

Prior to the enactment of the rule in 2008, the SA courts had generally refused to engage in a review of ostensible business decisions. A prime example is the antiquated

¹⁴⁹ Telman, (n112) at 884, 885.

¹⁵⁰ See, Linda Muswaka, "Directors Duties and the Business Judgement Rule in South African Company Law: An Analysis" International Journal of Humanities and Social Science, [April 2013] Vol.3 No.7

¹⁵¹ Du Plessis (n130) 349. In the South African case of *Ben-Tovim v Ben-Tovim & Ors, 2001 (3) SA 1074 (CPD)*, it was decided that it was not for the courts to inquire into the commercial wisdom of business decisions taken during company management.

decision in *Levin v Feld and Tweeds Ltd*¹⁵² where the courts seemed to reason along the line of earlier common law judgements, by stating that courts were not obligated to substitute their opinion on company affairs for those of qualified business managers. This view was adopted in two more recent decisions in *Lordon v Dusky Dawn investments (In Liquidation)*¹⁵³ and *Ben-Tovim v Ben-Tovim & others*¹⁵⁴. However, the drafters of S.76 (4), chose a different approach, choosing instead to consider the rule more as a standard of review, than a doctrine of abstention or judicial restraint.

There appears to be a lack of consensus on the doctrinal basis of the Business Judgment rule as well as the overarching principle of judicial non-interference in corporate matters. This also applies to the Business Judgement Rule, to which Telman states, “Part of the difficulty that courts face in applying the Rule is that there is no agreement as to what it is”¹⁵⁵. It appears to be a problem that the formalisation and codification of the rule is yet to resolve.

5.10. Recent Developments in Executive Pay legislation and the Judicial

Response

As result of the clamour for state intervention in the curbing executive pay and the excesses which some believed contributed to the financial meltdown of 2008, the response was a legislative attempt at tightening aspects of the pay setting process to enhance fairness and transparency.

¹⁵² 1951 (2) SA 401 (A) 402 C-D

¹⁵³ 1998 (4) SA 519 (SECLD) 521B-D.

¹⁵⁴ 2001 (3) SA 1074 (CPD)

¹⁵⁵ Telman, (n112) at 833.

In 2010, American legislators passed the *Wall Street Reform and Environmental Protection Act* (Hereinafter referred to as *Dodd-Frank*), which amongst other things, was intended to improve pay transparency by giving shareholders say on pay powers. A similar provision was adopted by the UK parliament via the *Enterprise and Regulatory Reform Act 2013*, which called for a shareholder vote on the director's remuneration report¹⁵⁶.

Naturally, a number of legal challenges arose following the passing of the Dodd-Frank law. These challenges, which concluded with limited success, would be examined subsequently, after a brief outline of the Dodd-Frank law's provisions regarding say on pay.

5.10.1 The Provisions of the Dodd-Frank Law

Amongst the provisions of the Dodd-Frank Act, the breadth of which touched on all facets of corporate governance, the most relevant to this discussion are the say on pay provisions, and more recent amendments which included pay ratio and performance sensitivity disclosures.

S.951 of the Act requires shareholder approval of executive compensation arrangements, including exit payments. This say-on-pay vote is required to be held at least once every three years, with the rules also leaving to companies to determine

¹⁵⁶ s.74 of the Act.

the regularity with which these votes are held. Shareholders can make this determination through a non-binding vote.

S.952 is presumably aimed at reducing CEO influence over the pay setting process, calls for greater independence for the compensation committee, as well as the firm's compensation advisers. The section makes it a key requirement for firm's seeking to be listed on the securities exchange and prohibits the listing of firms found to be in non-compliance with the statute.

Subsequent to amendments made to the Act in 2015, pay-ratio disclosure requirements were set out in s.953 of the Act. This required mandatory disclosure of ratio of CEO compensation, to the median income of the other employees. This in a bid to encourage greater transparency in executive pay reporting, by providing all interested parties with the information needed to measure the firms pay practices. As such, the pay ratio mandate requires firms to disclose; both the median of the firm's annual total compensation and the annual total compensation of the company. Furthermore, a 2015 amendment required firms to disclose the sensitivity of performance-based pay to company's financial performance, by disclosing the Total Return to Shareholder (TSR) for the previous 5 years. This disclosure, would facilitate a measurement of the firm's total expenditure on executive pay, as well its corresponding TSR, allowing for comparison with peer companies.

Following the passing of the Act, some commentators predicted a wave of compensation-based litigation in the states¹⁵⁷. Although, this anticipated wave of cases

¹⁵⁷ Ian M. Ross and Greenberg Traurig, '*The End of Say on Pay Litigation?*'. Available at <https://www.americanbar.org/content/dam/aba/administrative/young_lawyers/committee_newsletters/litigation_2013_fall_newsletter_sayonpay_jump.authcheckdam.pdf>

never materialised at par with expectations, a few however did arise following the early proxy seasons, which sprung from shareholder dissent. These cases which were mostly unsuccessful attempts by shareholders to challenge what they determined to be wasteful expenditure of company resources, with few exceptions.

5.10.2 The Say-On-Pay Derivative Litigation Cases

Recent decisions in executive compensation-based litigation in America, suggest that despite say on pay provisions in the Dodd-Frank Act 2010 intended to give shareholders an opportunity to have their say on their firm's compensation policy, the trend would show that a negative say on pay vote has done little to change the stance of the American judiciary on excessive remuneration. There have only been a handful of legal actions instituted following failed say-on-pay votes that have made it to the preliminary stages, with contrasting outcomes.

In *Teamsters Local 237 Additional Security Benefit Fund v. McCarthy*¹⁵⁸, the court held, applying *Aronson's* test, that the plaintiffs had failed to show that the board's independence had been compromised in the pay setting process and that as a result had failed to create reasonable doubt that the director's decision constituted a valid exercise of their business judgement. Similar decisions were reached in more recent cases i.e. *Iron Workers Local No. 25 Pension Fund v. Bogart*¹⁵⁹ and *Gordon v. Goodyear and Navigant Consulting*¹⁶⁰ were the court in granting the defendants motion to dismiss in both cases, stated that the respective plaintiffs had failed to satisfy the

¹⁵⁸ No. 2011-CV-197841, (Ga. Super. Fulton County Sept. 15, 2011).

¹⁵⁹ No. 11-4604 PSG, 2012 WL 21060436.

¹⁶⁰ No. 12 C 369, 2012 WL 2885695.

requirements of the *Aronson's test* and by implication the futility of a pre-suit demand for remedy.

Despite the clear majority of the decisions going the way of the defendant directors, there are however some encouraging signs for disgruntled shareholders as demonstrated by the *Cincinnati Bell Case*¹⁶¹, a case decided under Ohio law, instituted by disgruntled shareholders outraged by what they deemed excessive payments to executives because the company had been in steady decline. At the preliminary stages, the court dismissed the defendant's motion to dismiss stating that the negative say on pay vote as evidence that the recommended pay package could not be deemed to be in the company's best interest. Asserting its belief in the futility of a demand because the directors, in whom remedial powers were vested, had devised and approved the disputed pay plan. The fact that this case was decided under Ohio law was the difference between it and other less successful efforts. For under the Ohio law, and in contrast to Delaware, plaintiffs are not required to prove with particularity of facts the evidence to sufficiently rebut the presumption of a valid exercise of business judgement. Also, under Ohio law the demand requirement is jettisoned upon evidence of a director's involvement in the pay setting process¹⁶².

Recent years have witnessed some successful shareholder challenges of non-executive director pay. In *Calma v Templeton*¹⁶³, the court held that the directors had breached their fiduciary duty and wasted corporate assets by awarding restricted stock units, absent the requisite shareholder approval. Also, that same year, the case of *Espinosa*

¹⁶¹ *NECA-IBEW Pension Fund v. Cox*, 2011 WL 4383368 (S.D. Ohio Sept. 20, 2011).

¹⁶² S. Aronson et al, "*United States: Shareholder Derivative Actions: From Cradle to Grave*" www.Mondaq.com, accessed on 01/08/2014.

¹⁶³ 114 A.3d 563, 2015 Del. Ch.

*v Zuckerberg*¹⁶⁴, instituted by investors challenging the reasonableness of share awards to directors of Facebook, was allowed to proceed by the Delaware court, prior to settlement being reached by the parties involved. It should be noted by way of a caveat, that these cases involving non-executive director compensation are subject to a different standard as the Business Judgement Rule would not normally apply, given that the pay decisions involved the director's own compensation. There the requirement for disinterestedness could hardly be met.

In summary, so far, the outcome of the say on pay derivative cases bears witness to how frustratingly difficult litigating executive pay issues are for aggrieved shareholders. Even worse, is that the deduction from the bulk of the decided cases, would seem to suggest that a negative say on pay vote does not necessarily obviate the need to prove the second prong of the *Aronson's test*. The advisory nature of the say on pay provision as stated in the *Dodd-Frank Act*, does not seem to have increased the fiduciary responsibility of directors to exercise due care in dealing with corporate assets, nor has it imposed additional liability for failure to meet their duty of care obligations, at least from a judicial stand-point¹⁶⁵.

¹⁶⁴ 124 A. 3d 47 – 2015.

¹⁶⁵ The bulk of the say on pay derivative cases that were dismissed at the preliminary stages for failure to prove demand futility, as the courts were not swayed by the negative say on pay votes due to its advisory nature nor were they swayed by the argument that a negative vote was evidence of a compromised board, which would obviate the need for demand.

5.11. The Post-Crisis Legislative Attempts to Address High Executive Pay in the UK: The Passing of the Enterprise and Regulatory Reform Act 2013.

Following the last financial crisis, a high pay commission was established by the then newly-formed coalition government. The commission's recommendations called for greater transparency in the reporting of executive pay and an advisory forward-looking vote on remuneration reports¹⁶⁶. The then Department for Business Innovation and Skills, released a discussion paper on executive remuneration reforms, some of which subsequently formed the basis for the Enterprise and Regulatory Reform Act 2013. This Act along with further amendments to the Companies Act 2006, via the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, granted more extensive say-on-pay powers to shareholders. The preceding would examine their respective provisions.

5.11.1 Say on Pay in the United Kingdom

The *Enterprise and Regulatory Reform Act 2013*, called for member's approval of the Director's remuneration report and policy. S.79(4) required companies listed on the stock exchange to provide notice of an intention to move an ordinary resolution approving the director's remuneration policy. The vote was required to focus on the company's policy with regards to bonuses and other performance-related aspects of executive pay, distinct from the pay package as a whole. The policy must contain

¹⁶⁶ Chuka Umunna, 'Reciprocity at the Top Table: progress on boardroom pay'. Available at <http://highpaycentre.org/files/Reciprocity_at_the_top_table_Progress_on_boardroom_pay.pdf>

information on how each company director's pay would be determined, the metrics for performance-based pay etc. According to the Act, this vote was intended to be held every three years and was to be of an advisory nature. This represented a watered-down version of the initial proposals set out within the discussion paper.

However, following amendments to the *Companies Act 2006* via the *Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013*, a binding vote was established with regards to pay policies of the largest public companies and these are to be held at least once every three years. Furthermore, an annual advisory vote was to be held on pay awards made pursuant to the shareholder approved remuneration policy.

