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Executive Compensation

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EXECUTIVE COMPENSATION

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List of abbreviations

Aktiengesetz (AktG) , *German Stock Index*

Deutscher Aktienindex (DAX), *German Stock Index*

Deutscher Corporate Governance Kodex (DCKG) , *German Corporate Governance Codex*

Europäische Union (EU), *European Union*

Europäische Kommission (EC), *Commission of the European Union*

Gesetz über die Offenlegung von Vorstandsvergütungen (VorstOG), *Law about the disclosure of executive compensation*

Gesetz zur Angemessenheit von Vorstandsvergütungen (VorstAG), *Law on the appropriateness of director compensation*

Mid-Cap DAX (MDAX) , *Mid-Cap Stock Index*

A. German Law

This part of our joint research paper will deal with executive compensation in Germany. It will put light on the questions of the levels, the structure and the regulation of executive compensation in Germany.

I. Introduction

Executive compensation is a topic that is always present. Not only is it present in the media but also is it present in the legal science as a big part of corporate governance.

This paper will deal with executive compensation in Germany on different levels. First of all this paper will describe the development of executive compensation in Germany, then turn to the structure and the levels of executive compensation and in the end focus on the legal framework of executive compensation. In order of relevance this paper will concentrate on executive compensation in stock corporations since stock corporations are not only a German phenomenon. What this paper tries to outline are the different acting parties when it comes to executive compensation and what their interests are. It will be examined if they all do have the same interests and what the government's role in this area is. The last part of the paper will deal with the European Unions involvement in the field of executive compensation. What are the planning, did they suppose anything and if yes does this correlate with the common German system?

II. Development of Executive Compensation in Germany

To have a better understanding of the current situation of executive compensation it is necessary to have a look at how this has developed throughout the years. Maybe there are turning points, such as the financial crisis in 2008 that have led to a change in the remuneration of executives in Germany.

When having a look at the remuneration of an average CEO in Germany one can see that between 1997 and 2005 its remuneration has been growing by 8.6 per cent.[1]. But this growth does not continue endlessly. In 2008 the financial crisis hits the world and this also effects the remuneration of executives. The following numbers concern executives from big German Corporations, which are either, listed in the German Stock Index (DAX) or the Mid-Cap

[1] *Geiler,Renneboog* in: *Anderson/Baker* (eds.), Corporate Governance, 263-83.

Stock Index (MDAX).[2] In the year of the financial crisis in 2008 and in 2009 the average remuneration of an executive was 17 per cent lower than in 2006 before the crisis.[3]. But these numbers need to be examined differently since the remuneration of executives consists of several different parts. The average remuneration, which decreased rapidly throughout the financial crisis, was heavily affected by the decreasing of the bonuses. The average bonus decreased in 2008 compared to 2006 about 31,3 percent. In 2009 this is only 29,5 percent but still a lot less than before the financial crisis.[4] The fixed part of the income, which is compared to the bonuses, not depending on performance of the stock value or anything else even had a growth from 2006 to 2009 of about 8 per cent.[5] What else can be found when looking at the numbers is that in 2011 the levels of executive compensation had risen so far that they have surpassed their 2007 levels.[6]

So one can see that executive compensation has undergone some changes in the latest history. After a steady growth it came to an end during the financial crisis, especially because the performance based parts of the remuneration packages decreased heavily but they recovered again and are now even higher than before the financial crisis.

III. Structure and Levels of Executive Compensation

A remuneration package for an executive is a very complex matter because it does not only consist of a fixed sum, which is paid out monthly. Such a package can be split into two parts, the fixed and the variable part.[7]

1. Fixed part of Executive compensation

The fixed part of the income is easy to explain. It mostly consists of a fixed base salary, which gets paid out monthly to the executive.[8] In addition to the fixed salary there can also be smaller payments made to the executive that count into the fixed part such as subsidies for rent or insurances.[9] One big benefit of a fixed base salary is that it is easy to understand who gets paid how much.[10] This can be of a special interest for the shareholders of a company.

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[2] *Döscher,* Stand und Entwicklung der Vorstandsvergütung, 118, 2014.
[3] *Döscher,* Stand und Entwicklung der Vorstandsvergütung, 121,2014.
[4] *Döscher,* Stand und Entwicklung der Vorstandsvergütung, 121, 2014.
[5] *Döscher,* Stand und Entwicklung der Vorstandsvergütung, 121, 2014.
[6] *Thomas/Van der Elst*, 14-10 Vanderbilt L. and E. Research Paper, 655, 691 (2014).
[7] *Langenbucher,* Aktien und Kapitalmarktrecht, 39 (§4 Nr.32).
[8] *Döscher*, Stand und Entwicklung der Vorstandsvergütung, 14,2014.
[9] *Döscher*, Stand und Entwicklung der Vorstandsvergütung, 13, 2014.
[10] *Pape,* Vergütungs- und Abfindungszahlungen an Vorstandsmitglieder, 67, 2004.

But since the influence of the fixed part of the remuneration packages is decreasing throughout the years the focus needs to be laid on the variable part and why companies do grant it.[11]

2. Variable part of Executive compensation

The first question that needs to be put up is what can be count to the variable part of a remuneration package. The variable part of executive compensation has one characteristic, which can always be found when talking about them. Variable pay is always performance related. [12] In the contract of an executive it usually says that there will be a variable pay but that the amount will be depending on various criteria. The only thing that differs is on which criteria this performance is measured and what effect these payments are supposed to have.

a) Short-term incentives

One sort of payment that can be found in almost every company is an annual bonus which is related to the companies accounting or stock performance of the last business year.[13] Despite the annual bonus a golden handshake, a bonus when the executive leaves the company, or a bonus for a good merger do also count as short-term payments.[14] Such remuneration can be described as a short-term incentive for executives.[15] It is called a short-term incentive because it gives the executive an incentive to do everything to achieve higher results, either accounting results or stock performance in a short time. Usually companies set forward an annual goal and if the executive accomplishes his goal he will get rewarded with a bonus. That is the way short-term incentives work.

b) Long-term incentives

Despite annual bonuses related to stock performance there are also several other ways to use the stock development in remuneration packages. The most common way to use the stock development as a long-term incentive is to pay the executive in stock options.[16] This means that the executive receives the right to buy a certain amount of the companies stock for a fixed price.[17] But stock options are due to some regulation if they are going to be used as a long-term behavioral control. It is not possible to cash these stock options immediately, they need

[11] *Pape*, Vergütungs-und Abfindungszahlungen an Vorstandsmitglieder, 18, 2004.
[12] *Döscher,* Stand und Entwicklung der Vorstandsvergütung, 13, 2014.
[13] *Murphy,* in: *Ashenfelter/Card (eds.),* Executive Compensation, 2486, 2498.
[14] *Arnold/Günther,* Handbuch Börsennotierte AG, §20 Rn.40.
[15] *Döscher,* Stand und Entwicklung der Vorstandsvergütung, 16, 2014.
[16] *Pape,* Vergütungs- und Abfindungszahlungen an Vorstandsmitglieder, 70, 2004.
[17] *Pape,* Vergütungs- und Abfindungszahlungen an Vorstandsmitglieder, 71, 2004.

to be held for four years due to §193 para.2 no. 4 Aktiengesetz (in following referred to as AktG)[18]. This long holding period carries out the main will of the legislator, which is to build up a remuneration structure, which is focused on the sustainable long-term development of the company.[19] Another regulation for stock options is that after a ruling of the Federal Civil Court of Justice in 2004 they are only allowed in the remuneration packages of executive board members.[20] The court stated that it is not the will of the legislator that the supervisory board is subject to the same behavioral control mechanism than the executive board is because this would jeopardize the system of management board and supervisory board.[21]

c) Alignment of interests

As described above the different sorts of variable pay are used as an instrument for behavioral control of executives. To have a better understand who is having interests in those behavioral control actions it is necessary to point out the different parties acting in a stock corporation.
On the one hand there are the owners of a company, the shareholders. On the other hand there are the executives, who are sitting in the board of executives and are in charge of managing the company by themselves.[22]

aa) Principal-agent theory

In the following shareholders are referred to as principals and executives are referred to as agents. The principal-agent theory has been developed in the field of economics but has great influence on modern day corporate governance.[23]
With a greater diversification of ownership in a stock corporation it gets more and more difficult for the principals to supervise what the agents are doing.[24] Whenever a task is delegated from a principal to an agent this creates an imbalance of information. So having a stock corporation in mind this means that the agents are in a superior possession of information compared to the principals.[25] The principal-agent theory is now saying that the agents do not act in the interests of the principals but rather in favor of their own best interest.[26] The closest solution would be to start with the implementation of monitoring structures. This idea comes to an

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[18] German Stock Corporation Act.
[19] *Langenbucher,* Aktien-und Kapitalmarktrecht, 38 (§4 Nr.30a).
[20] *Unknown,* 2004 NJW, 1109, 1009.
[21] *Unknown,* 2004 NJW, 1109, 1009.
[22] *Langenbucher,* Aktien und Kapitalmarktrecht, 38 (§4 Nr.1).
[23] *Langenbucher,* Aktien und Kapitalmarktrecht, §1 Nr.16-21.
[24] *Pape,* Vergütungs- und Abfindungszahlungen an Vorstandsmitglieder, 63, 2004.
[25] *Langenbucher,* Aktien und Kapitalmarktrecht, §1 Nr.17.
[26] *Pape,* Vergütungs- und Abfindungszahlungen an Vorstandsmitglieder, 63, 2004.

end with the fact that such monitoring structures would cost a lot of money and not necessarily provide any improvement for the principals.[27] In fact in Germany there is a monitoring system implemented by the AktG. §111 para. 1 AktG states that it is the task of the supervisory board to monitor the executives of a stock corporation. The supervisory board is elected by the shareholders general assembly. But besides the monitoring throughout the supervisory board principals do also use remuneration packages to overcome the above-described problem.[28] So the principals try to align the interests of themselves and the agents by using the different types of remuneration packages.

Especially long-term incentive orientated remuneration packages such as stock options have been considered an appropriate way to overcome these principal-agent problems.[29] But also this way of paying agents does open a lot of loopholes that might not be in the best interest of the principals. For example if the stock options are only connected to the overall development of the stock and not to the development of the stock compared to other competitors from the same industry.[30] So stock options would need to be a highly complex matter to overcome these principal-agent problems. In practice a few German Dax-listed companies have come up with another way of using stocks to create incentives for behavior which is favorable for the principals. They force their agents to hold a certain amount of the companies stock, which might in some cases be worth up to 300 per cent of the annual salary of the agent.[31]

Short-term incentives do not seem to be to optimal solution for the problem as well. They may lead to short term results that are very favorable for the principals but an executive only paid with those might not want to focus on a long-term development of the company. In addition to this problem a payment with just short-term incentives is restricted in §87 para. 1 S. 3 AktG. It says that the remuneration structure needs to be focused on a sustainable long-term development of the stock corporation.

What comes into mind when having a look at the positive and negative effects of the above described variations of executive pay is a mix that contains all of these parts.

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[27] *Langenbucher,* Aktien und Kapitalmarktrecht, §1 Nr.23.
[28] *Langenbucher,* Aktien und Kapitalmarktrecht, §1 Nr.21.
[29] *Langenbucher,* Aktien und Kapitalmarktrecht, § 1 Nr. 27.
[30] *Langenbucher,* Aktien und Kapitalmarktrecht, §1 Nr.28.
[31] *Haar,* in: *Randall/Hill (eds.)* Executive Compensation under German corporate law, 486, 496.

bb) Managerial power theory

This theory is based on the thought that executive compensation is not only a way to overcome the agency problems described above but also as part of the agency problems itself.[32] The theory is based on the believe that that the pay for executives will be higher when they are more powerful.[33]

According to this theory one very relevant fact in the process of setting up a remuneration package is how relevant outsiders will perceive this package, especially the amount of rent that the executive is able to extract. [34] The group of relevant outsiders that may criticize the remuneration package can either be the media of parts of the shareholders itself.[35] There is empirical evidence for this theory stating that CEO´s of big companies who have been target of such outrage had their remuneration package reduced in the following years.[36] As a consequence to this the theory states that executives to invest a lot into camouflage of their remuneration agreements and so the matter of transparency and disclosure is becoming more and more important.[37] According to the managerial power theory this whole outrage effect leads to the point that powerful executives do find other ways to get themselves high remuneration packages without causing an outcry, such as borrowing money to their executives at interest rates that are way below market level.[38]

In Germany stock corporations are being forced by the Gesetz über die Offenlegung von Vorstandsvergütungen[39] (in following referred to as VorstOG) to disclose the remuneration packages individually in the companies' annual report.[40] This shows that the legislator is somehow trying to fight the power of the executives by forcing to disclose material. Even though it is not the interest of the legislator to actively steping into the decision process of designing a executive remuneration package.

cc) Conclusion

To conclude the two theories described above for the case of executive compensation in Germany it seems like there is a mix out of both. On the one side principals are trying to over-

[32] *Bebchuck/Fried, 9813 NBER Working Paper Series,1, 1 (2003).*
[33] *Bebchuck/Fried,* 9813 NBER Working Paper Series,1, 9 (2003).
[34] *Bebchuck/Fried,* 9813 NBER Working Paper Series,1 5 (2003).
[35] *Bebchuck/Fried,* 9813 NBER Working Paper Series,1, 5 (2003).
[36] *Bebchuck/Fried,* 9813 NBER Working Paper Series,1, 5 (2003). ; *Thomas/Martin,* The effect of shareholder proposals on executive compensation, 1999, 1021.
[37] *Bebchuck/Fried,* 9813 NBER Working Paper Series,1, 6 (2003)
[38] *Bebchuck/Fried,* 9813 NBER Working Paper Series,1, 10, 13 (2003).
[39] *Law about the disclosure of executive compensation as of August 5,2005, BGB1. I 2005, P.2267.*
[40] Aktiengesetz Kommentar *Seibt*, §87 Nr.24-26 (2015).

come the agency problems but on the other hand the height and the structure of the compensation can be a problem itself.

