

## Regulation of Say on Pay: Engineering Incentives for Executives and Directors

Experiences from the United States and Implications for Regulation in Switzerland

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*The debate about the compensation of executives and directors is a discussion about incentives and agency costs. This article analyzes basic tools to reduce agency costs and also assesses the ongoing debate about the future regulation of the compensation of executives and directors. It draws upon legislative experience from the United States. Recently proposed legislation in Switzerland attempts to empower shareholders with the redraft of the applicable section of the Swiss Code of Obligations (CO). The main motivation behind this draft law is the reduction of excessive executive compensation. Directors and shareholders with a higher degree of independence might be less conflicted in their decisions but they might also have a lack of firm-specific know-how. In*

*effect, this could lead to weaker bargaining power of directors in relation to executives when they have to contract for new employment agreements with their executives. Moreover, shareholders often do not have the time or ability to process complex disclosure about executive compensation. This will lead to uninformed voting behavior of rationally apathetic shareholders. Additionally, some shareholders, e.g., institutional investors, may prefer to stay on good terms with the CEO or directors because they want to have a good long-term relationship with the board and the executives. This article advises against implementing a specific salary cap for so called "very high compensation" and also advises against the implementation of tax burdens for executive compensation.*

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### I. Public Outrage Causing Regulatory Intervention

The public debate about executive compensation is still raging. The former CEO of a public company received a one-off payment of ca. 148 Mio. Swiss Francs in 1996, which the board of directors made

public in 2002.<sup>1</sup> Various other scandals have been discussed since then in the tabloid press. Many directors or executives have paid themselves sums that have caused public outrage,<sup>2</sup> and this has triggered regulatory activities such as the upcoming Swiss referendum "against rip-off salaries"<sup>3</sup> and the related regulatory debates in the Swiss parliament.<sup>4</sup> Propo-

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<sup>1</sup> See *Beat Gygi*, Managerlöhne als Privatsache, Einstellung der Strafuntersuchung gegen ABB-Pensionäre Barnevik und Lindahl, *Neue Zürcher Zeitung* (October 6, 2005), 21.

<sup>2</sup> See *Lucian A. Bebchuk/Yaniv Grinstein*, The Growth of Executive Pay, *Oxford Review of Economic Policy*, 21 (2005) 300–302.

<sup>3</sup> See e.g. <<http://www.ripoff.ch/>> and BBl 2009, 299–346. See also the alternative draft in <<http://www.parlament.ch/dokumentation/berichte/berichte-legislativkommissionen/kommission-fuer-rechtsfragen-rk/Documents/entwurf-rk-s-10-443-2010-10-25-d.pdf>> by the Commission for Legal Affairs of the Council of State. The latest parliamentary debate and draft of the proposed legislation and the comment of the Federal Ministers can be found in BBl 2010, 8307–8332. See also the item of written comment of the Federal Ministers in BBl 2011, 243–254.

<sup>4</sup> See for instance the proposed Art. 731c of Swiss Code of Obligations as found in BBl 2009, 344. See also the alternative draft: Art. 731c–731m CO as found in BBl 2010, 8314–8319. For Switzerland, see generally *Christoph B. Bühler*, Vergütungen an Verwaltungsrat und Geschäftsleitung: Volksinitiative "gegen die Abzockerei" und Gegenentwürfe, in: Rolf Watter (Ed.), *Die "grosse" Schweizer*

nents of these regulatory movements demand say on pay for shareholders regarding the compensation for directors and executives. In the U.S., say on pay – or more broadly: Accountability and Executive Compensation – is being addressed by §§ 951 to 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (hereinafter “Dodd-Frank Act”).<sup>5</sup> This issue has become even more prominent since the bailouts of giant banks all over the world carried out to prevent an imminent meltdown of the global financial system.

As of today, the compensation of executives and directors is solely a duty of the directors of Swiss companies limited by shares. The proposed initiative wants to shift this duty – at least partially – to

the shareholders.<sup>6</sup> In order to examine the proposed changes to the pay-setting process, it is helpful to look at the experience in the U.S., where a similarly complex set of problems exists. The main assumption of this paper is that directors and executives in a company are incentive-driven.<sup>7</sup> Based on the economic discussion of legal issues, this article provides suggestions for future regulation.