Furthermore, the amendments required the company to report how it had taken employee pay into account while determining executive pay. It required more transparency in the reporting of executive pay, by requiring a clear statement of each director's pay award, to show clearly how the latter was linked to firm performance and set out clearly what performance measures had been attained¹⁶⁷. If the pay policy was rejected by a majority of the shareholders-following the vote which required a simple majority-the director's remuneration policy put forward the following year, shall then be subject to a binding vote¹⁶⁸. These provisions were subsequently adopted by the Financial Conduct Authority (FCA) in its listing rules, making them applicable to

¹⁶⁷ Ibid at 11.

¹⁶⁸ Ibid.

all companies listed on the UK stock exchanges, regardless of where they are domiciled¹⁶⁹.

It is fair to say that these enacted provisions leaned heavily towards giving shareholders a major say in executive pay reforms, requiring active participation to be effective.

5.11.2 How Effective Has Say-on-Pay Been in Making Executive Pay Fairer

Given that say on pay has been operative in the UK for half a decade, this section would seek to examine how effective it has been in bringing executive pay closer to a more ideal position of fairness.

Since the passing of the ERRA, average pay for FTSE 100 CEOs rose by approximately 10 per cent between 2014-2015, from an average of £4.96m to £5.48m, while the median pay increased slightly to £3.98m within the same time frame¹⁷⁰. The following year witnessed a sharp decline of 17 per cent from 2015 levels to an average of £4.5m for FTSE 100 CEOs. This is in part due, to substantial reductions for some of the highest paid CEOs within the index, while some of the lower paid saw pay increases¹⁷¹. The CEO-average worker pay ratio also fell to 129:1 in 2016, from 148:1 a year earlier, this

¹⁶⁹ Peter King, Lauren Pau and Rebecca Grapsas 'Disclosure of executive remuneration in the UK: recent developments and US comparison'. Available at <[https://uk.practicallaw.thomsonreuters.com/1-523-1863?transitionType=Default&contextData=\(sc.Default\)&firstPage=true&bhcp=1](https://uk.practicallaw.thomsonreuters.com/1-523-1863?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1)>

¹⁷⁰ High Pay Centre Report 'The State of Pay: High Pay Centre briefing on executive pay'. Available at <http://highpaycentre.org/files/The_State_of_Pay_2015.pdf>

¹⁷¹ Taking into consideration the reduction in Sir Martin Sorrell pay at WPP from £70m to £48m, without which the actual reduction would only be 15 per cent.

could be attributed more to the reduction in average CEO pay, rather than an increase in average earnings, which has remained stagnant¹⁷².

With regards to shareholder approval of executive pay levels, the figures seem to suggest a level of general support for executive pay packages since the ERRA passed. The year 2016 was the first proxy season, where shareholder could pass a binding vote against or in favour of the company's remuneration policy. There were a few high-profile revolts to pay proposals, most notably in BP and Smith & Nephews, with the latter having 59 per cent of the shareholders vote down the CEO's pay package. These aside, statistics show an average of 93 per cent of shareholders voted in favour the firm's remuneration policy and 92 per cent in favour of the remuneration report in the year's 2016 and 2017. This is with an average of 73 per cent of eligible shareholders participating in the vote¹⁷³.

The decline in average CEO pay for 2016 could perhaps be in response to the hostility which greeted some pay proposals, and some may suggest, companies may have begun to consider more seriously shareholder concerns about rising pay and calls for greater performance sensitivity¹⁷⁴. That regardless, one could argue credibly that executive pay levels are still unconscionably high and far removed from the realities of average worker's experience. That a pay gap of 129:1, remains unsustainable, irrespective of the decline from previous years.

¹⁷² CIPD Research Report '*Executive pay Review of FTSE 100 executive pay packages*' August 2017. Available at <

http://highpaycentre.org/files/7571_CEO_pay_in_the_FTSE100_report_%28FINAL%29.pdf>.

¹⁷³ KPMG Report '*The 2017 AGM season — Final review*'. Available at <

<https://assets.kpmg.com/content/dam/kpmg/uk/pdf/2018/01/makinson-cowell-review-of-the-2017-agm-season-january-2018.pdf>>

¹⁷⁴ Ben Chapman '*Executive pay: shareholders flex their muscles in 2017 AGM season to reduce ballooning salaries*' The Independent, 16 August 2017.

Considering the ERRA, it would perhaps be too early to forge a definitive opinion on its effectiveness. It would require an evaluation over a significant period of time to make such a determination. There is evidence that say on pay has provided an outlet for the public's hostility towards executive excess to be channelled and this febrile environment is causing companies to rethink their remuneration policies¹⁷⁵. What progress has been made since the passing of the Act, does not dampen the suspicion that more needs to be done to make executive pay fairer. To the latter point, in the absence of substantive judicial interference on the subject, more drastic and radical legislation would present the only viable option.

The ERRA alongside the current corporate governance regime provides a good framework on which to build future efforts on. There are areas which could perhaps be strengthened to heighten its efficacy.

5.12. Making Executive Pay Fairer: Possible Enhancements to the Current Corporate Governance Regulatory Framework

The current corporate governance regulatory framework provides a reasonable foundation upon which legislative efforts intended to make pay fairer could sit. This concluding portion of the chapter would discuss some of the adjustments which could be made to the ERRA, as well as the corporate governance rules, to increase their effectiveness. Most of the following recommendations are geared towards the pay

¹⁷⁵ The board of BP reduced the pay of its CEO Bob Dudley by 40 per cent, after it was voted down by investors concerned that the initially proposed 20 per cent increase was not aligned with company performance. see, *ibid*.

setting process, due to its importance to the justice of the outcome. As highlighted in Chapter Three, that for the process of executive pay setting to accord with Nozick's postulation of a legitimate process, the pay setting process must meet the requirements of voluntarism, acquiescence and transparency. Hence, the following recommendations are intended to ensure these key requirements factor within the pay setting process.

5.12.1 An Annual Binding Vote for Company Shareholders

Firstly, the current regime of an annual advisory vote on the director's remuneration report and a tri-annual binding one on the remuneration policy, could be modified slightly to increase the level of scrutiny on corporate remuneration policies. A binding vote every year would allow shareholders scrutinise and question pay decisions and policies they do not deem justifiable, in the light of company performance. The recent dip in average executive remuneration in the UK is unlikely to be unconnected to the disaffection and vitriol which greeted some remuneration proposals in the 2016 proxy season-which was the first-year shareholders could exercise a binding vote following the passing of the ERRA¹⁷⁶. It could be argued that an annual vote with binding effect, would apply the needed downward pressure on executive pay levels, which could force remuneration committees to carefully metric pay so it accords to performance levels. When investors bear witness to tangible performance gains, the likelihood of a negative response to a generous executive pay package would diminish.

¹⁷⁶ Madison Marriage 'Executive pay rebellions loom in 'shareholder spring''. Financial Times, February 13, 2017.

The possibility was proposed by the Conservative Government in 2016, as part of a bouquet of reforms to UK corporate governance. This portion however, was jettisoned in the subsequently released Green paper in November 2016. The reason(s) for this is unclear, however, this proposed measure was subject to a fair amount of pushback from within the business community¹⁷⁷. Those opposed to the measure cited amongst their concerns the possibility that shareholders may be less likely to vote against pay proposals they disagree with, due to the consequences of a negative vote. That the uncertainty an annual binding vote would create, might cause nervous companies to consult investors incessantly. Furthermore, a binding vote may hamper the company's ability to pay the CEO while negatively impacting the ability of UK firms to attract and retain global talent¹⁷⁸.

Possible variations to a mandated binding vote, could include limiting the vote to certain performance-related elements of executive pay, rather than the entire package. Also, an escalation approach could be adopted, whereby a negative advisory vote, could then lead to a binding vote to be called on the affected remuneration policy¹⁷⁹.

Irrespective of the approach adopted, it is the opinion here, that a binding vote would present a formidable means to create the levels of shareholder engagement in the pay setting process, the ERRA was intended to create. Adopting a less nuanced approach

¹⁷⁷ PWC Report '*Time to Listen*'. July 2016. Available at < <https://www.pwc.co.uk/services/human-resource-services/insights/time-to-listen.html>> at p.9.

¹⁷⁸ Ibid.

¹⁷⁹ Ibid.

would create the potency required to achieve the latter aim, as well as the end-point of fairer executive compensation.

5.12.2 *Requiring Companies to Publish CEO-Employee Pay Ratios*

Furthermore, mandating firms to publish the pay ratios could help make pay fairer. Mandatory pay ratios have been put in place in the United States and were first proposed in the UK in August 2017. The UK government introduced secondary legislation in 2018, which would compel company boards to publish the ratio between CEO's pay and the median within the firm¹⁸⁰.

Pay ratios have long been a controversial measure, with its advocates citing the potential for the outrage they elicit, to force pay downwards, while its opponents argue against its tendency to mislead. Pay ratios were implemented in the U.S via an amendment to the Dodd-Frank Act, with 2018 being the first year the affected firms were required to publish. It would perhaps be too early to judge the success of the measure, however, there is already evidence of its potential to mislead¹⁸¹.

That said, the possible positive impact cannot be overstated, the effectiveness of pay ratios lies in the outrage factor. Disclosures in 2017 suggested a 129:1 ratio between CEO pay and that of the average UK employee¹⁸². The government's response to the November 2016 consultation was released in August 2017, there it outlined eight reforms, cut across three areas: executive pay, employees and stakeholder engagement and corporate governance within large private firms in the UK¹⁸³.

¹⁸⁰ *The Companies (Miscellaneous Reporting) Regulation 2018* was passed into law in June 2018.

¹⁸¹ Carol Wolf 'How the new CEO-to-worker pay ratios can mislead'. Available at <https://www.cbsnews.com/news/how-the-new-ceo-to-worker-pay-ratios-can-mislead/>

¹⁸² CIPD Report (n173).

¹⁸³ House of Commons Briefing Paper 'Corporate Governance Reform'. No 8143, July 2018, p.12.

Concerning the issue of pay, amongst the three reforms dedicated to the latter, was the introduction of a mandatory requirement for companies over a certain size limit to publish pay ratios. This provision was passed into law in July 2018 via the *Companies (Miscellaneous Reporting) Regulation 2018*, it required quoted companies with more than 250 UK employees to publish annually the ratio of their CEO's pay to the median, 25th and 75th percentile of their UK workforce. The regulation also requires firms to include as part of their reporting, a narrative showing how the ratio had changed from year to year, with an explanation for the reason behind these changes¹⁸⁴.

The stated intent behind this requirement, is the need *"to give shareholders a new tool to assess whether, and how, pay at the top of quoted companies is consistent with pay and incentives throughout the company, rather than to compare pay ratios between different companies or prescribe 'good' or 'bad' ratios"*¹⁸⁵. Furthermore, quoted companies would be required to report on how share price growth impacts executive pay. The reason for this, is to allow shareholders consider the way share price movements over given performance cycles affect the quantum of executive pay. As well as to encourage the exercise of discretion by those in charge of pay setting, to avoid *"mechanistic pay outcomes"*¹⁸⁶.

The initial government proposal to enact a pay ratio mandate, was released following collaborative research by the Chartered Institute of Personnel Development and the High Pay centre, showing the breadth of the CEO-worker pay disparity. What impact the above revelation had on the government's decision is unclear, but it would not be

¹⁸⁴ Ibid, 28.

¹⁸⁵ Explanatory memorandum to *the Companies (Miscellaneous Reporting) Regulation 2018*, No.860, p.3.