IV Legal framework of executive compensation

After having a look at the development of executive compensation and its different levels it is now time to have a look at the legal framework of it. In order to understand the following explanations it is important that Germany in contrary to the US has a legal system that is code based and not case law based.

1. Rules and regulations

The primary source of rules and regulations concerning stock corporations in Germany is the Aktiengesetz. It applies to every stock corporation that is established under the laws of Germany.[41] Due to the fact that the Aktiengesetz applies to every stock corporation established under the laws of Germany it also regulates matters concerning Corporate Governance, especially the topic of executive compensation. The Aktiengesetz provides a section concerning remuneration packages for executives. This section will be subject of the next paragraph.

Besides the Aktiengesetz there is also another source of regulations and rules concerning good Corporate Governance for stock corporations in Germany. This other source is the Deutsche Corporate Governance Kodex[42] (in following referred to as DCGK). The DCGK is the result of a commission that the Germany government has set up in 2000 to identify the weaknesses existing in German leadership and control system.[43] In opposite to the Aktiengesetz the DCGK is only applying for German stock corporations that are listed.[44] Another opposite to the Aktiengesetz is that its rules are technically not binding rules, so the companies do not have to obtain them.[45] Never the less it would be better for stock corporations to obtain these rules because due to §166 para. 1 AktG they have to explain annually to which extend they comply with the rules of the DCGK and if not why there is a non-compliance. So even if the DCGK is non binding it has quite a big regulatory effect for publicly traded stock corporations. This rule can be dated back to a main idea that the founders of the DCGK had which is that corporations should not be forced into inflexible rules but on the other hand

[41] *Hausemann/Bechtolh-Ort,* 2010 11(2) E.B.O.R, 195, 205 (2010) .
[42] *German Corporate Governance Codex.*
[43] *Mathieu,*38 Brook. J.Int'l L., 580, 606 (2013).
[44] *Hausemann/Bechtolh-Ort*2010 11(2) E.B.O.R, 195, 205 (2010) .
[45] *Mathieu,*38 Brook. J.Int'l L., 580, 607 (2013).

could be possibly facing some uproar by their shareholders in case of non-compliance.[46] The only problem that comes along with this assumption is that it assumes that there are shareholders who are informed about the different rules and provisions of the Code. If this is not the case then the whole system of comply-or-explain is worthless.

2. Developing a remuneration package

The development process of a remuneration package has changed in the last years. Before the Gesetz zur Angemessenheit der Vorstandsvergütung[47] (in following referred to as VorstAG) was passed, it was common practice that the supervisory board would delegate the task of developing and deciding about a new remuneration system to a committee that they have founded.[48] Now §107 para.3 S. 3 AktG states that the supervisory board has to decide about such topics itself. They do not need to figure out every aspect in the supervisory board but they do have to take the final decision by themselves.[49]

Shareholders do not play a role when it comes to the development of remuneration packages. The only time shareholders participate in the process of granting a remuneration package is when they need to vote on a stock option plan for executives at the general assembly.[50] Nevertheless this shareholders vote should not be understood as a possibility for shareholders to participate in the developing process of a remuneration package, its reason can be found in the financial constitution of a stock corporation when it comes to the topic of buying stocks.[51]

a). Benchmarks for remuneration packages

The Aktiengesetz states several benchmarks for executive compensation that need to be obtained by the supervisory board. The first benchmark for developing a remuneration package for executives is set up in §87 para.1 S.1 AktG. This provision states that the remuneration needs to be in order with the performance and the tasks of the executive it is designed for as well as well as it needs to be in good balance with the situation of the corporation and should not exceed usual remuneration. Measuring the remuneration with the performance of the executive is highly relevant when it comes to variable components.[52] Usual remuneration means for the supervisory board that they need to measure their remuneration decision in two differ-

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[46] *Mathieu,*38 Brook. J.Int'l L., 580, 607 (2013).
[47] [47] *Law on the appropriateness of director compensation as of July 31 2009, BGB1, 50 2005, p. 2509.*
[48] Handbuch Börsennotierte AG *Arnold/Günther,* §20, 910, p. 919-920 (2014).
[49] Handbuch Börsennotierte AG *Arnold/Günther*, §20 910, p. 920 (2014).
[50] *Langenbucher, Aktien- und Kapitalmarktrecht , 36 (§ 4, Nr.26).*
[51] *Langenbucher,* Aktien- und Kapitalmarktrecht, 36 (§ 4, Nr.26).
[52] Handbuch Börsennotierte AG *Arnold/Günther*, §20, 910, 922 (2014).

ent factors. First of all they need to identify the usual remuneration in their field of industry in Germany and then figure out the overall usual remuneration for executives in Germany.[53] In a second step the usual remuneration for executives also needs to be orientated on the usual remuneration for average workers in their company.[54] So the element of pay ratio is included into the provisions of the Aktiengesetz, even though there are no concrete numbers which pay ratio should be unusual. In consequence the supervisory board still has a big discretionary power. As well according to §87 para. 1 the supervisory board is allowed to distinguish from the CEO and another executive, what usually results in a way higher remuneration for CEOs that for other executives.

The second benchmark can be found in §87 para.1 S.2 AktG. This provision states that executive remuneration in listed stock corporations needs to be orientated upon the sustainable development of the company. The question arising from that is if short-term incentives are now not allowed anymore. According to legislation material this provision does not exclude short-term incentives from executive remuneration in total[55], they can still be used in a mixed remuneration package as long as they are having a long-term basis[56]. How many years are supposed to serve as a basis for the long-term assessment of the remuneration is disputed since it is not laid down in the Aktiengesetz. In the literature a time span between two or three years is being suggested for that.[57] A long-term assessment basis also requires for the executive remuneration to be related to the state of the company.[58] This means that the remuneration needs to be in anyhow related to the development of the company, so if the company develops badly the remuneration needs to decrease. A claw back mechanism could be a possible way of integrating negative developments of the company into remuneration.[59]

According to §87 para.1 S. 3 the supervisory board is supposed to install a cap for overall positive unusual developments. This means that the executive is not supposed to fully participate in these unusually positive developments, which are resulting from a good merger or anything like this in a way of high bonuses.[60] The way this cap is supposed to look like is up to the supervisory board[61], no further information on that can be found in the law.

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[53] Handbuch Börsennotierte AG *Arnold/Günther*, §20, 910, 923 (2014); *Fleischer*, 2009 NZG, 801, 802 (2009).

[54] Handbuch Börsennotierte AG *Arnold/Günther*, §20, 910, 923 (2014).

[55] *Bundestagsdrucksachen, 16/13443, p.16.*

[56] *Deilmann/Otte, 2009 GWR, 261, 261 (2009).*

[57] *Deilmann/Otte,* 2009 GWR, 261, 262 (2009); *Seibt,* AktG-Kommentar Volume 1, 1332, 1341 Nr. 12 (2015).

[58] Handbuch Börsennotierte AG *Arnold/Günther*, §20, 910, 927 (2014).

[59] Aktiengesetz Kommentar *Seibt*, 1332, 1341 Nr. 12a (2015).

[60] Handbuch Börsennotierte AG *Arnold/Günther*, §20, 910, 928 (2014).

[61] *Deilmann/Otte, 2009 GWR, 261, 263 (2009).*

b). Legal consequences arising from inappropriate remuneration

As we can see above there are several benchmarks that need to be considered when a new remuneration package is being developed. But are there any consequences arising from a remuneration package that is not within the outlines laid out in the Aktiengesetz? For an executive who receives a remuneration package that is not within these outlines this has, according to the superior legal opinion no effect for him personally.[62] He can still demand his remuneration to be paid out and does not have to fear that the company demands it back. The stock corporation for exceeding the outlines laid out in the Aktiengesetz can take the supervisory board into liability.[63] The corporation may demand compensation from the supervisory board according to §116 S.3 AktG.

3. Say on pay in Germany

What is say on pay? Say on pay means that the shareholders of a stock corporation are being asked to vote about the remuneration for their executives. The following will describe how say on pay in Germany developed and what it means for stock corporations in Germany.

a). Applicability

Say on pay was first established in German corporate law in 2009 when the parliament passed the VorstAG. Now the Aktiengesetz provides in §120 para. 4 that listed stock corporations can have their general assembly of shareholders vote on the system of executive compensation. The vote of the general assembly is only an advisory vote. According to legislation material the vote is not meant to be a recurring event, which is supposed to take place on an annual basis. §120 para. 4 S.2 AktG states that the vote is of a non-legally binding character and therefore has no direct influence on the system of executive remuneration. Even though the vote is of a non-legally binding character the lawmaker thinks that say on pay works the way it is supposed to do. For them the key factor of the whole system is the pressure that is being build up in connection with a negative vote and the media coverage about it.[64] Some scholars even believe that the executive remuneration system does not have to suffer a defeat at the general assembly, dissenting votes of about 20% will be enough to have the supervisory board adjust the remuneration system.[65]

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[62] Aktiengesetz Kommentar *Seibt,* §87 *Nr.* 17 (2015).
[63] Handbuch Börsennotierte AG *Arnold/Günther*, §20, 910, 929 (2014).
[64] *Vesper-Gräske, 14* German Law Journal, 749 (2013).
[65] *Vesper-Gräske, 14* German Law Journal, 749 (2013).

In theory this means that if the shareholders are able to create a certain amount of media coverage of the whole event they might be able to have the supervisory board rethink its decision. This would be revolutionary when just thinking about its effect.

b). Say on pay in practice

What needs to be examined now is if the lawmaker and the scholars were right with their theories or if in reality the supervisory board is to powerful to be challenged by a group of shareholders. When having a look at the 30 biggest German companies listed in the DAX one can see that they all had their shareholders vote on their system of executive remuneration since 2010.[66] At the MDAX the situation is a little bit different. It seems like that the smaller the companies are, the less they want to get their remuneration system be up on vote. Only 78% of the companies that are listed in the MDAX had their general assemblies to vote on the remuneration system, the numbers do even decrease when turning to companies that are not listed in the MDAX anymore. [67] The point that the say on pay vote is not meant to be a recurring event can also be seen in the numbers. Since 2010 the number of companies that submitted their remuneration system for vote dropped heavily. In 2011 only 14 out of 30 had submitted their systems for vote, these 14 mainly consisted of companies that did not vote in 2010.[68] So the number of companies that had their shareholders vote for more than one time is far away from 30 out of 30, in fact it is 3 out of 30 that allowed their shareholders to vote annually[69] .

Most of the companies did not face any opposition from their shareholders. But there are a few examples where the shareholders did not approve the remuneration system or the company had to face a serious number of dissenting votes. The only company that had its remuneration system denied was Heidelberger Cement in 2010[70], the shareholders denied a remuneration system that would grant would grant the executives a remuneration of 8.6 million € in 2008 to develop up to 16 million € in 2009[71]. After the rejection Heidelberger Cement developed a new remuneration system and submitted it up for vote in 2011, over 96% of the shareholders approved it now.[72] Even though the remuneration system of Deutsche Bank was not refused in 2010 it is of great interest. At the general assembly in 2010 the remuneration sys-

[66] *Thomas/Van-der-Elst,* 14-10 Law and Economics Working paper, 655, 692 (2014).
[67] *Thomas/Van-der-Elst,* 14-10 Law and Economics Working paper, 655, 692 (2014).
[68] *Vesper-Gräske, 14* German Law Journal, 749 (2013).
[69] *Vesper-Gräske, 14* German Law Journal, 749 (2013).
[70] *Thomas/Van-der-Elst,* 14-10 Law and Economics Working paper, 655, 692 (2014).
[71] *Vesper-Gräske, 14* German Law Journal, 749 (2013).
[72] *Thomas/Van-der-Elst,* 14-10 Law and Economics Working paper, 655, 693 (2014).

tem submitted by Deutsche Bank faced a number of dissenting votes of 42%.[73] As a result their resubmitted their remuneration system in 2012, even though they only made minor changes to it but tried to keep it more transparent itself, they received an approval rate of 92%.[74]

c). Conclusion

To conclude the topic of say on pay in Germany two things can be said. First of all even though say on pay is not mandatory for listed companies, a great majority of them had submitted their systems for vote, at least once since 2010. The second point that can be seen is that the influence of shareholders is relatively modest. Of course the companies that have experienced pressure from the shareholders changed their systems, but the changes that have been made were relatively small and did not overthrow the whole remuneration system. One result of the whole new say on pay system that the media has figured out, is that companies are having more deliberations with their biggest institutional investors such as Banks or Funds to figure out remuneration systems for executives that they are willing to approve at the general assembly.[75] This is due to the German stock market where institutional investors are in control of a lot of companies.