## II. Managerial Power and Agency Costs

### 1. Principal Agent Problem

In the typical model, the pay-setting process for executives is basically influenced by the top executives’ managerial power in a company. Economists assume that setting managerial pay is the product of arm’s length contract negotiations. Such a pay-setting process, would, according to theory, always produce an efficient outcome.<sup>8</sup> A better model for the setup of negotiations describes the relationship between the

Aktienrechtsrevision, Eine Standortbestimmung per Ende 2010, Zurich/St.Gallen 2010, 247–283; *Hans-Ueli Vogt/Emanuel Schiwow/Karin Wiedmer*, Die Aktienrechtsrevision unter Corporate-Governance-Aspekten, Bestandesaufnahme, einige Auslegungsversuche und ein paar wichtige Anliegen vor der Erstberatung im Nationalrat, AJP 18 (2009) 1375–1388. *Ralph Malacrida/Till Spillmann*, Pay-back Time?, GesKR 3 (2008) 345–358. For an overview of the recent debates and legislative actions see *Hansueli Schöchli*, Die Karten der “Abzocker”-Debatte werden neu gemischt, Neue Zürcher Zeitung (February 25, 2011), 31; *Hermann Bürgi*, Indirekter Gegenentwurf zur Volksinitiative “Gegen die Abzocker”, Langes Seilziehen für mehrheitsfähige Lösung, ST 85 (2011) 50–51 and *Rolf Sethe/Moritz Seiler*, Entwicklungen im Gesellschaftsrecht und im Wertpapierrecht/Le point sur le droit des sociétés et des papier-valeurs, SJZ 106 (2010) 510–511. Similarly in the U.S.: *William T. Allen/Reinier Kraakman/Guhan Subramanian*, Commentaries and Cases on the Law of Business Organization, 3<sup>rd</sup> Ed., New York 2009, 335–338.

<sup>5</sup> The regulation of say on pay has parts of its roots in the United Kingdom. This paper discusses only evidence from the U.S. For the situation in the U.K., see e.g. generally: *Brian R. Cheffins/Randall S. Thomas*, Should Shareholders Have a Greater Say over Executive Pay: Learning from the US Experience, *Journal of Corporation Law Studies* 1 (2001) 277–316; *Joseph A. McCahery/Luc Renneboog*, Managerial Remuneration: The Indirect Pay-for-Performance Relation, *Journal of Corporate Law Studies* 1 (2001) 317–332; *Cynthia A. Williams/John M. Conley*, An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct, *Cornell International Law Journal* 38 (2005) 494–551; *Fabrizio Ferri/David A. Maber*, Say on Pay Votes and CEO Compensation: Evidence from the UK (October 15, 2010), available at SSRN: <<http://ssrn.com/abstract=1420394>>; *Jeffrey N. Gordon*, “Say on Pay”: Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In (August 2009), Columbia Law and Economics Working Paper No. 336, ECGI – Law Working Paper No. 117/2009, available at SSRN: <<http://ssrn.com/abstract=1262867>>.

<sup>6</sup> See Art. 716 of the Swiss Code of Obligations (CO); *Peter Böckli*, Schweizer Aktienrecht, 4<sup>th</sup> Ed., Zurich/Basel/Geneva 2009, § 12 N 237–262; *Daniel Daeniker*, Vergütung von Verwaltungsrat und Geschäftsleitung schweizerischer Publikumsgesellschaften, Eine Bestandesaufnahme aus rechtsvergleichender Sicht, SJZ 101 (2005) 384–388; *Peter Forstmoser/Arthur Meier-Hayoz/Peter Nobel*, Schweizerisches Aktienrecht, Bern 1996; § 28 N 121; *Guy M. Gächter*, Managementvergütungen: Grundlagen, Kompetenzen und Verfahren, Zurich 2008. However, Art. 29 of the Swiss Stock Exchange and Securities Trading Act (SSETA; Börsengesetz, BEHG) is limiting the power of the board directors to grant certain compensation; see *infra* Part III.1; see generally *Rudolf Tschäni/Jacques Iffland/Hans-Jakob Diem*, in: *Basler Kommentar zum Börsengesetz/Finanzmarktaufsichtsgesetz*, Rolf Watter/Nedim Peter Vogt (Eds.), 2<sup>nd</sup> Ed., Basel 2011, Art. 29 N 24 BEHG [hereinafter: BSK BEHG]; *Rudolf Tschäni/Jacques Iffland/Hans-Jakob Diem*, Öffentliche Kaufangebote, 2<sup>nd</sup> Ed., Zurich/Basel/Geneva 2010, N 541–542 and 747. An unofficial translation of the SSETA can be found here: <[http://www.six-swiss-exchange.com/participants/regulation/federal\\_acts\\_en.html](http://www.six-swiss-exchange.com/participants/regulation/federal_acts_en.html)>.