¹⁸⁶ Ibid.

taking liberties, to suggest some correlation. This perhaps best demonstrates the outrage factor pay ratio disclosures and the potential to make executive pay fairer. When properly implemented, pay ratios could have one of two effects: it could either force companies to reduce executive pay levels to limit the disparity or cause a wage increase for lower level employees. The latter was the approach adopted by a global financial services institution¹⁸⁷.

The reason for the reforms to executive pay-as part of the wider slew of governance reforms-was the “*concerns about social justice as much as (if not more than) from concerns about the effective management of companies*”¹⁸⁸. It is believed in some quarters, that high pay differentials between CEOs and non-executive employees could affect productivity both in the long and short term¹⁸⁹. The costliness of high pay differentials is manifested, when employees become convinced of the inequitable pay distribution. Which could cause them to shirk or tail off, lead to high turnover-due to employees seeking employment in firms they believe have a more equitable distribution of resources or may lead to costly industrial action¹⁹⁰.

In contrast, some research suggests high differentials have no significant impact on employee productivity levels¹⁹¹. Faley et al reduce this non-significance to the fact

¹⁸⁷Edward Helmore ‘JPMorgan Chase raises its minimum wage by 20%’ The Guardian, 12 July 2016.

¹⁸⁸ Commons Briefing Paper (n183) 10.

¹⁸⁹ High Pay Centre Report, ‘*The High Cost of High Pay: Analysis of Pay Inequality Within Firms*’ <http://highpaycentre.org/files/High_Cost_of_High_Pay1.pdf>

¹⁹⁰ While University Vice-Chancellor pay in the UK remains notoriously high, staff within these universities have been threatened with severe cuts to their pension arrangements, prompting them to engage in costly industrial action. Reports show that university bosses wages in some instances, far outstrip the earnings of all other public-sector executives. Even at a time when cuts are being made to the entitlements of other University employees. See, Richard Adams and Elisabeth Gamperl ‘*University vice-chancellors are paid far more than Public Sector Peers*’ the Guardian, 11 March 2018.

¹⁹¹ Olubunmi Faley, Ebru Reis and Anand Venkateswaran ‘*The determinants and effects of CEO–employee pay ratios*’ Journal of Banking and Finance, [2013] Vol.37 3258-3272.

that most lower level employees are uninformed of the true level of disparity. That in the instances where there are informed, particularly in larger firms, they often feel the level of executive compensation is commensurate with the responsibilities they have within the firm¹⁹². Accordingly, pay differentials bear a greater significance in smaller firms with higher levels of skilled employees. The differential, in these cases, is said to have an incentivizing effect¹⁹³.

With the proposed legislation mandating pay ratios said to come into effect in 2018, time would tell what sort of impact it would have on pay at either end of the distribution scale. The somewhat moderate success of the changes introduced by the ERRA 2013 in terms of the way it galvanised shareholder activism, gives cause for some optimism. We would undoubtedly be able to judge more accurately in the years following the implementation of the measure.

5.12.3 Employee Engagement on Pay Decisions: Having Employees Represented on the Remuneration Committees

Although, Regulation 13 of *the Companies (Miscellaneous Reporting) Regulations 2018*, calls for greater stakeholder engagement, with an emphasis on employee, the law however stops short of prescribing a direct means by which this could be attained. The government had initially discussed the inclusion of workers on company boards, this requirement was however jettisoned from the published proposals in November 2016¹⁹⁴. While the government's initial remarks were welcomed by employee and

¹⁹² Ibid, 3259.

¹⁹³ Ibid.

¹⁹⁴ During her leadership campaign in 2016, Theresa May outlined plans to have companies include employee representatives on the board. These plans were reaffirmed in a speech later that year to the

trade unions, the business community had rejected the implementation of employee representation as a compulsory measure. To this end, the *Confederation of British Industry* (CBI) called for the maintenance of the unitary board system¹⁹⁵.

The government's proposals to improve employee engagement in corporate governance, were applied via revisions to the Corporate Governance Code. The 2018 iteration of the Code set out the means by which this could be attained, which could be through one or more of the following:

- *a non-executive director designated to represent employee views;*
- *a formal employee advisory council; or*
- *a director from the workforce*¹⁹⁶

These, as with all the Code's provisions are voluntary and only implemented on a comply or explain basis. As such companies are not required to adhere, provided they have valid reasons for not doing so. Furthermore, a company's adherence to the provisions is unlikely to dramatically alter the status quo, due to the advisory nature of the proposed measures.

This Chapter proposes a mandatory requirement to have employees not only represented on company boards, but also within the process of executive pay setting.

It is the argument here; that employee engagement would represent a further step

Conservative Party Conference. However, these proposals were significantly watered down a month later, when she advised the annual conference of the CBI, that companies would not be forced to include workers on the board. '*United Kingdom: Government launches consultation on worker representatives on company boards*'.

<<https://www.eurofound.europa.eu/publications/article/2017/united-kingdom-government-launches-consultation-on-worker-representatives-on-company-boards>> (accessed on 06/08/2018).

¹⁹⁵ Ibid.

¹⁹⁶ FRC: *UK Corporate Governance Code 2018*, July 2018, p.5.

towards the goal of executive pay reform and enhance the fairness of the same. This argument is supported by empirical evidence from jurisdictions which mandate board level employee representation¹⁹⁷.

The foremost example of this is the German system of co-determination. This governance model requires companies with 2,000 or more employees to operate a dual-board system: have a management board consisting of executive directors and chaired by the CEO, and a supervisory board, made of employee and shareholder representatives. The system is intended to improve worker participation in the governance process, by encouraging the *“equal participation of shareholders and employees in a firm’s decision making and shall complement the economic legitimacy of a firm’s management with a social one”*¹⁹⁸.

The supervisory board is charged with the nomination and appointment of the management board, has oversight over the latter’s activities and helps determine executive pay¹⁹⁹. Employee influence in these co-determined boards varies with the company size. The quasi-parity system applies to large firms-with a minimum of 2,000 employees and requires that employees make up 50 per cent of the supervisory board. The system requires that the chairman-usually a shareholder representative-is given

¹⁹⁷ Research shows that board level employee representation often leads to higher wage levels for ordinary works and overall lower levels of income disparity between managers and the ordinary employees. See Felix Horisch ‘The Macro-Economic Effect of Co-determination on Income Equality’. Working Paper No. 147, 2012, available at < <https://www.mzes.uni-mannheim.de/publications/wp/wp-147.pdf>>. Also see, Bennet Berger and Elena Vaccarino ‘Codetermination in Germany – a role model for the UK and the US?’ Bruegel Blog Post, October 13, 2016. Available at < <http://bruegel.org/2016/10/codetermination-in-germany-a-role-model-for-the-uk-and-the-us/>> (accessed on 06/08/2018).

¹⁹⁸ Ibid.

¹⁹⁹ Katharina Dyballa and Kornelius Kraft ‘Does Codetermination Affect the Composition of Variable Versus Fixed Parts of Executive Compensation? - An Empirical Analysis for Listed Companies in Germany’. ZEW Discussion Paper No.15-053, p.2. Available at < <http://ftp.zew.de/pub/zew-docs/dp/dp15053.pdf>>

an extra vote in the event of a tie. For companies with less than 2,000 employees, one-third co-determination applies, where employees form a 33 per cent of the supervisory board.

The benefits of this system of governance range from increased productivity, greater long-term investment and better monitoring of the executive²⁰⁰. Studies show employees share an interest in the long-term sustainability of firm growth, just like shareholders. However, most relevant to this discussion is its impact on executive pay levels and one study shows a direct correlation between board level employee representation and lower executive compensation²⁰¹. Vitols found a negative relationship between stock option use and dual-board system, with this limited utilisation of equity-based compensation leading to lower levels of CEO pay. Also, Dyballa and Kraft found a greater performance-sensitivity of executive pay, in firms with co-determined boards²⁰².

Although CEO pay has grown substantially over the last two decades, the pace appears sluggish when compared with the growth rate in places like the U.S²⁰³. The reason for this could be attributed to the high degree of employee representation in the pay setting process, where they have a major say in the approval of pay proposals. Hence,

²⁰⁰Berger and Vaccarino (n196).

²⁰¹ Sigurt Vitols, 'Board level Employee representation, Executive Remuneration and Firm performance in Large European Companies'. Available at http://www.efesonline.org/Database%20of%20employee%20ownership/Users/2010_ceo_pay_paper.pdf

²⁰² Dyballa and Kraft (n198) 18.

²⁰³ The German CEO to worker pay ratio currently stands at about 50:1, when compared with the UK and U.S pay disparity which measure at 129:1 and 275:1 respectively. Dieter Fockenbrock 'German executive pay gets supersized'. Handelsblatt Global, March 15, 2018.

Berger and Vaccarino, state that countries with a co-determined board system, have a higher degree of income equality²⁰⁴.

Attempts at enhancing the fairness of executive pay must focus on improving the transparency and accountability of the pay setting process. Increasing the representation of employees as board level, represents a means by which, the latter could be attained. It also goes the beyond the voluntarism and advisory nature of that prescribed by the Corporate Governance Code. It is the argument here, that the failures within the Anglo-American corporate governance framework, allow managers substantially influence the board as well as the pay setting process. That greater board level employee engagement and participation in pay setting, would present a substantial check on these powers and stop the CEO-worker pay gap from getting any larger. As workers would generally have an interest in keeping the disparity between theirs and managerial pay as moderate as possible²⁰⁵.

Evidence from Germany suggests a co-determinative board system as having a sobering impact on executive pay levels. It is not conclusive however, that lower levels of executive pay in dual board systems like Germany, are a direct consequence of the governance system. As Vitols notes, it is almost impossible to draw a conclusive causal link between employee representation on boards, given the difficulty in controlling for *“country-specific effects”*²⁰⁶. Factors such as a low tolerance for excessive levels of inequality, which may prevent executive pay from getting to levels which are normative in the UK, amongst other places.

²⁰⁴ Berger and Vaccarino (n196).

²⁰⁵ Vitols (n200) 3.

²⁰⁶ Vitols (n200) 29.

5.12.4. Executive Pay Caps: An Unthinkable Proposition?

There are valid arguments that could be made for the implementation of pay caps. Aside from its apparent restrictive nature, which goes against the free market ideology upon which Anglo-American corporate governance rests, properly implemented mandated pay caps could help make executive pay fairer. The composition of executive pay, shows a substantial portion of total pay is performance-based²⁰⁷. This latter fact, basically lifts the ceiling on how much executives could earn, provided it could be justified by a corresponding rise in performance.

There is however, precedent for this, as provided by the Israeli legislature's institution of pay limits of 44:1 for the highest earners within the nation's financial sector. The law also set limits on total pay-both variable and fixed-with a punitive tax rate for sums exceeding the set limits. The law also took the unprecedented step of placing an absolute limit on salaries, benchmarked to the growth of the lowest wages²⁰⁸. In the Israeli version however, these mandated limits on pay were restricted to the financial sector.

The successful implementation of pay caps, would depend largely on the socio-economic climate within the affected jurisdiction. Switzerland for instance-a country which proposed but failed to implement mandated caps to executive pay-has an

²⁰⁷ CIPD Report (n172) at 5.