In 2012 the German government proposed another amendment to the Aktiengesetz that would have made annually say on pay votes mandatory and legally binding.[76] This proposal never went into law.

4. European Union and executive compensation

Since the European Union (in following referred to as EU) is taking an active role in a lot of areas of the law it needs to be outlined if they are as well active in the filed of corporate Governance, especially executive compensation. In the field of business law the EU is not actually issuing binding laws for the member states, they approach this topic by issuing recommendations.[77] Recommendations are legally not binding for the member states[78], so the member states can follow them or not.

In 2004 the Commission of the European Union (in following referred to as EC) published a recommendation on appropriate remuneration regimes for executives of listed stock corpora-

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[73] *Thomas/Van-der-Elst,* 14-10 Law and Economics Working paper, 655, 692 (2014).
[74] *Thomas/Van-der-Elst,* 14-10 Law and Economics Working paper, 655, 693. (2014).
[75] *Johson,* Financial Times, January 27, at para. 6 (2013).
[76] *Ziemons,* 2013 GWR, 283, 284-285 (2013).
[77] *Vesper-Gräske, 14* German Law Journal, 749,751 (2013).
[78] Das Recht der EU *Nettesheim*, Art. 288 Nr.200 (2015).

tions[79]. The recommendation consists of various parts concerning executive compensation. The recommendation states, that every listed stock corporation should provide its shareholders with an individualized report concerning the remuneration system. According to the EC this report should explain why the different parts of the remuneration package where chosen and on which kind of information they are calculated upon.[80] As well did the EC recommend that the shareholders should vote upon the remuneration system at the annual general assembly.[81] In the aftermath of the financial crisis the EC released a second recommendation, which is supposed to complement the recommendation of 2004.[82] The main point of this new recommendation is to make sure the structure of executive compensation is orientated upon a long-term sustainable development of the corporation.[83] As well included in the recommendation is that the EC supports the establishment of clawback mechanism to reclaim parts of variable pay in case of failure.[84]

The latest actions of the Commission regarding executive compensation took place in 2014 when the EC published the proposal of a EU directive concerning the rights of shareholders.[85] The EU directive would make it mandatory for companies to put their remuneration policy up for vote every three years at the general assembly, the vote would as well be legally binding.[86] Stock corporations would also need to state how the pay ratio in the company is and how it influenced executive remuneration.[87] This would be a huge step of EU interference into business law of the states.

A lot of points that the EC suggested in their recommendations are already put into law in Germany. Especially the suggestions about disclosure of executive compensation, provisions concerning this topic can already be found in the Aktiengesetz. What is not put into law in the intensity that the EU might wish for it is the regulation about say on pay. Even though German stock corporations can put their remuneration for executive up for vote at the general assembly this is not legally binding at all.

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[79] *Recommendation 2004/913/EC of the Commission of December 14 2004,* O. J. Of the EU Nr. L385, p. 55.
[80] *Vesper-Gräske, 14* German Law Journal, 749,751 (2013).
[81] *Vesper-Gräske, 14* German Law Journal, 749,751 (2013).
[82] *Commission Recommendation C(2009) 3177 as of April 30 2009 complementing recommendation 2004/913/EC.*
[83] *Vesper-Gräske, 14* German Law Journal, 749,751 (2013).
[84] *Hausemann/Bechtold-Orb,* 2010 11(2) E.B.O.R, 195, 198 (2010).
[85] *Proposal 2014/0121 for the change of EU directive 2007/36/EG as of July 11 2007,* O. J of the EU Nr. L184, p.17.
[86] *Mense,* 2014 GWR, 232, 235 (2014).
[87] *Mense,* 2014 GWR, 232, 235 (2014).

V. Conclusion

To conclude this paper about executive compensation in Germany there are several things that can be said. First of all executive compensation is a very complex matter where several different parties do play a role. Every different acting party, such as the shareholder, the executives themselves and the supervisory board has their own interest when it comes down to designing such a remuneration package. The biggest interests can be split up into two groups. On the one side there are the shareholders whose interest it is to maximize their own wealth, which goes hand in hand with a maximization of the wealth of the company. On the other hand there are the executives who might not always bee that interested in the long-term development of the company since they do not hold any shares of it. Executive compensation is being used to align the interest of all the acting parties. In order to do so especially incentive orientated compensation plays an important role.

At this point the lawmaker comes into play with the legal framework for executive compensation. Its main idea behind all the rules and regulations concerning executive compensation in Germany is to protect interests of the shareholders. Especially in the aftermath of the financial crisis in 2008 when incentive orientated compensation was at its peak the lawmaker became active. A set of different laws was passed with the aim to grant shareholders a better protection. The requirement of a sustainable basis for executive remuneration is maybe the biggest point that developed out of this process in the aftermath of 2008. In the past years the European Union became more and more active in the field of executive compensation as well. Until today the European Commission has passed two proposals concerning executive compensation and a first draft of a EU directive. All these proposals and drafts consist in most parts of things that are already turned into law in Germany by some degree. Even though the proposed provisions about say on pay and disclosure are stricter than the German provisions about these topics.

B. US part

Introduction

This section, of the work on Executive Compensation, a comparative approach between Germany and US, deals with a very general view over executive compensation in the US from a corporate governance perspective. The purpose is to analyze executive compensation, its purposes and the way the US legislative as well as the market has approached the topic in order to align and discipline compensation practices that depart from shareholder value creation. Misaligned incentives, between shareholders as principals and executives as agents, have created a so-called agency problem in the managers' compensation decision process.[88]

The goal of this paper is to answer the following questions: Should the US federal government intervene and regulate executive compensation? Is or has government disclosure and disclosure refinement approach over executive compensation been the right way of intervention and what is the impact of those measures over the society, the market, shareholders and the press? Are disclosure and independence requirements enough?

In order to answer the questions, we will analyze a broad range of factors that under a corporate governance perspective have shaped executive compensation. In Chapter I, we will go through the history and development of executive compensation in the US and the legal approach of the federal government. In Chapter II we discuss the way executive compensation is structured and its authorization process. In Chapter III, we work on the levels and the relationship between power and pay, as well as the economic determinants and the forms and reward types that are applicable to managers pay packages. Finally, in Chapter IV, we analyze the legal framework governing executive compensation in the US, considering the federal government approach and the states courts one. We also discuss the latest reforms and their effects. At the end we conclude that, despite the assertiveness of US disclosure and independence approach, there are still some risks and challenges to take into account in order to properly frame executive compensation, an agency problem that is in a continuous evolution.

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[88] *See* Lucian Bebchuk and Jesse Fried. Pay without Performance – The unfulfilled promise of Executive Compensation at 16

I. Historical Development of Executive Compensation

• USA

Generally, the historical development of executive compensation, has been carried out or driven either by the public or by federal action. It is important to realize that executive compensation was not an issue until the early twentieth century when large corporations began to dominate the economy. [89] The corporation's growth required investment from many sources. Hence, as a result of the shareholder dispersion, company's original owners could not control company's management any longer.[90] Moreover, owner-managers had the authority and control over executive compensation, forthwith over their own pay. In contrast, non-owner executives had to negotiate their compensation – agency problem relationship. [91] As a result, by the 1930s, retail shareholding was already a large-scale phenomenon, which provided political support for the New Deal legislation. This legislation was designed around the dispersed stock ownership of the Berle-Means modern corporation, thus making it viable.[92] Executive compensation scheme was changing. During the 1960s the executive compensation rose quickly and then slowed during the 1970s. Between 1980 and 1993, executive compensation increased dramatically.[93]

○ Early Stages

The first recorded controversy over executive compensation dates from the 1920s. Bethlehem Steel Corporation disclosed that it paid its President, Eugene G. Grace, annual bonuses that "reached $1,000,000 to $1,500,000."[94] At the end of the 1920s the economy fall dramatically and the US was going through the great depression, as a result during the early 1930's executive compensation became a public issue, due to series of disclosures.[95] In 1933, after two years of litigation, the American Tobacco Company ("ATC") executive compensation was found by the Supreme Court large enough to warrant investigation.[96] An ATC shareholder brought action, challenging the validity of a bylaw, which authorized payments to executives

[89] *See* Urska Velikonja. Negotiating Executive Compensation in Lieu of Regulation at 626
[90] Urska V, supra note ii at 626
[91] *Id.*
[92] *See* John Armour and Jeffrey N. Gordon. The Berle-Means Corporation in the 21st Century at 2
[93] *See* Sean M. Donahue. Executive Compensation: The New Executive Compensation Disclosure Rules Do Not Result In Complete Disclosure at 64
[94] Urska V, supra note ii at 626
[95] *See* Harwell Wells. "No Man Can Be Worth $1,000,000 a Year": The Fight Over Executive Compensation in 1930s America. (*http://lawreview.richmond.edu/?p=1375*)
[96] *See* Rogers v. Hill, 289 U.S. 582, 53 S. Ct. 731, 77 L. Ed. 1385, 1933 U.S. LEXIS 194, 88 A.L.R. 744 (U.S. 1933)

in addition with their salaries. US people inconformity during the great depression was coupled with the perception of executives abuse off excessive salaries product of self-dealing.[97] The Bethlehem Steel and American Tobacco revelations, combined no doubt with a Depression-generated disgust with corporate management, fueled public perceptions that executive compensation was both excessive and the product of self-dealing. ATC and other executive compensation scandals obtained the spotlight and raised questions of how much corporate executives ought to be paid. Franklin D. Roosvelt's New Deal included the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934. In those securities acts the legislative included disclosure of information to be done in the proxy and registration statements of corporations. [98] By the 1950s, some CEOs were making relatively large salaries, but many salaries were still at this stage not exorbitant.[99]

- **1970;**

In the 1970's CEO compensation was mostly in the form of salary, thus relatively insensitive to performance. Hence, observers noted that CEO pay did not track the typical indicators of company performance. CEO's additionally received discretionary annual bonuses.[100] The board decided the payment of the CEO and then, the CEO was responsible, directly or indirectly, of the compensation of the other employees.[101] Again, the relationship between shareholder wealth maximization and pay was at this stage low, resulting in an inadequate supervision of company's performance. Therefore, CEO's benefited largely of agency costs.[102] In 1978, the Commission implemented the tabular form disclosure, where all direct and indirect compensation required to be revealed to the public.[103]

- **1980;**

During the 1980's performance based compensation started slowly to play a role in the press and created much debate. [104] As a result of 1978 disclosure requirements, shareholders started

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97 Harwell Wells, supra note viii
98 Sean M. Donahue, supra note vi at 65
99 *Idem* at 63
100 *See* Allen, Kraakman and Subremanian. Commentaries and Cases on the Law of Business Organizations at 331
101 Allen, Kraakman and Subremanian, supra note xiii at 331
102 *Idem* at 332
103 *See* Jerry W. Markham. A financial history of the United States from Enron-Era Scandals to the Subprime Crisis, Routledge at 101
104 *See* Donald P. Delves. Stock Options and the New Rules of Corporate Accountability: Measuring, Managing, And Rewarding Executive Performance 19 (2004).

expressing their concerns about the determinants of managerial pay.[105] Also, some academics started discussing that executives were paid "handsomely"[27] and about the "excessive" payment received by the executives versus the normal employer payment.[106] The tabular form disclosure of 1978 was amended in 1980 and again on 1983, in order to increase transparency in the disclosure statements through a narrative approach.[107]

- **1990;**

Performance-based compensation started is progress in companies' boards in the early 1990's. Stock and Stock options were the primary forms used to link performance and compensation.[108] In 1992, an election year, executive compensation was a recurrent topic in debates for both, republicans and democrats. During Bill Clinton's campaign, he promised to tax excessive pay, and he did.[109] In 1993, the §162(m) of the Internal Revenue Code was enacted, which limited deduction of compensation that exceeded $1 million and that was not a performance-based.[110] Another common practice in this stage was option repricing – to favor CEO's in option loss of value, the board reset the strike price of the options – thus restoring the benefit without providing any incentive.