<sup>7</sup> See generally *Michael C. Jensen/William H. Meckling*, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics* 3 (1976) 305–360; see also *Allen/Kraakman/Subramanian* (Fn. 4), 330–331.

<sup>8</sup> See *Lucian A. Bebchuk/Jesse M. Fried*, Pay without Performance: Overview of the Issues, *Journal of Corporation Law* 30 (2005) 648–649; but cf. *Martin Lipton/William Savitt*, The Many Myths of Lucian Bebchuk, *Virginia Law Review* 93 (2007) 733–758.

board of directors in corporations and the shareholders as a principal agent problem.<sup>9</sup> The principal agent problem describes a situation where the principal transfers the control of ownership to an agent. The principal cannot perfectly monitor the agent. Furthermore, the principal wants to maximize the value of his company, whereas the agent primarily wishes to maximize his own utility. Maximizing the value of the company is only a secondary objective for the agent. Additional assumptions in this model are that the principal is risk neutral and the agent is risk averse.<sup>10</sup> The principal can diversify his risk at relatively low costs with portfolio strategies on the stock market. An agent, however, cannot diversify his job position for practical reasons (e.g., being CEO at ten companies at the same time). This conflict of incentives and information asymmetry results in agency costs. Agency costs consist of the following components: monitoring expenditures by the principal, bonding expenditures by the agent and the residual loss of the agency relationship.<sup>11</sup> In economic terms, "compensation is excessive when it is greater than it would be if agency costs were zero."<sup>12</sup>

There are several reasons leading to excessive compensation of executives. Primarily, excessive compensation is a consequence of the transfer of control of the firm by the principal to the agent and the lack of transparency about the agent's actions and performance. The tools most discussed, therefore, in order to reduce agency costs are monitoring (i.e., disclosure) and incentive alignment.<sup>13</sup>

The first tool, monitoring, is costly for the principal (viz., the shareholder), and he may not be the perfect monitor in every case. The agent usually has better and more specialized abilities to serve in such a position than the shareholders do, i.e., he can run the business better than the principal and can camouflage some of his actions. In the past, payments were camouflaged using the Generally Accepted Accounting Principles which allowed companies to issue employee stock options without recognizing them as expenses.<sup>14</sup> Another problem is that pension fund managers investing in pharmaceutical companies normally do not know how to conduct research in pharmaceuticals (i.e., there is an information asymmetry). In general, requiring full disclosure of all material compensation elements is a necessary building block of enhancing transparency and reducing agency costs.<sup>15</sup> However, even with full disclosure, monitoring is still a complex and costly undertaking.<sup>16</sup> In fact, even specialized lawyers and accountants are not always able to interpret company disclosures correctly in every aspect,<sup>17</sup> since tools necessary for interpretation, such as Black-Scholes option pricing,<sup>18</sup> are rarely discussed comprehensively in the core curriculum of law or business schools.

<sup>9</sup> See generally *Jensen/Meckling* (Fn. 7), 305–360; but cf. *Lipton/Savitt* (Fn. 8), 749–752.

<sup>10</sup> See *Hans Caspar von der Crone*, Risiko und Corporate Governance, in: Hans Caspar von der Crone/Peter Forstmoser/Rolf H. Weber/Roger Zäch (Eds.), Aktuelle Fragen des Bank- und Finanzmarktrechts, FS Dieter Zobl, Zurich 2003, 555 and 560–561.

<sup>11</sup> See *Jensen/Meckling* (Fn. 7), 308–309.

<sup>12</sup> *Richard A. Posner*, Are American CEOs Overpaid, and, if so, What if Anything Should be Done about it?, *Duke Law Journal* 58 (2009) 1015.

<sup>13</sup> See e.g. *Rolf Watter/Karim Maizar*, Aktionärsdemokratie – Über erweiterte Zuständigkeit der Generalversammlung und Erleichterungen bei der Stimmrechtsausübung in schweizerischen Aktiengesellschaften, in: Peter Breitschmid/Wolfgang Portmann/Heinz Rey/Dieter Zobl (Eds.), Grundfragen der juristischen Person, FS Hans Michael Riemer, Bern 2007, 411–415; *Peter Forstmoser*, Stärkung der Aktionärsdemokratie – aber wie?, Es sollte auch über neue Formen von Mitwirkungsrechten nachgedacht werden, *Neue Zürcher Zeitung* (July 29, 2010), 26.