²⁰⁸ Meirav Arlosoroff 'Israel Has Gone Too Far in Capping Executive Pay' www.haaretz.com, March 23, 2016.

economy which thrives on foreign investment. The country is one of the world's foremost financial centres and having one of the lowest corporate and income tax rates in the developed world²⁰⁹. It ranks in the top 5 for equality in income distribution and citizen happiness indices²¹⁰. The measure failed there, due largely to fears it might lead to flight of foreign capital investment and a talent drain²¹¹. The statistics suggest a citizenry not quite as bothered by high executive pay, given the relative prosperity in which it largely subsists.

The conditions preceding the implementation of caps in Israel, where remarkably different. Recent OECD figures show Israel as having some of the highest income inequality rates, alongside the U.S.²¹², where banker's wages prior to the mandated cap stood at around 70 times the average wage²¹³. As such in 2016, the parliament (the Knesset) proposed and subsequently passed a law setting wage limits above which would be subject to a tax penalty and a salary cap at just over £460,000 or 44 times the lowest salary. The pay cap followed previous attempts at curbing high executive wages which included corporate governance reforms by way of an amendment to the Companies Act, requiring pay be more clearly linked to performance. The results were modest, prompting the government to adopt the more controversial pay caps, via a

²⁰⁹ By 2015, companies registered in Switzerland were levied about 11.5% of profit after tax in the form of corporate taxes. See, Switzerland: Taxes on corporate income. Available at (<http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/Switzerland-Corporate-Taxes-on-corporate-income>).

²¹⁰ *Inequality index: where are the world's most unequal countries?* The Guardian, 26 April 2017.

²¹¹ The proposition was setting a 12:1 limit on CEO pay, in a country where the average CEO earned 43 times the average wage. See, John Hooper, 'Switzerland votes against cap on executive pay' The Guardian, 24 November 2013.

²¹² Lior Dattel and Dafina Maor 'Income Inequality in Israel Among Highest in OECD' Haaretz.com, May 22, 2015.

²¹³ Maria Gallucci 'Israel Adopts New Law to Cap Bank Executives' Salaries at Less Than \$1 Million A Year'. International Business Times, 29 March 2016.

unanimous parliamentary vote of 56-0²¹⁴. Unfortunately, the law was not so unanimously well received, with some commentators decrying the potential effects on the business and financial sector in its wake²¹⁵. Whether the impacts would be negative, time would tell, but the existence of pay caps in a democratic and reasonably free market economy, raises legitimate questions regarding its applicability in Anglo-America.

Such an intrusive measure could be justified by the consideration of executive pay as an issue of public policy. As highlighted in earlier portions of the thesis, the externalities of high executive pay, strengthen the arguments for a public policy interventionist approach²¹⁶. While previous attempts at reform have largely left action to the markets, the latter consideration would lay the groundwork for the sort of direct intervention that mandated pay limits represent.

Arguments that the solutions to unjustifiably high executive pay should be left to the market and investors to resolve, start to bear very little weight. Instances like the Carillion Plc example, where dividends are paid out to shareholders, by companies in the throes of insolvency could be resolved by the implementation of pay caps²¹⁷. The institution of pay caps may encourage executives to pursue the enhancement of long term value, as against irrational and unsustainable governance measures.

²¹⁴ Arlosoroff (n207).

²¹⁵ Ibid.

²¹⁶ In Chapter 2, the thesis argued that the externalities of high pay qualified executive pay for consideration as an issue of public policy, allowing for direct intervention, see Chapter 2, 2.6. the externalities of high pay and its impact on income distribution was discussed in Chapter 4, 4.5.

²¹⁷ Despite consecutive profit warnings, the company's directors sanctioned the payment of bonuses and a pay raise for the embattled CEO. Other executive directors received relatively high salaries, which some of them continued to receive, following their dismissal for poor performance. see, Simon Goodley '*Carillion's 'highly inappropriate' pay packets criticised*' The Guardian, 15 January 2018.

As noted by the *Parliamentary Committee* investigating the Carillion collapse, the anomalous pay practices that preceded the firm's failure, were a symptom of a dysfunctional corporate culture and were by no means isolated to Carillion²¹⁸. The reports cited the government as having a role to play in the reordering of corporate culture, and in the tightening of regulations to ensure directors take seriously their s.172 duties. It is the strongly held opinion that the implementation of pay caps, provides a viable option and one to be seriously considered.

Over a century ago, JP Morgan stated his bank would refrain from investing in companies whose CEO earned more than 20 times the lowest wage, as that was evidence of the CEOs self-interestedness²¹⁹. Considering the current CEO of the bank he built earned roughly 364 times the median wage within the bank, one would be curious to know what his thoughts were on that²²⁰. His comments suggest however, that businesses are not incapable of pursuing an egalitarian ethos, it might require the intervention of the state to help rediscover that.

5.13. Conclusion

The non-interventionist approach adopted by the Anglo-American courts, which manifests itself as a codified Business Judgement Rule in the U.S and a general deference to managerial expertise in the UK, has important implications to the

²¹⁸ House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees Report on Carillion, Published on 16 May 2018, at p.67.

²¹⁹ Aditya Chakraborty 'Is it time for a maximum wage cap? Our panel responds to Jeremy Corbyn'. The Guardian, 10 January 2017.

²²⁰ Ben McLannahan 'Dimon pay day means a year's wages for typical JPMorgan staff' Financial Times, March 22, 2018.

executive pay debate. In a system wherein there appears to be little clarity on what fair compensation for the highest paid executives in the largest public companies, should constitute, has not been helped by the failure of the judiciary to lend its opinion to the debate.

In a situation where there are no clear determinants of what could be determined to be excessive compensation or if it is just for CEO pay to exceed the organisational average by 129:1. Existing case law on the issue would in theory provide a frame of reference for those charged with trying to make pay fairer. In the absence of the latter- despite several opportunities to do so- it falls on the legislature to take the needed steps.

Required to do so this would be corporate governance rules that state clearly what the metrics of fair executive compensation should be. Which could take the form of a pay ratio mandate or the more drastic pay caps. The legislative climate and the almost intersectional relationship between political institutions and business community, leaves little optimism on whether the political will exists to adopt these measures.

It is undeniable however, the political relevance of the issue, given its impact to on income distribution in Anglo-America. The wide gap between CEO pay and average earnings both within and without the corporation raises legitimate concerns, with regards to the extent to which corporate greed impacts the fabric of society. With the courts thus far failing to take leadership on the issue and the political will to take meaningful action lacking, one of the more outrage-worthy issues of the modern era, may yet go unresolved for a while longer.

Chapter Six

The Justice of High Executive Pay: A Summary

6.1. Conclusion

The objective of the thesis, is to determine whether current levels of executive compensation are justifiable and fair. To highlight this, the thesis examined executive pay using Nozick's theory of entitlement, whereby he posits that outcomes would be considered just when they arise through "*justice preserving means*"¹. Applying this thought process, to the executive compensation issue, the thesis adopted a two-part approach, which required an evaluation of high pay by examining the purity of the pay setting process on the first part, followed by a context-based evaluation, which leaned heavily on the social impact of executive pay i.e. its effect or potential effect on income distribution.

Therefore, the thesis sought to answer two basic research questions;

Did possible compromises in the pay setting process render high executive pay unjust?

Even if executive pay passes the first test, is it rendered unjust, via its sheer size, and disparate impact on income distribution?

To create a platform for some of the arguments made within, the thesis began in Chapter Two, by considering whether executive pay could be treated as a public policy

¹ Which according to Nozick, are distributions which originate from a just situation and whose "*repeated transitions*", either through acquisition or transfer, adhere to the demands of justice. Robert Nozick '*Anarchy, State, and Utopia* (New York: Basic Books) 152.

issue, allowing for a statist intervention of some sort. To answer this question, it was prudent to first determine what sort of institution the firm could be regarded as i.e. is it to be regarded as a private (one which is solely profit-oriented in its outlook and exists for the benefit of its members) or wholly public institution (one with a more generalised approach to its governance, which countenances the interests of the community it inhabits). A firm which is wholly private would have its affairs determined strictly within market structures, being excluded from the purview of public policy, this would apply as well, to its compensatory tendencies. on the other hand, the contemplation of the firm as a public institution, would allow for its affairs to be subject to public policy dictates and create the ideological platform for intervention in the public's interest. These arguments are particularly relevant to the research questions because, the consideration of the firm as a wholly private institution, would render a debate about the justice of executive pay irrelevant. If we argue that the implications of high CEO pay are the company's concern only, it then becomes irrelevant discussing issue with the pay setting process or the distributive consequences of high pay. The Chapter is also relevant to the discussions regarding reform highlighted in Chapter Five, as it would be unnecessary and for the state to intervene in issues which are of a wholly private nature².

In Chapter Two, the thesis highlighted arguments which favour a single minded, shareholder-centric view to corporate governance, in contrast to the more pluralistic approach. While the former originates from a view of the corporation as simply a profit-oriented entity devoid of any social responsibility, the latter sees the

² Chapter 5, 5.12.

corporation as inter-woven within the social fabric, with its activities touching almost every facet of society by way of externalities. Hence, the latter fact ensures that the firm bears a responsibility to those whose well-being it impacts. This becomes relevant when we consider the externalities of high executive pay, considered in Chapter Four, including rising income inequality³. The conclusions in Chapter Two, favoured the argument for the firm as a public institution and by implication, executive pay as subject to the dictates of public policy.

The thesis proceeded in Chapter Three, to answer the first research question, by an examination of the pay setting process, using Nozick's theory of entitlement as a measure of its fitness in ensuring a just outcome. The thesis examined three of the common arguments and theories regarding the setting of executive pay, which were classed into two defined categories. Agency Theory and the Arm's length Bargaining argument, which fall within the mainstream view on compensation setting and the managerial interference/ board capture theory on executive pay setting, categorised under the alternative view of pay setting⁴.

A recognition of the interest conflict managers faced, necessitated a rethink of managerial compensation methods. Therefore, a compensation strategy which sought to incentivise shareholder value and simultaneously recognised the inherently flawed humanity of the corporate manager became requisite. Pay for performance, the need to closely align managerial wealth to firm performance emerged as the most viable way to counter-balance the managerial conflict of interest⁵. Closely linked to agency

³ Chapter 4, 4.5.

⁴ Chapter 3, 3.2.

⁵ Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' Journal of Financial Economics, (October 1976) Vol. 3, No. 4, 305-360.

theory, is the arm's length or optimal contracting view of compensation, premised on the ideal that managerial incentives are negotiated and structured to optimise output. By a management board, whose only interest is increasing shareholder value. Therefore, as the optimal contracting view argues, CEO pay results from negotiations at arm's length, which largely base pay on performance. As such, high executive pay is fair because it results from efficient processes⁶.

6.1.1. Research Question One: Analysing the Pay Setting Process

As was mentioned in Chapter Three, where both arguments diverge is in the notion that high executive pay is; (a) the result of intensive negotiations between managers and a disinterested board and (b) and the notion of negotiations carried out at arm's length. Managerial influence/Board Capture theorists, like Bebchuk, hoist a counter-argument to the mainstream view of pay negotiations being an adversarial affair or of shareholder value enhancement being the main thrust of these negotiations. Accordingly, pay negotiations are sullied by compromise, owed largely to the vestiges of prior relationships or the need to forge mutually beneficial alliances between individual board members and the CEO⁷. Furthered by implicit cognitive biases, whereby directors, most of whom are highly paid themselves, are non-cognizant of the concerns high pay packets would normally provoke. This is not unrelated to the fact that directors are mostly men of means themselves and beneficiaries of similar largesse⁸.