Additionally, from 1993 to 2000, the amount of executive compensation increased sharply. In large companies, such as those representing the S&P 500, average CEO pay increased from $3.7 million in 1993 to $17.4 million in 2000.[111] This increase happened because of several short-term and mostly long-term trends, (i) CEO's work became stringent because of globalization; (ii) companies inclination of hiring "superstar" CEOs during this time period[112]; (iii) growth in stock options based compensation[113]; and (iv) the 90's bull market. Moreover, congress elimination of the corporate income tax deduction for non-incentive-based compensation in 1993 was also a catalyzer for compensation increase.[114] Also, in 1993 the Securities Exchange Commission (SEC) adopted amendments to 1983 regulation, to increase the disclosure while categorizing the various elements of compensation and promoting comparability

105 *See* Saks Frydman. Executive Compensation: A New View from a Long-Term Perspective, 1936–2005 at 1
106 Urska V, supra note ii at 627
107 Jerry W. Markham, supra note xvi at 101
108 Allen, Kraakman and Subremanian, supra note xiii at 332
109 Urska V, supra note ii at 627
110 Allen, Kraakman and Subremanian, supra note xiii at 334
111 Sean M. Donahue, supra note vi 64
112 Allen, Kraakman and Subremanian, supra note xiii at 335
113 Saks Frydman, supra note xviii at 19
114 *See* Roberta Romano. Reforming Executive Compensation: Focusing and Committing to the Long-term 2009 at 361

from year to year and from company to company.[115] Furthermore, companies had to disclose the annual compensation (i.e. restricted stock awards, option awards), and all other compensation for the top five executives. Since this decade, congressmen, policymakers, and academics alike have raised concerns about executive pay because of executive compensation steady increase.[116] However, is in this particular era, when the trend of transparency started playing an important role in the development of executive compensation. The 1993 amendments intention was adjust the disclosure requirements to the new forms of compensation (long-term compensation), the increased shareholder activism and as a response of the negative public perception regarding executive pay.[117] The disclosure of corporate compensation through narrative descriptions allowed companies to provide obscured information in order to minimize outrage. Thus, SEC's goal of clear and concise disclosure[118], generated a framework where executive pay was more visible *bis-a-bis* other executives, boards and the general market.

- **2000;**

Executive compensation peaked in 2000 and decreased during 2001, due mainly to the poor performance of the stock market.[119] Afterwards, the scandals of many once-proud America corporations, including not only ENRON, but also WorldCom, Qwest, Global Crossing, HealthSouth, Cendant, Rite-Aid, Lucent, Xerox, Tyco International, Adelphia, Fannie Mae, Freddie Mac, and Arthur Andersen[120]

2001 Corporate scandals and the Sorbanes-Oxley Act

The collapse of those iconic companies and the shape of the accounting and corporate atrocities, meant also a collapse of the corporate governance structure. Particularly, in the context of executive compensation, some outrages exposed the many flaws of corporate governance structures. Just before filing bankruptcy, Enron allowed a small number of executives to withdraw millions of dollars from their deferred compensation accounts.[121] The US Congress reaction came just after. In 2002, US Congress passed the *Sorbanes-Oxley Act* ("SOX"), as a

115 *See* SEC - Executive Compensation and Related Person Disclosure (https://www.sec.gov/rules/final/2006/33-8732a.pdf)
116 Urska V, supra note ii at 627
117 *See* Patrick J. Straka. Executive Compensation Disclosure: e SEC's A empt to Facilitate Market Forces at 806
118 *Idem.* at 816
119 Sean M. Donahue, supra note vi at 64
120 *See* Kevin J. Murphy. Executive Compensation: Where We Are, and How We Got There at 92
121 *Idem* at 99

response to, among other things, executive's ability to reap large financial awards and later modifying financial statements.[122] In particular, Section 304 of said Act provides that if a re-statement is required as a consequence of executive misconduct, the CEO and CFO will have to pay back to the company any bonuses, other incentive-based or equity-based pay, and/or trading profits realized in the twelve months after the incorrect financial information disclosure.[123] As of to day, this provision was added by the Dodd Frank act as we discuss in the following chapters.

2006 disclosure reforms

In August 2006, the SEC amended the executive compensation disclosure rules. The 1992 rules required significant changes in order to improve transparency required investors and the market.[124] The leader of this movement was Chairman Christopher Cox. He argued that the increased transparency would pressure directors to keep executive compensation under a "reasonable" standard.[125] The new rules provided a broader tabular disclosure while simultaneously improving narrative disclosure.[126] In other words, the new rules included a single number rule that accounts all compensation for each of the top executives, as well as improved disclosure rules on retirement payouts, perquisites, director's pay, and related-party transactions.

2008 Crisis and the Financial Institutions Executive's role

The Dodd-Frank Act, the legislative reaction to the 2008 financial crisis, addressed the flaws of executive compensation with a strengthened disclosure approach. In 2008, some years after the corporate scandals, the financial crisis hit the US. The global impact of the failure of some of the prominent Financial Institutions threw the spotlight again on the US corporate regulation. Again, executive compensation was on the spotlight of commentators, academics and regulators. The pressure of shareholders, unions, the public, and the media elevated disputes about executive pay to national prominence. Some authors argue that companies seemed to give higher rewards to executives that were exposing their companies to higher risks. As a result, some argue, that those higher risks generated large losses once the mortgage crisis

[122] Allen, Kraakman and Subremanian, supra note xiii at 337
[123] *Id.*
[124] *Idem.* at 336
[125] *Id.*
[126] Sean M. Donahue, supra note vi at 66

stroke, like in the case of Goldman Sachs that we will discuss in the following chapters. In short, excessive-risk management was threating and at the end triggered the financial crisis, which had global effects.[127] US Congress reaction to the financial crisis, was the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which President Obama signed into law in August 2010.[128] The Dodd-Frank Act included five sections (§951-§955) addressing executive compensation regulation. Through its provisions, the Dodd-Frank Act affects the governance of issuers regarding executive compensation by imposing higher standards of disclosure, the say-on-pay rule, additional listing requirements, and pay-ratio disclosure.[129] In the following chapters we will work all sections in a more detailed approach. After the Dodd-Frank Act enactment, the SEC has taken action to address and adopt all of the mandatory rulemaking provisions of it.

[127] Urska V, supra note ii at 628
[128] *See* Ann Yerger. Say on Pay: Identifying Investor Concerns (*http://corpgov.law.harvard.edu/2011/11/15/say-on-pay-identifying-investor-concerns/*)
[129] *See* SEC release - Corporate Governance Issues, Including Executive Compensation Disclosure and Related SRO Rules (https://www.sec.gov/spotlight/dodd-frank/corporategovernance.shtml)

II. Structure of executive compensation in USA

"… Human beings … seek information concerning what activities are rewarded, and then seek to do (or at least pretend to do) those things, often to the virtual exclusion of activities rewarded."

Steven Kerr, On the Folly of Rewarding A, while hoping for B, p.1

- **Role of incentive orientated compensation**

To begin with, generally, compensation is the way of rewarding an employee for its service. Furthermore, compensation could also be an input to encourage behaviors and performance. Likewise, executive compensation means the reward that a high officer in a company will obtain. Executive compensation differs from the compensation of a normal employee because of the importance of their role, the noticeable contribution of the CEO to corporate value among many other factors that make an executive valuable. Therefore, the compensation of an executive will be higher than the one of a normal employee. While vested as an officer of the corporation, the main goal of an executive is to maximize shareholder value. Being that the responsibilities and objectives of an executive are high, an executive is normally awarded with a compensation package that includes several components to attract, engage, motivate or incentivize, and retain them.[130] Firstly, since compensation is the primary reason why executives choose to join or leave a company, the contract must provide enough value to induce the executive to accept and remain in the position being offered.[131] In other words, the contract must provide benefits whose value meets or exceeds the value of the other opportunities available to the candidate. Secondly, compensation arrangements design should provide managers with enough incentives to increase shareholder value. Again, the objective is to induce the executive to focus on shareholder interests and avoid self-serving choices is important.[132] On the whole, an executive compensation package could be designed to reinforce and commit the executive to align the company's performance to meet certain expected goals.[133] Coupling performance with compensation may require the company to generate tailored compensation packages that reward executives pursuing the company financial objectives. However, linking

130 *See* Larry Comp & Steve Smith. Quick and Easy Tips to Help you Manage Your Largest Investment at 3
131 Lucian Bebchuk and Jesse Fried, supra note i at 155
132 *Idem.* at 19
133 Larry Comp & Steve Smith, supra note xliii at 9

compensation to performance may require a company to increase an executive's compensation because compensation that is sensitive to performance is less valuable to managers than fixed pay with the same expected value.[134] Lucien Babchuk and Jessy Fred argue that managers, like most people, are generally risk-averse, meaning that they value a certain payment more rather than performance-based payment because the last depends on an expectation. [135]

- **Structure – how is executive compensation authorized**

The Board of directors is in charge of aligning the agency relationship between shareholders and managers. Therefore, U.S. corporate governance system gives boards substantial power and counts on them to monitor and supervise the companies' managers.[136]Like any other transaction with the corporation, the board must properly authorize the executive employment contract.[137] In the case of the shares of a stock-based compensation, the articles of incorporation need to consider that provision.[138] Moreover, the Board needs to approve any transaction involving company's stock, such as options or stock grants.[139] Customized articles of incorporation could also include provisions limiting the dilution of shareholders, due to the exercise of options, to shareholder approval.[140] Henceforth, the process of compensation authorization could vary depending on the plan an the articles of incorporation, but the key stone is that the Board is in charge of the reviewing, voting and approving executive pay. It is common for public corporations that the board delegates the task of reviewing and approving executive pay to a compensation committee composed primarily of independent directors.[141] However, the compensation package is prepared and designed by the Human Resources Department, who very often require an external compensation consultant advise them and the compensation committee.[142]

The purpose of the compensation committee with independent directors is to create an armored compensation decision process, aiming on business judgment deference.[143] Executive

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134 Lucian Bebchuk and Jesse Fried, supra note i at 19
135 *Idem* at 20
136 *Idem* at preface X
137 *See* Alan R. Palmiter. Corporations: Examples & Explanations at 312
138 *See* MBCA §2.02
139 *See* MBCA §6.24
140 *See* MBCA §6.21 (f) and NYSE Listed Company Manual Rule
141 Lucian Bebchuk and Jesse Fried, supra note i at 24
142 Urska V, supra note ii at Table 1
143 Lucian Bebchuk and Jesse Fried, supra note i at 70

compensation is not subject to fairness review, as long as, informed, disinterested, and independent directors approve it.[144] Given these points, in the following chapters we will discuss the judicial review of executive compensation decisions.

In the book *Pay for Performance*, Lucien Bebchuk and Jessy Fried argue that the executive pay decision is biased by the influence of the CEO who is trying to get the best deal for his personal benefit. In fact, their criticism to the structure of executive compensation authorization dispute the official theory of executive compensation, which assumes that the board bargains at arm's length with executives, solely with the interests of the corporation and its shareholders in mind.[145] Hence, recognition of managers' influence over their own pay is helpful in order to eliminate "generous" compensation packages and align this agency problem.[146] Directors have had several incitements to back up or allow compensation arrangements that favor managers. First, executive's power to influence board's decision relies among other things on; *(i)* the pay setting process; *(ii)* directors' desire to be reelected; *(iii)* CEO's power to benefit directors not only by directors pay process; *(iv)* general social and psychological factors; *(v)* CEO inherent authority; and *(vi)* the low risk and low costs of granting generous payments. Second, board's information regarding the package could be biased. Managers gain of their influence over the information production process, whether at the human resource level, subordinates of the CEO, or through the compensation consultants, hired through human resources department, and who might be willing to be hired for other assignments. Furthermore, Bebchuk and Fried, argue that market forces (competition, market for corporate control or proxy contest, managerial labor markets) are unlikely to force limitations on managerial pay and overall they allow deviations from an arm's length contracting.[147]

- **Executive Compensation – Variables affecting the decision process**

According to Larry Comp and Steve Smith, there are four major variables that influence executive compensation levels.[148] The role of the executive, meaning the responsibilities and duties, are being considered in order to achieve the right pay level. Also, the company size is

[144] Alan R. Palmiter, supra note l at 313
[145] Lucien Bebchuk and Jesse Fried, supra note i at 17
[146] *Idem* at 4
[147] *Id.*
[148] Larry Comp & Steve Smith, supra note xliii at 25

being measured for the design of the compensation package. Similarly, industry of the company plays a role, as well as, location, which is not always a very important and measurable variable because many public companies are now global companies.

III. Levels

• Relationship between Power and Pay

○ Economic determinants

The supply and demand for executives, a very scarce labor force, creates constraints on whatever agreements directors and managers are willing to make.[149] However, the fear of a hostile takeover or proxy contest should compel executives and directors to craft pay arrangements that maximize shareholder value and generate the right inputs to circumvent agency problems as well as retain directors. In the free market, generous pay and executive idleness will produce a market disadvantage.[150] Henceforth, it is very important for a company to have a well-constructed compensation plan to create the right incentives for the manager to lead the business aiming the expected financial results. Notably, managers should not be incentivized to take high risks to obtain such financial objectives.