<sup>14</sup> See *Böckli* (Fn. 6), § 8 N 251; *Lukas Müller*, Eigenkapitalbasierte Vergütung de lege ferenda – Rechtliche und betriebswirtschaftliche Aspekte, *AJP* 17 (2008) 527, 530; *Hans Caspar von der Crone/Pascal M. Kistler*, Mitarbeiteroptionen und Rechnungslegung, Eine Erfassung als Personalaufwand drängt sich auf, *Neue Zürcher Zeitung* (September 9, 2000), 28.

<sup>15</sup> See Art. 663b<sup>bis</sup> and Art. 663c Sec. 3 CO for the required disclosure in public corporations; see generally *Rolf Watter/Karim Maizar*, Transparenz der Vergütungen und Beteiligungen von Mitgliedern des Verwaltungsrates und der Geschäftsleitung (Art. 663b<sup>bis</sup> und 663c Abs. 3 OR), *GesKR* 1 (2006) 349–359; see furthermore supra Fn. 4.

<sup>16</sup> See *Michael C. Jensen/Kevin J. Murphy*, CEO Incentives – It's Not How Much You Pay, But How, *Journal of Applied Corporate Finance* 22 (2010) 69–70.

<sup>17</sup> See *Thomas Lee Hazen*, *Securities Regulation, Cases and Materials*, 8<sup>th</sup> Ed., St. Paul 2009, 292–305; *Posner* (Fn. 12), 1017.

<sup>18</sup> See originally *Fischer Black/Myron Scholes*, The Pricing of Options and Corporate Liabilities, *Journal of Political Economy* 81 (1973) 637–654 and *Robert C. Merton*, Theory of Rational Option Pricing, *Bell Journal of Economics and Management Science* 4 (1973) 141–183. See *John C. Hull*, *Fundamentals of Futures and Options Markets*, 7<sup>th</sup> Ed., chapter 13, for an easily understandable explanation of this option pricing model.

The second alternative, incentive alignment, involves creating incentives for the agent that are congruent with the interests of the principal. In public companies, this is usually done with equity-based payment plans.<sup>19</sup> However, one problem with equity compensation plans is the phenomenon of windfall gains. What happens if the stock options of executives are only inflating like a bubble because of the market or simply because central bankers are running an expansive monetary policy? Should the manager also get compensated if the company is underperforming in relation to the market in general (e.g., the market goes up 100% and the company only 20%)? If agency costs are a problem, windfall gains must not occur because they will undermine the effectiveness of incentive alignment plans.<sup>20</sup> Setting the right incentives is difficult; e.g., if the principal pays the agent for increasing net profit by 1% a year, the agent only tries to raise net profit by 1% even if he could have increased it by more than 1%. The rationale behind this behavior is that he tries to preserve profit increasing potential for the following years. Hence, such incentive alignment plans do not work perfectly. The better the monitoring system, the less need for incentive alignment which could lead, if wrongfully calibrated, to excessive compensation.<sup>21</sup>

## 2. Other Factors Influencing Agency Costs

Besides the solutions to the principal agent problem described above, the market for corporate control can also discipline managers. The underlying idea of this concept is that where managers perform badly; the stock price of a company will plunge. Hence, this event can attract raiders which want to substitute management in order to rearrange the resources of a company. This improvement in management will cause the stock price to increase, eventually making the company a profitable investment<sup>22</sup>. This phenomenon will have an effect on the agency costs. However, in practice, shareholders rarely throw directors out of a company. There are several reasons for this.