⁶ Alex Edmans and Xavier Gabaix 'Is CEO Pay Really Inefficient' European Financial Management, Vol.15 No.3 2009, 486–496 at 488.

⁷ Kevin F. Hallock "Dual Agency: Corporate Boards with Reciprocally Interlocking Relationships" available at (<http://digitalcommons.ilr.cornell.edu/articles/234/>).

⁸ Lucien Bebchuk and Jesse M. Fried, 'Pay Without Performance: Overview of the Issues' Journal of Applied Corporate Finance, [2005] Vol.17 No.4 at 13.

The alternative view rejects the mainstream argument that high executive pay is pay for performance and argues that its fairness is limited by failings within the pay setting process⁹. The argument therein therefore, was whether the pay-setting process meets the standards of a legitimate process set out by Nozick as a precondition for a just outcome. The issues with the process highlighted above, as discussed within the Chapter, seem to suggest that the answer to the stated question would be in the negative. These failures, which are inherent and arise from the governance framework in place within Anglo-American firms, create conditions which are less than ideal, if the standard were a process unsullied by compromise.

Further arguments against the pay for performance premise, is the quite common practice of artificially ratcheting CEO pay to accord with comparator averages, known as benchmarking. This argument is backed by figures which show this as a widely utilised approach adopted by remuneration committees in CEO pay setting amongst the larger firms¹⁰. As noted by Shin, upward ratcheting of pay is more likely in firms with significant corporate governance shortcomings, such as firms having a captured board, or with entrenched CEOs who might also chair the board¹¹. In Chapter Three, it was argued, admitting that although instances where CEOs influence pay decisions might be in the minority, a handful of pay decisions that result from compromised processes exacerbates the effect this might have. There this thesis highlighted figures which showed the most referenced companies in compensation making. With the

⁹ Patrick Bolton, José Scheinkman, & Wei Xiong, 'Pay for Short-Term Performance: Executive Compensation in Speculative Markets' *Journal of Corporation Law* [Summer 2005] 101, 118.

¹⁰ Mahmoud Ezzamel and Robert Watson, 'Market Comparison Earnings and the Bidding-Up of Executive Cash Compensation: Evidence from the United Kingdom' *The Academy of Management Journal* [April 1998] Vol. 41, No.2, pp. 221-231.

¹¹ Taekjin Shin 'Fair Pay or Power Play? Pay Equity, Managerial Power, and Compensation Adjustments for CEOs'. *Journal of Management*, Vol.20, No.10 at 9.

most referenced 62 times in 2013¹². Assuming this referenced pay award had it self been due to managerial influence and hence unfair and unjust, it follows therefore that the other pay awards, which were determined while referencing this flawed award, would have been determined based on flawed standards.

Nozick's process-oriented thesis requires the acquisition and transfer of income to be by means where the justice of the outcome is without question. Nozick therefore, is unconcerned by inequalities, provided the process which produced such, are just. it goes without saying therefore, that even the potential for compromise would be unacceptable in absolute terms. To suggest that basing the income of one executive on the earnings of another regardless of desert, is indeed a just way of determining executive pay, would be to negate the very essence of Nozick's entitlement theory.

6.1.2. Research Question Two: Putting High Executive Pay into Context

Chapter Four was intended to answer the second research question and required a context-based analysis of high pay, which focused on its impact within a wider social context¹³. As argued by Nozick, everything obtained through *justice preserving means* is inherently just, regardless of the size of the outcome. Therefore, a positive answer to the first research question would normally obviate the need for the second. The thesis however disagreed with that assumption and argued in Chapter Four-utilising Rawls' theory-the the justice of the outcome could not be conclusive, until its impact was determined. Believing that outcomes could only be regarded as just, when they

¹² S&P 1500 Peer Group Report 2014, C-Suite Insight by Equilar, Issue 14, 2014 at 35.

¹³ Chapter 4, 4.5.

functioned to the benefit of all in society, coming to the inevitable conclusion that outcomes that produce inequalities, were in themselves unjust, unless those inequalities bettered the lot of the least in society¹⁴. Thereby rendering the justice of the process irrelevant.

Utilising the Rawlsian principle, the thesis proceeded to show the negative externalities of high executive compensation. Externalities like, the increasing adoption of advanced technologies by companies in production and service provision, increasing globalisation as well as devices to consolidate corporate power. Admittedly technological advancement and globalisation may have been naturally occurring phenomena, not necessarily devised by corporations for financial gain. That said, these have been fully utilised by corporations in a bid to optimize productivity. Approaching this with a focus on profitability is important, because firm performance, at least in principle, is the most significant determinant of executive pay, in the light of the increasing use of equity-based incentives for CEOs¹⁵. Such that, CEO and shareholder value are as intricately aligned now, as they have ever been. Making shareholder value maximisation a pursuit for CEOs, having more than mere reputational or legacy related consequences, but consequential to her personal fortune. Therefore, with wages normally constituting a significant portion of a firms operating expense, keeping the latter at a minimum becomes essential to maximise profits and pay. Wage suppression appears to be the intent underlying normative practices such as offshoring and production outsourcing to low wage locations.

¹⁴ John Rawls: *A Theory of Justice* (HUP, 1971) 56.

¹⁵ Equilar Report '*Executive Incentive Plans: How Leading Companies Pay for Performance*' Available at (<http://www.equilar.com/reports/35-executive-incentive-plans>).

As was argued in Chapter Four, the adoption and utilisation of advanced technologies in production and service provision, have been effective tools in constricting the bargaining powers of the Anglo-American worker¹⁶. With almost no leverage to bargain with, workers are forced to accept low paying jobs, demands for better pay and conditions are often met with veiled threats of relocating sites to low wage countries¹⁷.

The foundations for the current regime of suppressed wages were laid in the 1980s, where, a wave of neoliberalism began to swell in the U.S and UK, preceding a shift to shareholder wealth maximization. Making shareholder value the stated goal of economic success, made it needful to eliminate all obstacles, to its realisation. Leading to the systematic stifling-and eventual neutering of employee unions- aggressive rollback of government regulation, particularly for the financial sector, privatisation and denationalisation of hitherto state-owned or controlled infrastructure, as well as the wholesale adoption of a market mentality¹⁸. Under the new neoliberal regime, wages were to be determined by market forces, with little or no government intervention. As discussed in Chapter One, the pay for performance ideology for executives began to proliferate about the same time. Spurred on by government policies intended to foster an entrepreneurial spirit amongst corporate executives, as a catalyst for economic growth. It is ironic, that whilst leaving wages to the mercy of the markets made it subject to downward pressure, executive compensation however, began to enjoy an unprecedented rise¹⁹. It is almost impossible to ignore the

¹⁶ Chapter 4, 4.5.

¹⁷ Ibid.

¹⁸ Chapter 1, 1.3.

¹⁹ Ibid.

correlation between wage increases for executives and corresponding stagnation for ordinary workers or to ignore theories that suggest a cause-effect relationship there.

To determine its justice, the thesis then analysed executive pay, using the second Rawls's two principles of justice. Wherein, Rawls asserts that unequal outcomes are only just, when they are "*attached to offices open to all - equality of opportunity - and work to the "benefit of the least in society"*"²⁰. Relating the first part to high executive pay, renders the latter justifiable, only when "*citizens with the same talents and willingness to use them have the same educational and economic opportunities regardless of whether they were born rich or poor*"²¹.

In Chapter Four, the thesis discussed the potential for elitism and cronyism in CEO and NED appointments. Citing government statistics that show a disproportionate number of CEO and company directors in the UK as alumni of elite educational institutions when measured on a per capita basis²². Figures like these, suggest that executive positions are not necessarily accessible to all with the skills, qualifications or willingness to function within those roles. Suggesting a potential for exclusivity, which in conclusion renders the undue rewards and resulting inequalities unjust, according Rawls's theory.

Regarding the second part of the Rawlsian principle, that the inequalities must work to the benefit of the least in society to be fair, otherwise known as the difference principle. The difference principle requires social institutions to be ordered in a

²⁰Rawls (n13) at 53.

²¹ Stanford Encyclopaedia of Philosophy. Available at <<http://plato.stanford.edu/entries/rawls/#TwoPriJusFai>>

²² Chapter 4, p.144.

manner whereby those who inhabit the lower strata of the income distribution framework, benefit from the uneven distributions of wealth and income²³. Here, the spirit of the principle argues against the justice of current pay levels. As there is simply no evidence that high executive pay works for the benefit of the poorest in our societies and much evidence to the contrary in fact.

Furthermore, the absence of redistributive policies-like tax regimes that retain a substantial portion of the highest incomes, which help reduce the disparities in wealth and well-being-are inadequate and severely compromised. Such that the wealthiest can circumvent the legislative requirements with relative ease, as recent revelations suggest²⁴. The difference principle also forbids the wealthiest to increase their earnings at the expense of the least well-off. Given, the stagnation of wages of ordinary working people has had a bolstering effect on executive-pay due in part to its correlation to firm performance-provides another indication that high executive pay fails to meet the justice requirement.

Finally, in Chapter Four the thesis highlighted one of the main arguments in support of current pay levels, that high pay was necessary to attract and retain the best talent. Suggesting that high pay was not due to rent-seeking, but rather pay for talent. The thesis also mentioned that there was a similar justification for the premiums paid to other similarly compensated individuals, falling within a broadly defined category of Entertainers, Athletes and other Superstars (EAOS). This evidences the fetishization of talent as worthy of very high premiums. But this undue worship is in discord with the

²³ Rawls (n13) 63.

²⁴ Rupert Neate '*Panama Papers: US launches criminal inquiry into tax avoidance claims*' The Guardian, 19 April 2016.

difference principle, which generally treats talent or “*natural endowments*” as undeserved, and as such talented individuals are not entitled to a larger share of the income distribution as compensation, regardless of the demand on their talent.

Given the contextual nature of the second question, executive pay would only be just if when placed against an analysis of its social impact, it could be concluded to be better rather than worse for society. The pay setting process begins when performance metrics are set by the remuneration committee, the onus then is upon the benefitting executive to meet the criteria set, to earn the consequential rewards. The strategies employed by the said executive-CEO in this case-to meet these criteria is just as important as the size of the reward itself.

Therefore, evaluating corporate strategy becomes key in determining the justice of CEO rewards. As such, where CEOs oversee strategic decisions where a company opts for automation and production outsourcing, where these culminate in rewards which are multiple times the average, the justice of the latter would be rightly called into question. The pervasive practices adopted by companies to maximise profits, while leading to higher wages for the CEOs, have had the opposite effect on ordinary wages. Wages began to stagnate, about the time executive compensation began to explode. There is a strong argument for a correlation between high executive pay and wage stagnation for ordinary workers and income inequality. Evidenced by figures which show CEOs wage growth constituting a significant two-thirds of the income captured by the highest earners in both the UK and U.S²⁵. After all, the Lockean proviso maintains that an appropriation of a common resource could only be justified provided

²⁵ Thomas Piketty: *Capitalism in the 21st Century* (HUP, 2014) at 302.

there is “*enough and as good, left in common for others*”²⁶. Given that CEO pay constitutes not only a larger portion of company profits, but of national income, creating a situation whereby a small subset of earners captures a larger share of the income distribution, with majority having to make do with a lot less than they should. To conclude, regardless of the justice of the pay setting process-and the evidence suggests it is compromised-the fact that pay has risen at the expense of overall prosperity, makes it unjust.