○ Forms of Executive Compensation

Compensation packages could be tailored in many different ways, thus harness all possible rewarding forms. Generally speaking, we will divide executive pay forms in three direct forms, salaries and bonuses, Stock plans and Pension Plans.[151] Among the several forms to pick while crafting a compensation plan the following forms of compensation are some of the most common used. [152] Besides, all the factors to consider when picking a reward form, the compensation committee needs to consider the advantages and disadvantages of the form to the corporation, its shareholders and in relation with alignment of the incentives, as well as the tax burden of said form. It is remarkable that in the US, federal intervention prohibited companies to grant executives with corporate loans.[153]

▪ *Salaries and bonuses*

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149 Lucian Bebchuk and Jesse Fried, supra note i at 4
150 *Idem* at 57
151 Alan R. Palmiter, supra note l at 309
152 Kevin J. Murphy, supra note xxxiii at 6
153 Allen, Kraakman and Subremanian, supra note xiii at 355

Compensation plans include normally a salary component combined with bonus for performance. Base salaries for CEOs are typically determined through competitive "benchmarking," based primarily on general industry salary surveys, and supplemented by detailed analyses of selected industry or market peers. Size is traditionally measured using company revenues, although market capitalization is increasingly used.[154] A performance award or long-term incentive plan to pay out over multiple years can be linked to a number of measures.[155] Despite the linkage with performance, incentive plans are criticized because they *(i)* do not provide executives with a true ownership stake, and *(ii)* it is sometimes difficult to establish accurate long-term goals. In addition, there are also cash based long-term plans that have some tax advantages, like the Executive 162 "stay" bonus, which has the virtue of incentivizing executive retention.[156]

- ***Stock Plans – Options***

Equity based compensation means compensation based on the value of company stock. Restricted Stock is a plan where shares of stock are granted to the executive and the vesting will depend on the accomplishment of certain conditions. The advantage of restricted stock is that executives could turn into owners, thus aligning their interests with that of the owners. It also encourages retention, since an executive would be foregoing the value if they left prior to the end of the restriction period. However, a disadvantage of restricted stock is that it dilutes existing shareholders by issuing additional shares for which no purchase price was paid and outside of share price they lack a pay-for-performance relationship. [157] Likewise, Stock options consist of a plan that grants an executive the right to purchase a fixed number of shares of company stock at a fixed price over a specified period of time. One advantage of utilizing stock options is that the design of these plans can be very flexible. One of the disadvantages is that options are taxed when exercised, so there is no tax deferral, as such, the executive will need to pay for the shares plus the tax. Another disadvantage is that options encourage risky executive behavior in an effort to drive stock prices up with little regard for the downside. Options are very advantageous for managers because they give the holder the right, but not the duty, to buy an underlying asset by a certain date at a fixed price.[158] In the case of executive compensation, the underlying assets are normally shares of the company. To put it anoth-

[154] Kevin J. Murphy, supra note xxxiii at 10
[155] Larry Comp & Steve Smith, supra note xliii at 48
[156] *Idem* at 53
[157] *Idem* at 48
[158] *See* Andrew. M. Chisholm, Derivatives demystified at 2

er way, options give the right to the executive to buy certain number of company shares for a specific price "spot price". Therefore, if the value of the shares drops below the spot price, the executive can walk away without any consequence. As a result, options allow managers to obtain profits without being exposed to risk of losing money. Also, options do not have a linkage to performance besides of the movements in share price. Another form of compensation, which is very flexible, is the phantom stock. This kind of equity-based plan can be designed to mirror the value of equity-based plans without the complications of using real equity.[159] Another equity based plan that mirrors equity are the Nonqualified Stock Alternative Plan, which has also some tax advantages. There is another performance-based and/or time-based compensation that has been widely used, restricted stock. The key is that restricted stock does not create biased incentives the way options do. Restricted stock is a plan where an executive is granted shares of stock that are subject to forfeiture unless certain conditions are met.[160] On this side, restricted stock has advantages. First, if the restrictions have been met then the executive turns into an owner, thus minimizing the agency problem between shareholders and managers. Second, it also motivates retention because the executive would leave some money in the table if leaving. On the other side, the disadvantages of restricted stock are that it dilutes existing shareholders and that time based shares lack of the connection with performance.

- ***Pension Plans***

Many compensation contracts promise executives a substantial stream of benefits after retirement.[161] The most common reward to encourage retention is the insertion of a pension plan in the compensation agreement. In the design of the average employer compensation plan, companies usually use "qualified" pension plans because of the favorable tax treatment that they receive (beneficial deduction for the company and when employers retire the pension funds they get taxed.[162] On the opposite, companies prefer to award executives with a non- qualified "supplemental" executive retirement pensions (known as "SERPs") because this plans allow to shift some of the executive's tax burden to the firm. Also, SERPs benefit executives in the way that they are *defined benefit* plans, which guarantee fixed payments to

[159] Larry Comp & Steve Smith, supra note xliii at 51
[160] *Idem* at 48
[161] Lucian Bebchuk and Jesse Fried, supra note i at 107
[162] *Idem* at 97

the executive for life, rather than linked to the contributions made by the employee.[163] In addition, to the compensation plan, retired executives are sometimes subject to a consulting contract that offers them an annual fee for being available for advising the new manager.[164]

- **Reward types**

A compensation plan might include several ways of rewarding a manager for its service. As mentioned above, the purpose of a compensation package is to attract, engage, motivate or incentivize, and retain them. Despite the forms for achieving said purpose, in this section we will discuss some types of rewards that are different to the normal compensation plan that rewards an executive during the tenure of the position, described above. In particular this kind of rewards should be divided into two categories, the first as golden hellos, the second golden bye-bye. Golden hellos, are a large initial payment on top of the annual compensation package or the executives pay agreement. [165] The justification is that golden hi are necessary to attract star CEOs, who are reluctant to forfeit the substantial income they expect to earn in their current positions. Similarly, a golden bye-bye, is being used when the executive is leaving the company. This departure payments are not mandated under the CEO's contract at the time he or she decides (or is asked) to leave.[166] These gratuitous payments have often been made when the executive is fired, when the company is being acquired or in some cases when they retire. The objective of these additional payments is to sweeten executive's departure.

All together all this forms of executive payment are being used in the design of compensation packages to incentivize executives to obtain the performance awaited for the company. In addition provide the right stimulus to attract, engage, motivate or incentivize, and retain the executive.

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[163] *Idem* at 98
[164] *Idem* at 107
[165] *Idem* at 130
[166] *Idem* at 87

IV. Legal framework of executive Compensation - USA

• US Legal framework – Federal Regulation

The US federal regulation regarding executive compensation can be catalogued as a disclosure-transparency legal framework. Since the early 1978, when the Securities Exchange Commission implemented the tabular form disclosure, federal action in the field of executive compensation has promoted a stricter disclosure regime. The ground for that reasoning is that disclosure helps investor and the general market taking informed decision. In this section, we will focus on the most recent regulation over compensation, the Dodd Frank Act and its several sections which have been implemented by the SEC.

<u>Section 951 – Institutional Investment manager's vote's disclosure</u>

On October of 2010 the SEC implemented rules requiring institutional investment mangers to report their votes on executive compensation and "golden parachute" arrangements at least annually, unless the votes are otherwise required to be reported publicly by SEC rules.[167] The purpose of these rules is to make proxy and information statements, reports and registration statements easier to understand. Also, provide investors with a clearer and more complete picture of the compensation earned by a company's principal executive officer, principal financial officer and highest paid executive officers and members of its board of directors. The rules are in fact intended to provide better information about key financial relationships among companies and their executive officers, directors, significant shareholders and their respective immediate family members.[168]

<u>Section 951 – Say on Pay</u>

Some months after the Institutional Investment disclosure provisions, in January of 2011 the SEC implemented the Say-on-Pay rules. Section 951, say on pay rules require shareholder

167 *See* SEC - 17 CFR Parts 228, 229 et al. Executive Compensation and Related Person Disclosure; Final Rule and Proposed Rule
168 *Id.*

approval of executive compensation and of "golden parachutes".[169] This rule requires that *‘‘[n]ot less frequently than once every three years, a proxy or consent or authorization for an annual or other meeting of the shareholders for which the proxy solicitation rules of the Commission require compensation disclosure shall include a separate resolution subject to shareholder vote to approve the compensation of executives,*’’ (a ‘‘say-on-pay vote’’)[170]. Also, the rule allows companies to customize the timing of the say-on-pay votes. Through a non-binding vote shareholder will determine weather say-on-pay votes will be required to happen every one, two or three years. Say-on-Pay provides shareholders with a mechanism to influence executive pay. This tool provides shareholders with the opportunity to evaluate a firm’s publicly disclosed practices to provide direct feedback to boards of directors through a non-binding shareholder vote.[171]

However, some authors have criticized say on pay because companies will tend to suit their compensation agreements in anticipation of potentially unfavorable proxy recommendation from proxy advisors. The reason is that proxy advisor recommendations might significantly affect shareholder-voting decisions.[172] In other words, companies suit their compensation agreements prior the annual meeting in order to obtain a favorable recommendation from the proxy advisor. Henceforth, Board’s knowledge of the variables measured by proxy advisors and the way of arranging those variables to fulfill proxy advisors expectations is a tool to circumvent say-on-pay.

Section 952 – Stricter listing Standards

The SEC implemented rules and added section 10C to the Securities Exchange Act 1934 in January 2013. These rules prohibit exchanges to list any equity, which is not in compliance and take into account the proper authority of the compensation committee, the independence of the members of the compensation committee, and the consideration and the independence of compensation advisers. In relation with to compensation committees listing standards, companies are required to address[173]: *(i)* the independence of the members on a compensation

[169] *See* SEC - 17 CFR 229, 240, and 249 Shareholder Approval of Executive Compensation and Golden Parachute Compensation; Final Rule
[170] *See* SEC - Shareholder Approval of Executive Compensation and Golden Parachute Compensation, *A Small Entity Compliance Guide*
[171] *See* David F. Larcker. Outsourcing Shareholder Voting to Proxy Advisory Firms at 16
[172] *Idem* at 11
[173] *See* SEC - Listing Standards for Compensation Committees and Disclosure Regarding Compensation Consultant Conflicts of Interest – A small entity compliance guide

committee; *(ii)* the committee's funding and authority to retain compensation advisers; *(iii)* the committee's consideration of the independence of any compensation advisers; and *(iv)* the committee's responsibility for the appointment, compensation and oversight of the work of any compensation adviser. Regarding compensation consultants, the SEC requires issuers to disclose any conflict of interest that they might have with the issuer. Finally, the rules also take into consideration some exceptions to the listing requirements.

This rules aim is to detach CEO influence over the compensation process in public companies. As pointed out by many scholars, in particular by Lucien Bebchuk and Jessy Fried, CEO tend to have enough power to bend the process in order to obtain the most beneficial compensation arrangement at the expense of shareholder value. In our opinion, enhancing the standards of the compensation committee, as well as constraining the ability to hire compensation consultants will be favorable for the agency relationship, between executives and shareholders, and overall for the market.

Section 953 – Pay Ratio Disclosure

In October 2015 the SEC implemented the so-called "Pay Ratio Disclosure" final rule. This statutory mandate requires companies to disclose the ratio of the compensation of the CEO in relation to the median compensation of it employees. This transparency effort is aimed to provide investors and the public with information regarding the overall pay practices in a particular company and among them. In particular, Pay Ratio rules require companies to disclose: (A) the median of the annual total compensation of all their employees; (B) the annual total compensation of the company; and (C) the ratio of the amount in (B) to the amount in (A), presented as a ratio. Companies will bear the burden of applying metrics and gathering the information to disclose the pay ratio every three years. Companies could exclude from their pay ratio metrics, non-US employees from countries with data privacy laws or regulations that prohibit said disclosure.[174]

Section 955 – Hedging disclosure (proposal)

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[174] *See* SEC release – SEC Adopts Rule for Pay Ratio Disclosure

The SEC proposed rules that build up the disclosure of company's hedging policies applicable to executives and employees. In this proposal, companies will have to disclose their policies in proxy and information statements for the election of directors The company, its parent, its subsidiaries and any subsidiary of any parent of the company will fall under the umbrella of the hedging disclosure regulation. .[175]

In my opinion, this hedging disclosure rule could be understood and is in fact inside trading regulation. Albeit, transparency standards over the investment behavior of executives and employees over the equity of the company and its whole structure, might prevent unwanted conducts pursuing to lower the risk of any equity based compensation. As a result, this disclosure rule will promote that an executive receiving equity compensation will have the same risk exposure as any shareholder. However, the results of this rule might not be the ones expected because it is an annual disclosure. The timing constraints will not provide interactive information to the market, thus limiting market response to a risk-hedging conduct.

Section 953 – Pay for performance disclosure (proposal)

One of the most progressive regulations proposed by the SEC is the pay for performance disclosure released in April 2015. This proposal will encourage companies to disclose the relationship between executive compensation and the company financial performance. In other words, it will make clear and transparent the link between compensation and performance. The metric, performance to compensation, will result in the total shareholder return (TSR).[176] The TSR will provide quick and simple information regarding the company expenditure on executive compensation, as well as facilitating a comparison of TSR among peer companies and companies in the same industry. Moreover, companies will be required to disclose the TSR for the last five years.

This simple rule will encourage standardized payments among companies in the industry. Hence, compensation designers will be encouraged to use more performance-based compensation. At the same time, it might generate an unfair compensation threshold for the executive when negotiating its compensation. The board executive compensation decision will need to

[175] *See* SEC release – SEC Proposes Rules for Hedging Disclosure
[176] *See* SEC release - SEC Proposes Rules to Require Companies to Disclose the Relationship Between Executive Pay and a Company's Financial Performance

be linked and in accordance with the compensation received by the executives of their competitors. Then again transparent performance related compensation will create investors and public reactions over the TSR.

Section 954 – Recovery of Executive Compensation (proposal)

The last SEC proposal (July, 2015) aiming to implement the Dodd-Frank act provisions is the rule regarding recovery of executive compensation. The rule will encourage Securities Exchanges to implement listing standards inquiring companies to adopt and comply with a recovery policy.[177] The clawback requirement will instruct companies to include policies that will force executives to pay back any incentive-based that they were awarded by error. That is, if there is any accounting restatement or correction of a material error, the executives will have to return the compensation that they received due to the error. This rule will apply to current and former executives that received incentive-based compensation for the three fiscal years preceding. Finally if a company does not adopt the rules, they will be subject of delisting.

- **States Regulation**

In addition to the legal requisites of the authorization process contained in the MBCA and the Del GCL, states regulation is mostly shaped through the judicial decisions. Payment to directors looks like a self-dealing transaction (conflicting interest), but Delaware courts are reluctant to look at compensation with higher scrutiny. Therefore, the rule making in executive compensation cases is blurred and a business judgment standard applies.

- *Cases*

In Re the Goldman Sachs Group, Inc. Shareholder Litigation (2011 WL 4826104 (Del. Ch. Oct. 2011)[178]

[177] *See* SEC release - SEC Proposes Rules Requiring Companies to Adopt Clawback Policies on Executive Compensation
[178] *See* In re Goldman Sachs Group, Inc. Shareholder Litig., 2011 Del. Ch. LEXIS 151 (Del. Ch. Oct. 12, 2011)

An investor lawsuit claiming that Goldman Sachs employees compensation plan encouraged high -risk taking, which resulted in several losses after the financial crisis. The argument goes on by arguing that the business strategy was not in the best interest of the stockholders because the ones benefiting the most was the management. Goldman Sachs had an Auditing Committee and hedged positions in order to balance risk. The court ruled that Goldman Sachs' decisions were product of a business judgment rule.[179] Regarding the bath faith claim approval of compensation scheme, the court ruled that "the decision as how much compensation is appropriate to retain and incentivize employees, both individual and in the aggregate, is a core function of a board of directors exercising its business judgment." Under those circumstances, plaintiff pleadings were short in creating a reasonable doubt that a business judgment was in place.[180] Moreover, the plaintiff also alleged that the Board was uninformed when making the compensation decision - gross negligence standard (provision included in Defendants articles). The allegations suggested that there were metrics that were not considered while deciding the compensation package. Once again, the court ruled against plaintiff because the board was informed. Again, as long as the Board is reasonably informed, the adequacy of the information cannot constitute a claim. The Plaintiff also alleged waste. Hence, compensation levels where contended on the basis that they were egregious or irrational due to the allocation of risk. Correspondingly, the court argued that any rule would deter corporate boards from the optimal rational acceptance of risk and then again covered under the umbrella f the business judgment rule.[181]

In sum, Delaware law "provides corporate directors and officers with broad discretion to act as they find appropriate in the conduct of corporate affairs" and "in the exercise of their business judgment on behalf of the corporation."

Lewis v. Vogelstein (699 A.2d 327 Del. Ch. 1997)[182]

Lewis is a compensation case where the Board of Directors breached the duty of loyalty and granted themselves a generous stock option plan. Even though, this is a case conflicting direc-

179 Allen, Kraakman and Subremanian, supra note xiii at 347
180 *Idem* at 349
181 *Idem* at 352
182 *See* Lewis v. Vogelstein, 699 A.2d 327, 1997 Del. Ch. LEXIS 31, 22 Employee Benefits Cas. (BNA) 1052, 1997 WL 119848 (Del. Ch. 1997)

tors compensation, rather than executives, the rule of Law is applicable to executive compensation cases.

In 1996, Mattel, Inc. (Mattel) adopted a compensation plan for the company's directors including an option grant. The plan was then presented to the company's shareholders at the annual meeting for a vote and it obtained shareholder approval. Harry Lewis brought suit and argued that the directors had violated the duty of loyalty because the option grants represented self-dealing and thus had to be proven entirely fair to the corporation. Delaware standard of review has two possibilities if shareholders approve the compensation. The first is that directors don't have a right to reasonable compensation for ordinary services, but for extraordinary services. In the US directors approve their own pay. However, stock options are subject to shareholder vote. If shareholders approved the option plan Delaware courts review the fiduciary duty breach under two standards. First, a waste standard because compensation is governed only by waste, but appears to have a higher standard to meet than normal waste. And second, fairness standard (places burden on plaintiffs to show unfairness): compensation must be fair. In this case the Court found that the stock options were sufficiently unusual that they might be considered *corporate waste*.

<u>In re the Walt Disney Company Derivative Litigation (2005 WL 2056651 Del. Ch. 2005)[183]</u>

Eisner (Disney President) hired Michael Ovitz after past CEO died. When he was hired the compensation plan considered low risk and high return for the CEO. The argument was that Ovitz was a superstar. The package was designed in a manner that if company financial results were favorable then payment was going to increase and if the company performance was lower than expected then the CEO was provided with an exit package. In other words, the compensation package inputs were not properly aligned to provide incentives for performance. After thirteen months, Ovitz and Eisner relationship did not interlock, but Eisner could not find a legitimate basis for firing Ovitz for grossly negligence or malfeasance (thus avoiding the exit package). Plaintiffs claim Disney board breached their fiduciary duties to act with due care and in good faith by allowing Ovitz to be fired without cause, establishing and then triggering a massive golden parachute. Informally, Eisner hired Ovitz, though the compensation committee approved the contract. The court ruled that the directors did not breach

183 See In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 2005 Del. Ch. LEXIS 113, 35 Employee Benefits Cas. (BNA) 1705 (Del. Ch. 2005)

their fiduciary duties. Directors were reasonably informed in order to meet the requirements of the duty of care. The court analyzes three possibilities for duty of good faith. First, subjective bad faith, meaning fiduciary conduct motivated by actual intent to do harm. Second, lack of due care, where fiduciary action taken solely by reason of gross negligence and without any malevolent intent. Lack of due care was rejected because duty of due care and good faith are separate and distinct duties. And third, intentional dereliction of duty, a conscious disregard for one's responsibilities; an intent-based standard. In sum, the court held that the directors have to be 'reasonably informed' in order to meet the duty of care requirements. In the light of the above-mentioned cases and generally courts have been consistent in giving greater deference to board decisions over executive compensation if done under the business judgment rule. [184] Hence, if they relied on advice by outside experts and if nominally independent and informed directors approve the arrangement, their decision receives the business judgment protection. [185]

Calma v. Templeton (Del. Ch. 2015)[186]

In this derivative action brought against Citrix Systems, Inc. by a shareholder, Calma, who challenged non-employee director's Restricted Stock Units awards for being excessive. Plaintiff claimed breach of fiduciary duty and waste. Whereas the Court found that the directors breached the fiduciary duty, reviewed under fairness standard, because (i) the compensation committee was not disinterested, and (ii) the company did not obtained shareholder approval of any specific package to be paid to the non-employee directors, despite shareholders approval over the Company's 2005 Equity Incentive Plan. Moreover, the Court did not find that the compensation constituted waste, because did not impose realistic limits on the award's maximum, rather than it was an unjustly enrichment in excess of peer companies.

- **Shareholder action – Litigation**

Shareholder action could possibly be a mechanism to limit "generous" executive compensation arrangements. However, as shown in the case mentioned above, courts tendency is to give consideration to board decisions made under business judgment rule. Executive compensation would not be reviewed under fairness standard, if informed, disinterested, and inde-

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[184] Lucian Bebchuk and Jesse Fried, supra note i at 48
[185] *Idem* at 46
[186] *See* Calma v. Templeton, 114 A.3d 563, 2015 Del. Ch. LEXIS 126 (Del. Ch. 2015)

pendent directors approved the package.[187] Fairness will then be met with *(i)* a compensation committee composed of independent directors which is a requisite for public companies; *(ii)* directors of the compensation committee review the information prepared by the compensation consultant on the package to be awarded; and *(iii)* disinterested independent directors deciding the package, which is some sense implied with the independence of the directors and reinforced by Section 952 of the Dodd-Frank Act. As a result, the presumption, that courts support executive compensation decisions made under a business judgment rule, is to date reaffirmed. Back in 2004, Bebchuk and Fried, argued that courts generally defer to boards' decisions on compensations issues if those decisions were made under the eyes of the business judgment rule. [188] They also argued that if the process requirements were satisfied, the courts would generally refuse to consider arguments that the approved package was unreasonable.[189]

The litigation process[190], in particular regarding executive compensation, is based on the challenge of a plaintiff to the board on the argument that the directors breached the fiduciary duty to shareholders. First, the Board satisfies the factual requirement if the decision was made by independent and well informed directors. Accordingly, to meet the informed requirement, directors need to review or listen to presentation from an inside or outside expert. Again, if independent and informed directors have taken a decision over the compensation package, the business judgment rule presumption is met. Second, regarding the procedural requirements, the suit ought to be brought as a derivative litigation, where shareholders require the company to take action. As a result, the derivative demand requirement implies that the board will need to investigate and address the problems before the lawsuit. Board can either pursue the litigation or argue that demand was not made. As a result of the latter the board can usually have the case dismissed.[191]With this in mind, in order for the plaintiff to bring action against the Board, futility of demand needs to be proven. Futility requires plaintiff to present particularized facts arguing against the independence and disinterest of the directors, hence the plaintiff needs to dig over information that might not be accessible.[192] If futility is proven, then the claim goes to the court or the Board has the option to appoint a special litigation committee who will decide in the best interest of the firm. In sum, the merits of the claim will have to go through a complex litigation process, where the plaintiff does not have in many cases a rea-

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187 Alan R. Palmiter, supra note l at 313
188 Lucian Bebchuk and Jesse Fried, supra note i at 46
189 *Id.*
190 *Idem* at 45
191 *Idem* at 47
192 *Id*

sonable amount of information. Moreover, if the board was cautious enough and the compensation decision was taken under the business judgment protection the courts will mostly defer to the Board. Finally, there are two ways to challenge the business judgment presumption, the waste standard and the bad faith standard. First, the waste standard means that the compensation package passed was so irrational that no reasonable person could have approved it.[193] Second, bad faith standard means that directors "consciously disregard" their duties during the approval of the compensation package.[194]

To summarize, shareholder litigation is a complex mechanism that presents several procedural obstacles. Hence boards will try to secure compensation decisions by implementing as many corporate governance measures as required. One example is board ratification of compensation packages, after approval by an independent, disinterested and informed compensation committee. With this in mind, it is remarkable that the courts approach to executive compensation has been parallel to the requirements imposed by the federal authorities. Accordingly, the SEC requirement of independence has been also a requirement observed by the courts. Nevertheless, the SEC has approached courts factual requirements (informed directors, as well as the waste and bad faith standard) in a different manner. The Commission has used transparency mechanisms to address their concerns about the financial reasoning and motives behind the approval of a compensation package. Transparency has had the purpose of providing shareholders and the public with information to allow them to judge and in some way discipline the board with either decline or increase the share value of the company. Equally, the SEC has in some way helped shareholder litigation by encouraging disclosure of information. That pool of information could provide shareholder action with elements to strengthen a compensation case.

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[193] *Idem* at 46

[194] Alan R. Palmiter, supra note l at 313

Conclusion

Since the early 1930s, executive compensation has certainly obtained a lot of attention from the public and from regulators. Back then, executive compensation was a topic among academics, media, legislators and shareholders. Executive compensation throughout the 20th and the 21st centuries has encountered a rough public environment, triggered by “generous” payments running against shareholder value creation, flaws in compensation arrangements and the creation of harmful incentives. The federal government approach has been a result of public pressure, economic crisis or corporate scandals. Hence, the federal government’s intervention on executive compensation has been, since 1933 with the Securities Exchange Act, through disclosure and, since 2002 with the SOX, through instrumentation of independence standards. The most recent example was the Dodd Frank Act that came out after the financial crisis of 2008, which included a broad range of disclosure mechanisms intended to regulate executive compensation. In other words, the agency problems between the CEO, board of directors and shareholders regarding executive compensation, ought to be disciplined with independence mechanisms and transparency. Accordingly, in relation with executive compensation, the purpose of this research is to answer questions about the appropriateness of governmental intervention; disclosure approach and its effects; and adequateness of disclosure and independence standards.