6.2 How CEO Pay Could Be Made Fairer?

In Chapter Five, the thesis attempted to discuss the ways in which executive pay could be made fairer. The Chapter discussed the judiciary as well as the role stricter legislation could play in attaining the said goal. There, the thesis discussed the historical reluctance of the Anglo-American courts to interfere in corporate governance in general, with a focus on executive pay issues. This reluctance is founded on a principle of non-intervention, with has its origin in the common law²⁷. This principle of non-interference is codified in the U.S - amongst other jurisdictions -as the Business Judgment Rule. The absence of a codified version of the rule in the UK, has not precluded the courts from adopting an attitude of deference to director’s business judgement.

²⁶ Chapter 4, p.142.

²⁷ *Overend & Gurney Co v Gibb* [1871–72] LR 5 HL 480.

There are however certain exceptions to this principle in executive compensation cases; in instances where compensation has been challenged as a waste of corporate assets and where high pay is challenged for being unfairly prejudicial. These exceptions apply in the U.S and UK respectively. In these cases, the courts would be required to examine the rationale behind the compensation decisions to determine the justiciability of the latter. With corporate waste cases, this responsibility would be triggered once the applicant meets the threshold known as the demand requirement²⁸.

In the UK, the courts would be required to examine compensation decisions when a minority member alleges that the decision to compensate to the stated quantum would be detrimental to her interests as a member. As discussed, particularly with corporate waste cases, the threshold for judicial intervention i.e. the onerous nature of the demand requirement, often prejudices the success of these cases. Acting almost as a further shield for directors from the glare of judicial review, this is supported by the dismal returns in terms of the success of these legal challenges against compensation deemed to be excessive²⁹. The Chapter argued, that given the failure of the judiciary to make a meaningful contribution to the executive pay debate, that the courts could not be relied upon in the efforts to make pay fairer. The Chapter proceeded therefore to consider other measures by which the stated goal could be attained, highlighting legislative reform as potentially the most effective tool.

Given the failure of the courts to meaningfully intervene in the executive pay debate, the Chapter proceeded to discuss ways legislation could fill the void. The Chapter also

²⁸ *Aronson v Lewis*, 473 A.2d. 805.

²⁹ Chapter 5, 5.4.1.1.

considered the recent say on pay enactments in the U.S and the UK and discussed ways these could be tightened to heighten their effectiveness.

6.2.1. Say-on-pay in Anglo-America: Having the Desired Impact?

Furthermore, in Chapter Five, the thesis considered the effectiveness of the existing say-on-pay legislation. Looking at provisions within the Enterprise and Regulatory Reform Act 2013 and its American equivalent, the Dodd-Frank Act 2010. With the former, the say-on-pay provisions are contained in S.79, which- an amendment to the *Companies Act 2006* per s.439-in summary mandates an annual vote on the director's remuneration report and a vote on the company's remuneration policy for directors every three years.

The provision is intended to make remuneration fairer, by increasing the accountability of directors to shareholders, encouraging greater engagement by giving shareholders a say on remuneration. The provision is also intended to improve the transparency of compensation, by improving reporting to shareholders, to aid their voting decision, all in a bid "*to promote best practice on pay-setting*"³⁰. The advantages of s.79 were highlighted in a recent article³¹.

However, the success of the Act would be determined by its effect on executive pay levels in the UK. As discussed in Chapter Five, some of the signs have been encouraging. Since its enactment in 2013, UK corporate governance has witnessed a continuation of the wave of shareholder activism, which greeted the passing of the

³⁰ BIS Consultation Paper, '*Executive Pay: Consultation on Enhanced Voting Rights*' June 2012, at 3.

³¹ Ernestine Ndzi '*UK Shareholder Voting on Directors' Remuneration: Has Binding Vote Made Any Difference?*' *Company Lawyer* [2017] Vol.38(5), 139-149.

Directors Remuneration Report Regulation 2002, which required an advisory vote by shareholders. Since 2012 there has been a sustained effort by shareholder disgruntled by executive excess, at expressing their displeasure. Marked by an increasing number of dissenting votes against remuneration reports and policies, peaking in 2017 when a reported 3 percent of remuneration proposals were voted down-by more than 50 percent of the voting shareholders³². Figures have also shown a reduction in average executive pay in the FTSE 100, by a reported 17 per cent in 2016, although the median remained constant. The decline was due largely to sizeable reductions in pay for some of the highest earners within the index, which could be attributed to severe shareholder opposition³³.

These obvious signs of improvement do not obviate the need for more stringent action to be taken, to on the one hand make pay fairer, but also to bridge the CEO-worker wealth gap. As noted in Chapter Five, although the dip in 2016 pay levels saw the gap shrink from 148:1 to 129:1, the latter still represents a substantial earnings disparity.

The modest returns perhaps call into question the wisdom of centring reform on increased shareholder engagement. Despite improvements in shareholder activism, figures still show a startling amount of abstentions from compensation-related votes, which suggest that the Act may have failed to catalyse the higher levels of engagement it was intended to³⁴. There is a myriad of reasons, for this apparent disengagement

³² KPMG Report 'The 2017 AGM season — Final review'. Available at <<https://assets.kpmg.com/content/dam/kpmg/uk/pdf/2018/01/makinson-cowell-review-of-the-2017-agm-season-january-2018.pdf>>

³³ The fall in average CEO pay is in part attributed to the reduction in pay received by CEOs like WPP's Martin Sorrell, who following shareholder outcry, saw his pay fall from under £70m in 2015 to £13.9m in 2017. See, Mark Sweeney 'Martin Sorrell's WPP pay plunged to £13.9m for last year in charge' The Guardian, 27 April 2018.

³⁴ Ndzi (n31) 145.

with regards to remuneration proposals, which could include the relative costs of engagement, as well as the complexity of remuneration reports-which could be complex and not easily understandable³⁵.

It may suggest that the shareholding body in its current form is ill-equipped to carry the burden of making executive pay fairer, due to its composition and largely dispersed nature. To this point, it is telling that similar say on pay provisions in the U.S have produced comparably lukewarm returns³⁶.

In exploring ways to make the current regime better, the Chapter discussed the possibility of an annual binding vote on the firm's remuneration policy as against the current requirement for a tri-annual vote. This measure was briefly explored by the UK government's pay reform initiative, contained amongst proposals released by the Department of Business, Energy and Industrial Strategy in its *Green Paper on Corporate Governance Reform* in November 2016. The paper proposed the idea of a binding annual vote "*on all or some elements of executive pay*", because shareholders might be better engaged with the issues, if they believed their votes were more likely to effect a change³⁷.

The proposal was not widely well received; some of the challenges centred on the likelihood for annual binding votes to cause uncertainty amongst directors in the UK, as well as negatively impact the ability of UK companies to attract the best global talent. There, the thesis explored possible variations to the proposal, which could

³⁵ CIMA Report 'Complexity, Relevance and Clarity of Corporate Reporting' <https://www.cimaglobal.com/Documents/ImportedDocuments/cid_techrep_complexity_relevance_and_clarity_of_corporate_reporting_feb09.pdf> (assessed on 02/07/2018).

³⁶ Madison Marriage 'Executive pay rebellions loom in 'shareholder spring'. Financial Times, February 13, 2017.

³⁷ BEIS, *Corporate Governance Reform*, November 2016 at 22.

include limiting the vote to just the performance-related aspects of pay. Giving shareholders an annual say on the firm's remuneration policy, may constitute an effective means of ensuring that pay is made commensurate to performance in the short term and have longer term consequences on its fairness. Furthermore, the modest strides taken in closing the CEO-worker pay gap, could be reduced further, as directors whose pay policies were rejected by shareholders may be forced to carefully consider pay proposals in a bid to avoid the negative publicity and embarrassment of subsequent no votes. It is the position of this thesis, that despite the protestations of some, an annual binding vote would ultimately do more good than harm to efforts intended to make executive pay more equitable.

Furthermore, in Chapter Five, the thesis discussed the institution of pay ratios as a mandatory requirement for companies. While highlighting the controversial nature of the proposed measure, it was mentioned therein that pay ratios had already become mandatory for large firms in the U.S.³⁸. A similar undertaking was proposed in the UK in 2017, with the government placing before parliament draft legislation to that effect in June 2018. The measure which was passed within *The Companies (Miscellaneous Reporting) Regulations 2018*, called for the setting out of the ratio of CEO pay to that of the companies average UK employees³⁹. This measure is intended to apply only to companies with a minimum of 250 employees within the UK. Where the company in question is a parent company, the bill called for the ratio of the CEO to average group pay to be published.

³⁸ Chapter 5.10.1.

³⁹ Para. 19.

Given the measure is yet to be implemented, it is difficult to say what its impact would be on CEO pay levels. While some interested parties might view the institution of pay ratios as a means to apply downward pressure to CEO pay, causing them to either oppose or laud the efforts, it is the position of the thesis, that those who view this measure in either of those respects miss the point. Although pay ratios may yet have the effect of curbing the growth or reducing current pay levels, however, for the measure to be successful that should not be the intent. The appropriate intent should be to highlight the fairness of current executive pay levels in the UK, and where this is found to be wanting, encourage the taking of remedial steps. Making executive pay fairer exceeds a mere consideration of CEO pay, but rather the latter in comparison to average earnings in the CEOs immediate habitation. While publishing pay ratios may force directors to reconsider how much CEOs earn, it may also have the more positive effect of catalysing a wage rise across the board. The measure would be credited as successful if it eventually leads to the slimming of the CEO-worker wealth gap. This would be true, regardless of a reduction from the current level of CEO pay.

Similar consideration was given to the inclusion of employees to company boards and their involvement in the setting of executive pay⁴⁰. The Chapter considered the system of co-determination which is a staple within German corporate governance as well as other parts of the globe. The argument was made that board level employee representation, could be a means to increase the efficiency of the pay setting process and the fairness of the outcome. This view is supported by figures which show higher

⁴⁰ Chapter 5, 5.12.3.

levels of income equality in jurisdictions which mandate employee board-level representation⁴¹.

6.2.2. Executive Pay Caps: An Unthinkable Proposition?

Closely linked to the pay ratio debate, is the issue of mandatory pay caps. Would the imposition of pay caps be in the interest of fairness? The answer to the above question would be determined by one's attitude towards wealth disparities.

The Greek philosopher Plato once remarked that the wealthiest should never earn better than five times the value of the lowest incomes⁴². It may be contended that Plato's assertion, stems from a recognition of the need to value labour, with pay, which is a key indicator of how an organisation values said individual. Studies show pay disparities influence how workers rate the importance of their role within the company, with regards to their superiors⁴³. With morale further dampened, when disparities in pay suggest inequity in the way pay is determined⁴⁴.

In Chapter Five the thesis discussed the implementation of pay caps in Anglo-America, citing the recent passing of a similar measure in Israel as a template. While the discussion in the erstwhile Chapter focused on implementation in a theoretical sense, here the thesis would seek to expand on this discussion and explore the functionality

⁴¹ See Felix Horisch 'The Macro-Economic Effect of Co-determination on Income Equality'. Working Paper No. 147, 2012, available at < <https://www.mzes.uni-mannheim.de/publications/wp/wp-147.pdf>>

⁴² Charles Tilley 'For Fair Pay, See Plato'. The Guardian, 03 June 2010.