There is something certain about federal government intervention; it has calmed down the pressure of the press, society, market and shareholders. However, there is no certainty on whether it was the right thing to do or not because there are no measures to prove it right and corporate scandals and financial crisis, that occurred after regulation was enforced, have exposed flaws in executive pay. Correspondingly, managerial compensation design and plans are changing continuously in order to find the best way of incentivizing executives to obtain positive financial performance. Accordingly, corporate governance structures have to run parallel to this moving target in order to find the best control structures to solve the agency problem between executive pay and shareholder value. Under those circumstances, it is appropriate to think that the best way for the federal government to approach this issue is with auto regulation of the market participants, particularly inside companies. Whereas executive compensation ought to be evolving continuously and on a case-by-case basis in order to adjust to any particular setting and be able to allow the most suitable pay arrangements, government intervention should be constrained to broadly discourage behaviors that are generally considered to affect the agency relationship. Then again, the reason for legislative action to not constrain companies' design of pay arrangements is to give them a broad range of opportunities to incentivize their executives and leave them with the privilege to decide and include the economic factors and pay forms that will allow them to find the best compensation plan to meet their financial goals. For this reason, legislative action should only be taken in limited areas, which are: (*i*) self-dealing, (*ii*) manager's power to secure rents, (*iii*) outrage and (*iv*) the creation of bad incentives. With the purpose of shifting and managing the agency relationship of executive pay. In conclusion, US government transparency standards, allows a dialogue between market participants to discipline the development of compensation designs, which means a market self-regulatory approach.

Whether or not information access as implemented by the SEC after the Dodd Frank Act, will be useful to align managerial compensation practices departing from shareholder value creation is still a question that remains open. Until now, the federal government disclosure approach has tried to align compensation windfalls and unwanted behaviors, by providing the market with accurate and precise information. In my opinion, SEC's implementation of the different sections of the Dodd Frank Act, as described in chapter III, is intended to adjust market participants' perspectives and acceptance of compensation plans. Disclosure of compensation data might create the following: *(i)* market surveillance on compensation and its linkage with performance; *(ii)* reputation effects towards directors and executives; *(iii)* share value adjustment, due to flaws on compensation; and *(iv)* compensation arrangements that will consider in a broader way society's perception. As mentioned above, disclosure allows self-regulation of the market. First, an increase in market surveillance and scrutiny might encourage adequate performance-based compensation and it is intended to make directors decisions transparent, thus decisions over the compensation plan tend to be dependent on shareholder perspective and expectations. Board will take into account shareholder perspective on executive compensation plans to link them to performance. In this sense, the proposed pay for performance rule, will be a useful tool for market participants to scrutinize the efficiency and results of compensation plans and will make them accountable. Second, both CEO and Boards will be more exposed to a reputation effect. When generous compensation plans are approved, the market perspective of the CEO will be as an abusive executive and the Board as indulgent or ineffective agent of shareholders. Third, market forces could adjust share value if there is an evident outrage in compensation plans. This affects in two ways. On the one hand, it affects the general company market perception shifting share value down. On the other hand, it affects managers compensation linking it to share value. And fourth, generous compensation plans, might affect societies perception of payments that are not linked to performance and that are above the average employee payment. Societies perception is driven by "moral", "fairness-based" or "populist" perspectives opposing large amounts of pay. Pay ratio disclosure metrics will unwrap information in just a number that compares one to one, executive and the median employee compensation. That rule is aimed to provide clear-cut information that could trigger several press releases and criticisms of the perceived high salaries. Society will evaluate if a compensation plan is fair and if it is morally acceptable. Questions over the real value of the executive compensation might arise, as well as questions over the real value of the median employee salary. Dodd Frank's Act's information access implications could be broader, because it could potentially increase the number of participants and their influence over the executive compensation decision process. Pay Ratio will provide clear information that empowers social demands regarding pay arrangements in general. Hence, exacerbating the moral and social discussion of excessive compensation. Again, executive compensation has been viewed since its early stages (in the 1930s) as excessive. Therefore, Pay Ratio will likely trigger a discussion over the compensation policies inside the company and that discussion will develop over a very subjective ground. Therefore, social and labor pressure might trigger some biased modifications to employee pay structures within the companies. At the same time, not only public pressure over compensation packages will come more into play, but also other market participants' influence, due to the information disclosed. Similarly, Pay for Performance will allow a clear and quick comparison between performance and pay. This data will generate an intrinsic discussion between executives and their board of directors on why or why not is the comparison made correctly or if there are some factors not considered or over evaluated. On the one side, the performance metric will be based on a peer company comparison where general industry share price movements should be avoided. Thus, executives will try to promote those movements as a result of companies good performance if they are beneficial to them. The result will be a discretionary and vague decision on how a manager influenced company's performance trying to eliminate positive or negative outside shocks. On the other side, peer companies will have a clear *vis-a-vis* visibility and compensation will have to follow the trends among peers. The downside of this peer group comparison is that industry share value movements will tend to drive compensation amounts up or down without having any linkage to performance. Also, an overall critisism is that finding the appropriate peer group could be influenced by executives' power (Calma v. Templeton 2015)[195]. Compensation packages are being ranked in compensation indexes[196](where compensation amounts are being compared among peer groups, market capitalization and against many other metrics) and if they appear outrageous that will certainly be in the spotlight of the press and the public.[197]As a result, society will scrutinize not only the amount of payments and compensation policies of the companies, but also its linkage to performance and its justification. Moreover, increased information will allow the scrutiny to extend beyond the compensation package justification, up to analyze if amounts were fair and reasonable. Also, general market trends and over exaggeration of these or of any other metrics will be closely reviewed. In general disclosure is intended to provide the public with the required data to discuss any compensation package or policy in a very broad perspective, which implies that shareholders will have more information to sustain any suits against compensation packages. As a result, shareholders will have more elements to prove waste or bad faith in any derivative suit.

Whether disclosure and independence measures have been so far enough is a question that needs to take executive compensation as a constantly evolving corporate governance topic. There is no way of measuring the degree on how stricter regulation could have influenced executive compensation. In some way, some measures that were considered as strict, did not affect the market as expected. One clear example is the SOX enhanced requirement of a compensation committee composed of independent directors which was supposed to deter the amount of companies being listed and at the end it did not affect. Federal government has until now favored a free market development approach of compensation policies and packages, as well as and a free package design approach. Even though broadly recognized "bad practices" have been regulated in order to limit harmful behaviors, like inside trading or conflicts of interest in the compensation decision process, the playground for companies to craft and decide the compensation package that suits their own needs and expectations is encouraged to remain as unrestricted as possible. Albeit, crisis and scandals have exposed gaps in compensation regulation, enhanced disclosure rules have filled the loopholes. Disclosure is easy for government to require and makes market participants accountable and knowledgeable of the potential risks and behaviors inside the company. However, disclosure shifts costs to market participants because the company is required to gather information that in many cases is not

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195 Calma v. Templeton, supra note xcvi

196 *See* e.g. Bloomberg Pay Index or Salary Tracker Equilar)

197 *See* e.g. Bloomberg Business - NFL's Goodell Made More Than All But 61 Public Company CEOs February 16th 2016)

easily obtained or not routinely collected. It also allows shareholders and the public to supervise and scrutinize pay plans. Hence, transparency enables government to disengage regulatory action from compensation practices favoring a free market approach over pay plans with disclosure requirements.

In general, since compensation is the way of providing executives with the right incentives to drive companies performance, I believe that recent executive compensation disclosure reforms will be effective to the extent that market participants supervise and scrutinize executive pay decisions and pay decision process. There is no doubt that market participants have the right incentives to supervise and scrutinize. Hence, market participants' perceptions and their opinion will enable self-alignment and self-discipline of the whole compensation decision process. Transparency could certainly be beneficial as long as it gves rise to efficient and adequate compensation packages. In other words, more information and a intensified scrutiny could potentially trigger efficient and satisfactory compensation arrangements. Furthermore, independence standards are the best mechanism to reduce conflict of interest and inside trading in the company, as well as being the best Board's watch dog.

Going forward, there are several risks and difficulties that need to be overcome. In general, I agree with US disclosure and independent directors approach. However, recent reforms might result in new challenges. First, Pay ratio disclosure has a stockholder approach, which brings into the agency relationship of compensation practices a new participant. Despite the effort of providing investors with overall compensation practices information, it allows society to evaluate compensation policies under fairness and moral perspectives. I believe that the evaluation will be subject to various subjective standards, and in some way will erode general compensation practices in order to align all parties' incentives. Making society a participant could be a risky movement because the agency problem between shareholders and managers will have to include society perspective into an already biased equation. Moreover, the pressure that companies might receive from the press and the society could put again shareholder value creation aside. A good example that shows another way society might evaluate compensation occurred in the aftermath of the "Deepwater Horizon" oil spill. Transocean Ltd., awarded large bonuses to their executives owing to a great year of safety performance the same year that the "Deepwater Horizon" oil rig exploded and collapsed causing a massive oil spill.[198]

Transocean compensation package exemplifies the social influence over compensation. In that case some could argue that the compensation arrangement was excessive and did not take into account the overall damage that the spill created. Others could consider executives endeavor on managing the situation and their performance along the unfortunate event in the Gulf of Mexico. Second, Pay for Performance disclosure creates incentives for directors to participate in the most favorable peer group. Despite the benefit of having a number that shows the linkage between compensation and performance, it is still problematic that executives could try to adapt the metrics (industry or performance) in order for their company to be in the most favorable peer group. Again, allowing them to receive higher compensation. In this case, the press linked safety performance standards with compensation practices. Some could argue excessive compensation, while others could argue that executives were rewarded for their performance after the critical event. Again, society influence on executive compensation might bring to the game subjective standards in order to measure the adequateness of any compensation package. Third, I believe that the new regulation did not consider that in order to obtain the expected results of any information disclosure requirement should be without time constraints and on an interactive basis. For example, annual disclosure of any kind does not allow a proper and direct market reaction, which will be limited to happen just after the disclosure. Also, before the disclosure several factors could have been considered in order to minimize any negative impact. Having an interactive disclosure, like for example between pay and performance will allow companies performance to be directly reflected in share value. However, the cost of interactive information is high and it distracts executives from their own tasks. Moreover, it might produce incentives to focus on short-term investments on the cost of any long-term investment. I believe that further disclosures mechanisms need to take this more into account in order to allow market incentives to be more powerful. Fourth, there are concerns that pay for performance encourages risky behaviors. This came up after some incidents related with the financial sector where managers where exposed as incurring in conduct that resulted in losses to their company. One good example is the JP Morgan London Whale case, where the Chief Investment Office (CIO) excessive risk positions in derivatives turned against the bank and resulted in huge losses. As stated in the Permanent Subcommittee on Investigations report on the case "Incentive-based compensation systems … factors that

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198 *See* Forbes News (http://www.forbes.com/sites/jeffmcmahon/2011/04/02/transocean-bonuses-deepwater-horizon-gulf-spill/#629e0078235d)

influence individuals' performance and conduct is financial reward."[199] The CIO traders were among the employees receiving the highest pay of the bank. Even though not on an executive level, the role that compensation's incentives played should be considered because in some way risk taking and how the losses were hidden. Regardless of the clawback of almost two years of compensation of the involved employees, the case raises the question on the extent that performance based compensation can encourage risk taking. Finally, considering today's institutional investors power that contradicts the Berle-Means dispersed ownership model, their participation is very important to supervise and scrutinize companies' compensation policies and the link to performance. Also, the role of proxy advisors in the implementation of the regulation, like the say on pay, will be very important. Under those circumstances, further regulation and the development of the new rules on executive compensation will depend highly on their behavior, so not only companies will be under in spotlight, also these other market participants.

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[199] *See* United States Senate Permanent Subcommittee on Investigations - JPMorgan Chase Whale Trades: a Case History of Derivatives Risks And Abuses

C. Comparative section

It could be fair to suppose that executive compensation should not differ much between countries, at the end the same objectives and incentives should be encouraged in pubic companies of the both countries. However, the disparities between Germany and the US regarding executive compensation contravene said argument. This part of our joint research paper will point out the differences between Germany and US in the managerial compensation process and legal framework.

I. Introduction

It is important to acknowledge that corporate governance is organized in a very different way among countries. For example, some agency problems could be present in some jurisdictions and in others not. The case of executive compensation is a good example to frame such differences. In this part we will discuss the differences that exist between Germany and the US on the managerial pay approach, rather than describing the inherent structures of each country (like in the first sections). Despite the ownership model differences, where Germany has a "core"[200] shareholder model in contrast to US dispersed ownership model, there are few aspects of executive compensation that are similar both in Germany and the US. It is important to keep in mind the recent reforms on executive compensation that both countries' have recently implemented (Germany – AktG and Us - Dodd Frank Act), which have shaped the executive compensation regulatory structure of both countries. Moreover, we will approach the topic that has obtain the most press attention, which is the disparities regarding managerial remuneration between Germany and the US. The differences are huge, whereas in US executives are being paid much more than their peers in Germany. There might be many reasons for such a big difference in the amount of executive compensation but this will not be the main subject of this paper. In this comparative section we focus on the differences between the German and the US approach to executive compensation in order to accentuate the structures that work the best for each country, rather than evaluating the assertiveness of approach. In other words, the focus of this section is on the differences and similarities amid legal frameworks of executive compensation and its authorization process.

[200] Brian R. Cheffins. The Metamorphosis of "Germany Inc.": The Case of Executive Pay at 2

1. Legal framework of executive compensation

One major part when talking about executive compensation is the applicable legal framework to each country. First of all both, Germany and the US, have a totally different legal system.

In Germany there is a code based law system where in the US there is a common law system. As described above German regulation concerning executive compensation can be found in the Aktiengesetz. The Aktiengesetz is the main source of legal framework for executive compensation in Germany.

In the US the situation is a bit different. There are several participants in the legal equation. One participant is the US congress who is in charge of enacting and amending securities laws. Another participant is the Securities Exchange Commission (in following referred to as SEC), which is an agency of the federal government and whose responsibility is the implementation and enforcing of securities laws. For example, the SEC is in charge of implementing the sections Dodd Frank Act. They implemented rules over various topics that in detail are subject to another part of this paper. When having a look when these rules where passed one can see that as well in Germany as in the US a lot has changed in the aftermath of the financial crisis. Having an agency with supervisor and enforcing powers over securities laws is big difference between Germany and the US. In contrast Germany does not have an agency with similar powers and whose task it is to not only supervise that the current rules and laws are being obeyed but to implement and substantiate the provisions that are contained in federal law. The result is that without an agency properly empowered to implement laws you might have open-ended laws as the VorstAG, whereas in the US all of these provisions would be defined totally into detail.[201] Especially provisions concerning sustainability and the usual pay would most likely be defined.[202]

Another participant in the US legal system are state courts and laws. Companies ought to be incorporated in any state and they could have their business operation in another part of the US. As a result, many US companies are incorporated in Delaware where corporate law and corporate courts are at the forefront of the corporate legal development. Under those circum-

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201 *Mathieu,* 38. Brook. J. Int'L L., 580, 649 (2013).

202 *Mathieu,* 38. Brook. J. Int'L L., 580, 650 (2013).

stances, if any conflict arises, state courts will solve the dispute and they create precedent. Henceforth, courts can shift the way companies approach executive compensation because they will try to obtain business judgment deference. This is in fact one big difference between Germany and the US, because state courts have the power to erode the ground and incentivize companies to engage in corporate modifications that affect the executive compensation process. Yet, courts and federal government intervention have developed parallel without interfering between each other. In Germany there is only one the legislative power who is able to modify the legal framework. In general, there are core differences between Germany and US regulation. In contrast to German regulation, the US legal framework is able to adapt and readjust in an expedite manner in order to cover different cases and failures regarding executive compensation, that is through the SEC rulemaking process or through the State Courts when ruling over a particular case. However, the SEC has a limited authority to update or create rules and courts are constrained to create law on a case-by-case basis. Accordingly, executive compensation rules in the US ought to be found in different legal bodies, in contrast with Germany corporate governance code or AktG.

The Dodd Frank Act is a good example of SEC's limited authority to create laws. German government has been quick to adopt the VorstAG shortly after the financial crisis as a product somehow caused by public outrage and pressure about excessive executive compensation.[203] It was a fast reaction of the German lawmaker. In the US such a fast and innovative new law seems rather unrealistic.[204]

And this leads us straight to the second point where differences between Germany and the US arise. This difference does not deal with the authority enacting the rules, rather about the category of the rules. Generally speaking in the US rules and regulations can be described as a disclosure-independence legal framework. In Germany it is not easy to put the regulatory framework into a category but the approach is to encourage the development of the stock corporation. In other words, in Germany maximizing profits for investors has typically not been a prevailing priority. [205] Instead, German approach has been to strike a balance between various participants connected with companies and the main concern has been long-term sustain-

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[203] *Fleischer,* 2009 NZG, 801, 801 (2009).

[204] *Mathieu,* 38. Brook. J. Int'L L., 580, 652 (2013).

[205] Brian R. CHeffins. The Metamorphosis of "Germany Inc.": The Case of Executive Pay at 4

able growth. [206] Of course there are also provisions in the Aktiengesetz that deal with the topic of disclosure and transparency, but they can be seen as a supporting tool to achieve the main point of the legislator, which is to keep the stock corporation development on a long-term basis.

Deciding if one system is better than another is a different task. Of course every way of approaching the legal framework of executive compensation has its positive and its negative points. One can state in favor of the US way that it is a flexible on. Meaning that the SEC is able to react in a rather short time upon new developments. The SEC, despite the limitations, does not need to wait for the federal legislator to pass new laws, they can simply issue a new set of rules to encourage or discourage governance practices in the field of executive compensation. In favor of the German legal framework legal expectancies are clear for every participant of the market from the beginning on what is meant with the new laws. There is no need to wait for an agency to implement the provisions included in a federal law to know what will be its impact on their business. This offers some kind of security to every market participant and the ability to trust on the written law. But the flexibility of the SEC costs its price to companies. They are being confronted with a whole set of rules that could change continuously. The fact that the law is not defined into detail in Germany does not mean that stock corporations here do not use the terms provided by the law to define them. They just do it by themselves in order to work with them.[207] This can be described as some kind of self-reflection, which also may bring out good results concerning executive compensation systems.

As a result of the immense differences in the legal systems and therefore the legal background for executive compensation it is very difficult to decide whether one system is better than the other. It is simply not possible but maybe a few better ideas can be taken away from the German system. In fact, it leaves market participants with a bit more freedom and space for their own idea but the end the result is still regulated. Whereas in the US the disclosure approach encourages market participants to dialogue among themselves in order to find the most suitable compensation packages that will benefit their business. The best way to say it would be, that maybe both countries could still learn a few things on how to approach the topic from each other.

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[206] *Idem* at 5

[207] *Mathieu,* 38. Brook. J. Int'L L., 580, 650 (2013).

2. Authorization process

There is no doubt that the purpose of executive compensation in Germany and the US is to encourage managers to have a positive performance. Also, in both countries share the existence of an agency problem. In spite of the common economic determinants and the similar agency problems, executive compensation authorization differs between Germany and the US.

The general structure of managers' pay is in some way the same, in both countries; the governing body of the corporation has to approve compensation packages. However, in the US the board of directors can delegate the power to compensation committee who will be in charge of that task. Some years ago, the supervisory board was able to delegate such powers to a compensation committee but [now] not anymore. This is an important difference because US approach is to have compensation package decisions as independent as possible, in contrast to Germany where compensation packages design constrained by an employee "reasonable" component due to the employee representatives' in the supervisory board.

A very distinctive difference between executive compensation regulation in Germany and in the US, are the benchmarks or standards that German companies have to follow in order to grant a compensation package. Consequently, we can label this approach as a regulatory approach because the compensation plan will be shaped in such a way that it is in accordance to such standards (linked to performance, in balance with industry peer group, equitable to average employee and allowing sustainable development of the company). In reality, the US is also trying to approach those issues rather than with strict ruling like the German case, with through disclosure. Pay for Performance is similar to performance-linked compensation and in balance with industry peer group and Pay Ratio is similar to equitable to average employee. The only German benchmark, which has not been addressed in the US through disclosure requirements, is the one regarding sustainable development, which contains a long-term perspective element. In general, German regulatory approach in contrast to US disclosure approach has created strong limits to the design of compensation, rather than allowing market participants to design the most favorable compensation package that meets their goals and needs.

In neither of both legal systems, shareholders have an influential role. Shareholder vote is required in both countries when equity or options are being granted, due to the dilution of shareholder ownership. Recently, both countries have enacted rules concerning say-on-pay which allows shareholder to either favor or reject a compensation plan proposal.
In Germany these rules consist of a non-binding shareholder vote, there are no information concerning in which yearly basis this should be held. In the US these rules are only a little bit more explicit. The provision there states that a say on pay vote is supposed to be held once in a three year time span. But all these rules do not change the situation that shareholders in both legal systems do not have a lot to say.

Some authors have argued that Germany is in a transition towards an American capitalist model triggered from global companies, as well as from the European Union (EU) [208]. However, the evidence shows that the German approach will rather be directed to a long-term stable and continuous growth approach.

[208] Brian p. 8

3. Executive compensation going forward

The way we see further developments regarding executive compensation and trends in that field vary between countries. The reason for that is the way both countries will approach social perception of executive compensation both in Germany and in the US. Each country has considered public opinion into the compensation decision process. Hence, society is allowed to be a participant in the agency problem, could have power to bargain and include their interest into the game of executive compensation.

The game of executive compensation is already crowded with various parties that are trying to align their interest, but the society should not be forgotten when talking about it. Of course the people do not directly interfere with the design process of executive compensation packages, but they do create pressure upon the legislator. Just take the Occupy Movement as an example. In Washington they have protested heavily against the executive compensation practice and what a practice of injustice it is.[209]

In Germany the main protest against executive compensation practice took place right after the crisis. People felt like the whole system of executive compensation was unfair. In reaction to the crisis the German government passed the VorAG. Though, such law aim was not only to set up new rules concerning executive compensation, but also to give people the perception that something was being done.[210] Hence, it is arguable that executive compensation cannot be actively influenced by the society but in some extent societies could also play a role over the decision process and the amounts. In fact, this adds up another participant into the already complex scenery. There are already a lot of participants (shareholders, directors, CEO and other executives) trying influence the executive compensation package. As a result, the recent regulation over executive compensation will initially complicate the decision process, but will allow a better stakeholder scrutiny.

In the US there have been examples of public interference in executive compensation decisions. With the rule regarding pay ratio disclosure, public perception will come into play, due to the impact that the ratio will have over the society. Again, the public will have clear-cut information of the disparity, thus a "moral" or fairness judgment of the society could follow

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209 *Mathieu,* 38. Brook. J. Int'L L., 580, 652 (2013).
210 *Fleischer,* 2009 NZG, 801, 801 (2009).

and shape compensation policies. Having said that, it is possible that in the US executive payment decision process will have to start taking into account the society perspective. In the case of Germany, society participation has been somehow the rule.

II. Conclusion

In conclusion, there are several differences between the Germany and the US approach towards the regulation and the decision process of executive compensation. Hence, those differences arise because in each country different sets of factors apply. Moreover, the differences have shaped executive compensation through out its history, not only regarding the amounts, but also regarding the structures used in order for the companies in each country to have the best package to adequately align the incentives. In other words, corporate mechanisms of the two countries do not run in the same direction, the particular legal, society and economic context generate divergences between the US and the German approaches regarding executive compensation. It is remarkably that the purpose of executive compensation ought to be the same in both countries. Nevertheless the agency problem has been regulated in a different way because legislators have privileged some incentives among others. On the one side, the US legislator has promoted so far a shareholder supremacy approach through disclosure and independence mechanisms. On the other side the German legislator approached this topic with a different set of rules and regulations. First of all it seems pretty much like in the US that executive compensation and its difficulties are being challenged with rules and regulations. But when having a closer look at those regulatory actions one can see the differences. For example the provisions in the Aktiengesetz concerning the framework for executive compensation are much more vague than they would ever be in the US. Plus there are not actual court rulings concerning those rather new benchmarks for executive compensation such as sustainability. This is something that could not be found in the US. This puts a way heavier burden upon the supervisory board to develop a good and sustainable remuneration package that complies with the laws. Another factor that needs to be taken into account when talking about the legal framework in Germany is codetermination. The cornerstone of German corporate law is codetermination, especially in the supervisory board, which is in charge of the remuneration package. So the view of the view of those representing the workers, which are those who have a stake in the company, is being taken into consideration and account when it comes to executive compensation. In conclusion the differences between the German and US regulatory approach over executive compensation are remarkable and have potentially created divergences between the developments of executive compensation in both countries, on the one side Germany, with stronger social influenced rules and on the other side US with more free market approach. As a result, it is plausible to infer that the regulatory approach taken by each country has shaped executive compensation in different ways creating a different legal framework, a different decision process and finally could possibly have triggered a different economic shame. The different economic shame motivated in some extent by the different legislative approach could have been a reason for creating divergences of amounts granted. However at this point of time, the future of executive compensation seems to be going in the same direction. The recent Pay Ratio Rule in the US has a fair wage component, allows us to presuppose that despite the differences in regulatory approach, Germany and the US are ruling executive compensation in a similar way – a stakeholder direction.

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