⁴³ Ovidiu-Iliuta Dobre, 'Employee motivation and organizational performance' Review of Applied Socio- Economic Research [2013] Vol.5, 53 at 57.

⁴⁴ Marc Moore 'Corporate Governance, Pay Equity, and the Limitations of Agency Theory'. Available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2566314>

of pay caps, as well as some of the arguments which would usually be made against its implementation.

6.2.4. The Implementation of CEO Pay Caps: Hard or Soft Ceilings?

One of the strongest arguments against the implementation of CEO pay caps is the way it inhibits the variability of CEO pay. In an economic system where prices are thought to be market-driven, artificial restrictions on the quantum of CEO pay would run in stark contrast to this central tenet. However, pay caps are not an entirely foreign concept to the Anglo-American system. In the U.S for instance, the S.162 of the IRC set the limits for tax deductibility for executive compensation at \$1m⁴⁵. More recently the federal government placed a hard cap of \$500,000 for executives, of firms receiving government assistance, with very limited success however⁴⁶. Although these prior attempts had a limited scope, they could in fact provide a framework for future attempts at a more expansive approach to limiting pay.

The issue of hard pay caps was addressed as part of the *Hutton Review of Fair Pay in the Public Sector*, where in contemplating the feasibility of a hard cap within the UK public sector of 20:1, it was concluded “*that a hard cap would be inoperable across a diverse public-sector workforce*”, because they do not accord with the principles of fairness and just desert⁴⁷. Although the review failed to see the merit in instituting caps for public sector executives-or even private sector for that matter-it may not

⁴⁵ Allan Sloan, ‘*The Executive Pay Cap That Backfired*’ Propublica.org. available at <www.propublica.org/article/the-executive-pay-cap-that-backfired>

⁴⁶ Mary Williams Rush ‘*U.S. Faulted Over Pay at Rescued Firms*’ nytimes.com, January 24, 2012.

⁴⁷ *Hutton Review of Fair Pay in the public sector: Final Report*, March 2011, at 4.

however be conclusive of what the general attitude is within the country. A survey from 1999, showed the public believed the highest earner should be paid no more than 6.25 times the lowest paid⁴⁸. It is unlikely that this would be any different today, given current attitudes towards the wealthy elite.

State mandated pay caps have been in place for executives in parts of the developed world. The French for instance have capped pay for executives within state-owned corporations at 20:1⁴⁹. While the German government capped the salaries of executives of firms receiving state assistance at 500,000 Euros⁵⁰. More recently the European Union passed *The Capital Requirement Directives IV*, to which it appended a cap on variable remuneration for executives at continents largest banks⁵¹. Accordingly, bonuses paid are not to surpass a 100 per cent of the executive's fixed annual remuneration. With the directive being of jurisdictional consequence in the UK, by its EU membership at the time, the UK government reluctantly adopted these changes, following an unsuccessful challenge at the European Court of Justice⁵². Sceptics have declared the law might have the opposite effect, as bankers may find clever ways to circumvent its provisions, like ratcheting up fixed annual salaries, to maximise variable pay⁵³.

⁴⁸ John Hills '*Inequality and State*' (Oxford: OUP, 2004) at 34.

⁴⁹ High pay centre Report '*Leading or lagging Behind? Where does the UK stand in the debate on top pay?*' <http://highpaycentre.org/files/Leading_or_lagging_final.pdf >

⁵⁰ Ibid.

⁵¹ Ibid.

⁵² Alex Barker '*Osborne gives up on challenge to bank bonus cap*' Ft.com (Nov. 2014).

⁵³ Evidenced by promises made by Barclays Bank hierarchy to top-up fixed compensation. The proposed payments were reportedly to take the form of an allowance in addition to bonus and salary payments. See, Jill Treanor, '*Barclays aims to dodge EU bank bonus cap with new top-up payments to staff*' (The Guardian, 23 October 2013).

Adopting state mandated caps on executive pay, presents a major issue with regards to the form these should take. Do you opt for hard caps, which may not be surpassed, or do you set a soft ceiling on pay, that legislates penalties if violated?

Pay caps were discussed in the recently released *Green paper*. The paper discussed the possibility of “*an upper threshold for total annual pay*”, to be set out as part of the remuneration policy. These limits were not to be externally imposed but would give shareholders the option of a binding vote at the company’s general meeting where total pay exceeds the predetermined limits⁵⁴. Pay caps have been well used in the sports world for years. they are usually in two forms, hard caps set by the professional body, which may not be exceeded and have stiff penalties as a deterrent to violation and soft caps, which are not absolute, but may only be exceeded under certain circumstances⁵⁵.

The U.S legislature had flirted with a soft ceiling on executive pay, when it passed S.162(m) of the Internal Revenue Code, with well-known results⁵⁶. It would only make sense therefore to adopt a different approach, one perhaps which could involve a hard ceiling on executive pay.

The use is anathema in economies soldered to a free market ideology, where it could be argued that hard caps could have motivational consequences on executives, leading to a drop, in efficiency and hence shareholder value. Also, like in a lot of

⁵⁴ BEIS, *Green paper* (n31) 23.

⁵⁵ Most of the professional sports leagues in America have salary caps in place, notably the National Hockey League and the Major-League Soccer. With caps usually taking the form of a cap on the total wage bill, or on individual salaries. The intent is to maintain parity amongst the teams in the leagues. Pay caps have also been implemented in professional rugby in the UK.

⁵⁶ Allan Sloan, ‘*The Executive Pay Cap That Backfired*’ www.propublica.org. available at <<https://www.propublica.org/article/the-executive-pay-cap-that-backfired>>

instances where restrictive financial measures are proposed, opponents could argue a potential exodus of valuable human capital, as a likely fall-out of mandatory pay limits.

6.2.4.1 Hard Caps Would Inhibit Firm Efficiency

It could be argued that limiting how much executives could earn could have serious motivational consequences and could affect executive willingness to maximise firm performance. Re-introducing the agency problem, pay for performance was meant to correct. This argument is however not fool-proof.

First, it is possible the agency model overestimates the value of performance-based compensation. Osterloh and Frey posit that by focusing on monetary incentives to maximize CEO performance, agency theory underestimates the value of intrinsic motivation-motivation not determined by external circumstances-and in so doing could inadvertently suppress intrinsic motivation⁵⁷. Their theory is predicated on a belief that the individual's motivation is more broadly based, as such certain individuals derive utility from the activity in question, or "*because they wish to comply to given normative standards for their own sake*"⁵⁸. They emphasize the relevance of prosocial intrinsic motivation for CEOs, which is a desire to work for the common good, and these prosocial behaviours may be maximised if the appropriate institutional structures are in place.

⁵⁷ Bruno S. Frey and Margit Osterloh, 'Yes, Managers Should Be Paid Like Bureaucrats' Journal of Management Inquiry, [2005] Vol.14 No.1, 96-111.

⁵⁸ Ibid, 97.

They argue further, that when the institutional structures are geared towards external incentives, this could effectively “crowd-out” prior non-external motivation and the individuals’ innate desire to optimise performance for the sake of it. As such they argue for fixed salaries, as against variable performance related pay⁵⁹.

There are two points that could be derived from Osterloh and Frey’s theory in order to strengthen an argument for hard caps. First, if institutional and governance structures were rearranged to instead focus on incentivising performance via non-monetary means, it would harness the intrinsic desire to simply do a proper job and to meet set standards for the sake of it. Also, if the mind-set of performance optimisation is viewed as one’s duty and thus encultured within the corporate zeitgeist, then instituting hard limits on executive pay should not impact performance as much as proponents estimate.

Further on this point, hard caps which peg executive pay to the lowest incomes within the firm, could in fact improve firm efficiency. Given that executives are self-interested and rent seeking by nature, means they would naturally find ways to maximise pay regardless, as such every increase in CEO pay would trigger a contemporaneous rise in average wages. The effect on companywide morale due to pay rises, could trigger efficiency gains, as well as the acquisition and retention of talented individuals at mid to lower levels of the business⁶⁰.

⁵⁹ Ibid, 98.

⁶⁰ George A. Akerlof and Janet L. Yellen ‘*The Fair Wage-Effort Hypothesis and Unemployment*’ *The Quarterly Journal of Economics*, [1990] Vol. 105, No.2, 255-283.

6.2.4.2 Pay Caps May lead to Talent Flight

In Chapter Four, the thesis addressed the issue of talent as a carefully constructed narrative to justify outsized executive rewards. Talent retention-particularly rare CEO talent- could be touted as an argument against implementing pay limits. The seemingly unfounded concern that setting limits on pay, might on the one hand cause talented CEOs to relocate to less regulated environments and on the other hand discourage the best and brightest from considering positions, when they otherwise might have⁶¹. These objections appear to be hasty for the following reasons,

Firstly, it assumes that CEO decision making is primarily motivated by pay. Although it would only seem normal that remuneration would be factored into career decisions, it would be remiss to assume it as the overarching factor in those decisions. As shown previously, CEOs are motivated by reasons other than-or at least alongside-remuneration, such as an innate desire to succeed within the chosen field, and the reputational consequences that accompany a positive legacy built over many years.

Secondly, these arguments undermine the logistical difficulties of geographical relocation, as well as overestimating CEO mobility. Executives well established within a geographical location or environment, might be hard-pressed to relocate to a different environment, having built a reputation and a sphere of influence. Furthermore, the ability to relocate, is entirely dependent on the availability of similar positions in other less regulated environments. Given also, that Anglo-American executives rank amongst the highest paid globally, the adoption of pay caps may not

⁶¹ Mark Hoble, Patricia Bradley and Vicki Elliott 'Executive Pay Regulation: The potential Impacts of Proposed European Reforms' Special Issue (April 2013).
<<http://www.mercer.com/content/dam/mercer/attachments/global/Talent/executive-reward-perspectives/2013/executive-pay-regulation-us-april-2013-mercer.pdf>>

inhibit the competitiveness of the total pay, as they currently out-earn most of their peers on the continent⁶².

Similar objections were raised against the implementation of hard caps in Israel. However, it is not proven fact, that Israel is an attractive destination for international CEOs, nor is it trite that there currently exists a growing market for Israeli CEO talent, which could prevent the migration of foreign talent or cause local talent to easily take flight.

6.3. In the Alternative, How About Redistribution?

Nozick stipulates, that redistribution represents one way of correcting the flaws within the distributive process. This results from an acknowledgement of historical injustices which may exist within the process of distribution⁶³. Given the thesis' conclusion that high executive pay cannot be justified due to its flawed process of determination, a redistributive framework could represent a viable restorative measure.

one way to do this, would be to institute pay caps via a soft ceiling, i.e. a set limit with stated penalties for violation. This would mimic the Israeli model where pay for the country's top bankers was capped at about \$652,000 or 44 times the least paid

⁶² Zlata Rodionova 'UK is home to half of the ten highest paid CEOs in Europe'. Independent, 12 January 2016.

⁶³ Nozick (n1) 231.

employee at the firm⁶⁴. Anything beyond this would be subject to a punitive tax penalty.

This approach would be most recommendable for two reasons; it could have the unintended consequences of pulling the lowest wages up beyond their current levels, as it may force the hand of self-interested executives to work towards paying fairer wages at the bottom in a bid to keep theirs high, while remaining within the statutory confines. This is however unlikely given the effect it could have on the short-term profits of the firm, even if it may be beneficial in the long-term due to the morale boost and talent retention that would result. Secondly, a punitive tax penalty for exceeding set limits could have a redistributive effect, whereby high earners would then be required to pay more in taxes, which inevitably would benefit society. An example of this, was the so called “*super-tax*” of 75 per cent imposed by the French government on incomes above £780, 000 in 2012. Although the tax was reversed in 2015 due to disappointing returns, it did have some success as one commentator noted, it caused companies to agree with high earners “*to limit salaries for the two years and come to an agreement afterwards*”⁶⁵.

Although the French experiment proved unsuccessful, it may be that with adjustments, learning from the errors of the French system might make a similar application in the UK more successful. For one, the scope of application would need to be streamlined. Whereas the French attempt applied to all high earners, an Anglo-American version could be limited to top earners in quoted companies. With regards

⁶⁴ Maria Gallucci ‘*Israel Adopts New Law to Cap Bank Executives’ Salaries at Less Than \$1 Million A Year*’. International Business Times, 29 March 2016.

⁶⁵ Anne Penketh “*France forced to drop 75% supertax after meagre returns*” The Guardian 31 December 2014.

to this, the UK Labour Party in May 2017, in its published manifesto, laid out plans to institute an “*excessive pay levy*”. The levy would impose a 2.5 per cent charge on personal earnings above £330,000 and a 5 per cent charge for earnings above £500,000⁶⁶. If these proposals were to come to fruition, companies would have to pay an additional £4,250 for every worker earning above the lower threshold of £500,000 and £29,250 for any earning above a £1m⁶⁷.

Mandatory clawback provisions might also be a viable medium to ensure the fairness of executive pay. Provisions which allow firms recover all or parts of performance-related compensation, if the circumstances that precipitated the pay-out are later shown to be non-existent or resulted from manipulation by members of the executive. The U.S Securities and Exchange Commission is empowered by s.304 of the *Sarbanes Oxley Act 2002* to recover bonuses and other performance-related compensation paid out to the CEO and chief financial officer, if the firm had to issue a financial restatement due to misconduct or any other form of legal non-compliance. the provision targets payments made within a 12 month. The SEC have a proposed clawback rule to be included as an amendment to s.954 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, that would require companies to recover incentive compensation mistakenly paid to executives following accounting errors.

The Bank of England passed a provision regarding clawbacks in January 2015, which makes bonuses subject to a malus and clawback for a period of seven years from the

⁶⁶ Jim Pickard ‘*Labour extends pursuit of higher earners with ‘fat cat tax’*’ Financial Times, May 16, 2017.

⁶⁷ Anushka Asthana and Severin Carrell ‘*Labour reveals ‘fat cat’ tax pledge aimed at reining in excessive pay*’ The Guardian, May 16, 2017.

date of the award⁶⁸. In 2016, the Bank highlighted plans to expand the rule to allow bonuses to be recovered even after the employees leave the firm⁶⁹. These mandatory clawbacks only apply to banks and their employees, they could however be expanded further to include all publicly listed firms in the UK, following the American model. As they present an opportunity to enhance the fairness of executive pay.

As noted by Nozick, it would be up to the particular society to determine what principle of rectification should be applied to correct past injustices. Stating that, *“one cannot use the analysis and theory presented here to condemn any particular scheme of transfer payments, unless it was clear that no considerations of rectification of injustice could apply to justify it”*⁷⁰. It might not be possible to reverse some of the injustices which result from an avaricious culture of executive excess, however, the reforms discussed in the thesis might represent a viable starting point.

6.4. Compassionate Capitalism: Abandoning self-interest in Reaching for an Egalitarian Society

In a society guided by egalitarian principles, state-mandated pay caps would be wholly unnecessary. As the income distribution framework, would be informed by a need to maintain a balanced, fair and equitable distribution of wealth. As antithetic as it may seem, given the Darwinist nature of Anglo-American capitalism, examples exist of

⁶⁸ PRA Policy Statement ‘Clawback’ PS7/14, July 2014.

⁶⁹ Caroline Binham ‘Bank of England tightens bonus rules’ Financial Times, January 13, 2016.

⁷⁰ Nozick (n1) 231.

corporations, that have egalitarian principles embedded within its core value systems. A modern example of this would be department store John Lewis, accompany which caps its total CEO wage to 75 times the lowest salary, treats its members as owners in common, allowing them to have a direct financial stake in the company's success⁷¹.

Other examples exist of companies rejecting the traditionalist 'winner takes all' mentality towards remuneration, which has fostered inequity and inequality, adhering instead to notions of equity, that allow for narrower wealth gaps within the organisations. One successful example, is the Mondragon Model, which is derived from the organisational structuring of Mondragon Cooperative, one of the largest corporations in Spain. The Basque based cooperative, in eschewing the standard corporate model, bridged the gap between efficiency and equity, constructing a niche corporate model that has equitable principles at its core, while managing to stay efficient⁷². Other examples abound of corporations choosing rectitude over efficiency in grafting remuneration policies⁷³.

Whatever the immediate outcome, examples like these provide the basis for an '*alternative form of capitalism*', not driven by an indefatigable lust for power and wealth, but rather one in which the pursuit of efficiency and growth is tempered by

⁷¹ Harry Wollop, '*John Lewis chairman Charlie Mayfield paid 60 times more than average worker*' The Telegraph, 02/05/2015.

⁷² Ramon Flecha and Ignacio Santa Cruz, '*Cooperation for Economic Success: The Mondragon Case*' Analyse & Kritik 01/2011, 157-170.

⁷³ In 2015, the CEO of Gravity Payments-a U.S based credit card processing company-announced a minimum wage of \$75,000, to do this the CEO had to take a huge pay cut-accepting a similar sum, from an erstwhile figure of \$1.1m⁷³. By some accounts, the project could be described as successful, with some reports stating that surge in profits-because of the publicity- following the policy's implementation, others-including that of the CEO-are more circumspect with regards to the economic impact. See, Lucy Rock, '*Dan Price: the CEO who took a pay cut to give his staff a \$70k minimum wage*' The Guardian, 29 November 2015.

notions of egalitarianism, equity and fairness. Ideally, in such a system, corporate governance systems would be structured to foster the pursuit of growth and value enhancement in the long-term, as such remuneration policies would naturally follow suit. Much unlike the present version, which is largely short-termist both in its approach to business and in the construct of its reward systems.

Perhaps the greatest indictment on short-term capitalism and its extraneous remunerative culture, is its unsustainability. Not only for the fact that for our finite resources to keep pace with the growth of wealth at the top, would require a simultaneous diminishing of wealth at the other levels of the income distribution scale. But that the income and wealth gap that would result both within and without the corporation, could have potentially devastating consequences, both for the corporation and wider society. Changing this would require a recalibration of the way corporations think, with regards to the corporate strategy and the way they do business, but also the way CEOs are compensated.

Undoubtedly, the position of the chief executive is one deserving of the recognition that the title entails, as such CEOs need to be set apart from the rest of the employee pool, particularly with the regards to the way these positions are incentivised. However, over the past four decades, companies seem to have moved beyond the erstwhile traditional perks, to outlandish sign-on and severance packages, bonus payments and share awards. Such that as at 2015, FTSE 100 CEO pay bests the median full-time wage by 183 times, and 129:1 the total pay of their average employees. These figures are astounding and worthy of the vitriol that usually accompany such

revelations, leading to suspicion that current CEO pay in Anglo-America is unsustainable.

Besides its unsustainability, it is also unfair and unjust. That CEO wages have grown despite a general stagnation in wage growth, suggests a cause and effect relationship between the two i.e. CEO wage growth has been catalysed by wage stagnation and wage stagnation could be attributed majorly to corporate greed.

Which then brings us to the challenging issue, of how to make executive pay fairer. Recent discourse has shown a preference for legislative intervention rather than the current regime of market self-regulation. The scepticism with regards to the latter is understandable, as it is akin to giving *turkeys a vote on Christmas*. However, it is apparent, that any true solution would require a combination of the two. Not only should governments regulate corporate activity and legislate on pay, but corporations need to adopt a more egalitarian stance as well. Eschewing the current view of a primary responsibility to investors, with others falling in line, in favour of a more realistic approach which recognises the importance of the other constituencies. Companies cannot function without employees, nor can they do business without society's custom, investors may be the residual owners, but are in no way responsible for the company's success, hence should not be the major beneficiaries thereof. The wealth should be allocated amongst all stakeholders, to employees in form of higher wages in good times and better working conditions and to consumers in cheaper goods and overall value for money.

As such, companies need to embrace initiatives that foster greater social responsibility and not stand in opposition. Corporations owe a responsibility to the communities

they inhabit, and this should not be limited to minimising the negative externalities their operations could cause, but rather taking deliberate steps to better the communities, by providing or helping improve public infrastructure, protecting the environment and ensure well-paying jobs are created.

Arguments could be made for corporate social responsibility to be made hard law, following the template laid in places like India. Where in 2014, a law was passed requiring companies with revenues over £150m to allocate a minimum of 2 per cent of its total revenue towards a philanthropic cause. Though arguments remain with regards to whether the law is effective or useful, but the indisputable fact is, that following the law's enactment, philanthropic spending by India's largest corporations has increased by almost 600 percent, from £357m before the law was passed, to its current level £2.63bn⁷⁴. Most of these donations have been put towards investments in social infrastructure, making a difference in areas where a government handicapped by inadequate resources, rampant corruption and a swelling urban population, would inevitably fall short.

Although an equivalent piece of legislation in Anglo-America may not be feasible-at least not in the short-term-efforts could be made to encourage corporations to take an active role in Anglo-American society providing infrastructure in disadvantaged communities and as well as opportunities for those left behind by austerity programs, put in place by governments struggling to meet its obligations, with ever diminishing resources.

⁷⁴ Oliver Balch *'Indian law requires companies to give 2% of profits to charity. Is it working?'* The Guardian, 5 April 2016.

While we could hope for a corporate sector with CSR at its core, the reality is steps need to be taken to ensure corporations meet these obligations⁷⁵. Such as paying their fair share of taxes, focus on job creation within host communities and limit outsourcing to save costs and amplify profits, above all and most importantly make wages a fair reflection of the firm's success and standing. The latter applies to CEOs and ordinary workers alike. The argument is not just that executive pay is unfair, but that the gains of growth seem to go to those at the helm only. Perhaps a more equitable distribution of performance gains would allow wages at the bottom to keep pace, and perhaps executive pay may attain a semblance of fairness.

⁷⁵ As part of a bouquet of corporate governance reforms, the UK government via *the Companies (Miscellaneous Reporting) Regulations 2018*, sought to enhance the duty of company directors to take into account, their responsibility to the wider stakeholder community, under s.172 of the Companies Act 2006. With the belief that it is pivotal to the sustainable long-term success of the firm, when companies pay more than lip service to the interests of employees, customers and the environment, in the formulation and undertaking of its strategic business objectives. Companies would therefore, be required to publish a statement as part of their annual reporting requirements, highlighting the measures undertaken to meet this obligation. Apart from encouraging firms to improve employee board level engagement, the law via Regulation 13 underpinned the proposed revisions to the Corporate Governance Code 2018. The revised code contained a principle calling a stronger employee voice at board level. This principle however, left it up to the companies to determine the most suitable method of attaining the stated objective.

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