First, it is hard to find capable directors. Shareholders would have to assess and recruit possible CEO candidates even though they may not know the company very well from the inside. Second, once shareholders have found a possible director, they have to nominate him in order to appoint him as a director. But the fact that shareholders in a public company are dispersed makes it difficult to obtain sufficient numbers of shareholders to take this action.<sup>23</sup> This creates a collective action issue or a free rider problem. For a shareholder that only owns a handful or a few thousand shares, the benefits of being an activist shareholder and to engage in proxy fights can virtually never exceed the costs of this engagement. Thus, this will lead to "rationally apathetic" shareholders.<sup>24</sup> In order to address this problem, proxy rules for shareholder use ought to be made less costly so that the benefits from shareholder activism may outweigh the costs. It is necessary to make it easier for shareholders to gain a voice in company management; to this end, it is essential that more meaningful disclosure of relevant information is provided. This would lower the information collecting and processing costs for shareholders.<sup>25</sup>

## 3. Remedies against the Principal Agent Problem

### 3.1 Monitoring

#### 3.1.1 Independent Directors: Golf Club Syndrome vs. Expertise

One problem in setting efficient compensation is the so-called "golf club syndrome", i.e., it is hard to object to a compensation agreement for an executive

<sup>19</sup> See generally Müller (Fn. 14), 527–534.

<sup>20</sup> See *Bebchuk/Fried* (Fn. 8), 665–666; *Posner* (Fn. 12), 1013–1047.

<sup>21</sup> See *Posner* (Fn. 12), 1023; see also *Jensen/Murphy* (Fn. 16), 66–67.

<sup>22</sup> See *Henry G. Manne*, Mergers and the Market for Corporate Control, *The Journal of Political Economy* 73 (1965) 110–114.

<sup>23</sup> See *John C. Coffee*, Liquidity Versus Control: The Institutional Investor as Corporate Monitor, *Columbia Law Review* 91 (1991) 1285.

<sup>24</sup> See *Stephen M. Bainbridge*, Executive Compensation: Who decides?, *Texas Law Review* 83 (2005) 1615, 1655; *Stephen M. Bainbridge*, Director Primacy and Shareholder Disempowerment, *Harvard Law Review* 119 (2006) 1751–1757; *Jeffrey N. Gordon*, The Mandatory Structure of Corporate Law, *Columbia Law Review* 89 (1989) 1576 and 1580; *Roberta Romano*, Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws, *Columbia Law Review* 89 (1989) 1607; *Rolf Watter/Katja Roth Pellanda*, Shareholder Activism, in: Peter Leibfried/Dirk Schäfer (Eds.), 25 Jahre Unternehmertum, FS Giorgio Behr, Zurich 2010, 87–90.

<sup>25</sup> But cf. *Arthur Meier-Hayoz/Peter Forstmoser*, Schweizerisches Gesellschaftsrecht, 10<sup>th</sup> Ed., Bern 2006, § 16 N 361–363.

with whom a director is friends. Directors seeking to lower compensation must address a potentially thorny subject, and in addition they may have to say "no" to a friend or a colleague. This is often difficult.<sup>26</sup> Apart from this psychological issue, in situations where a CEO disagrees with the lowering of his compensation, he might influence the board in a way that the directors who are setting his pay will not be nominated again at the next annual shareholder meeting. The CEO could, for instance, ask for an ultimatum where the other directors either have to decide whether they will nominate somebody else as director, or look for a new CEO. In such circumstances, replacing an unpopular director is easier than substituting the CEO who is running the daily business. One way to avoid the golf club syndrome is by appointing independent directors for the pay-setting process. In Switzerland, independent directors usually set the compensations of the inside directors and the top-level executives through a remuneration or compensation committee.<sup>27</sup> It is a way to ease conflicts of interests in a board of directors.<sup>28</sup> But there is also a tension between expertise and independence. Strengthening the independence of directors will necessarily reduce their firm-specific knowledge. As a result of this lack of firm-specific expertise, independence in a context where the directors have to fulfill difficult tasks such as performance evaluation and pay-setting decisions, may be a problem. Directors with limited time will perform worse when they have to do more difficult

tasks with less knowledge in a situation where the management has the agenda setting power. This makes it difficult to bargain and thus increases managerial bargaining power.<sup>29</sup>

Given this issue, how can independent directors maintain their expertise? One solution is to utilize advisors.<sup>30</sup> However, the advisors themselves may have a conflict of interests. Hiring advisors for the board of directors or the compensation committee has its own problems. The board and the compensation committee need advisors on which they can rely, thus they need advisors acting with objectivity.<sup>31</sup> Take compensation consulting firms as an example: these firms consult companies on their employees' pension plans. Assignments will be awarded to the consulting firm by the CEO. Simultaneously, the same consulting company advises the board of directors or the compensation committee about the executive compensation of their executives. This is an actual conflict of interest which becomes even more evident if one compares revenues of these two types of consulting businesses. Empirical evidence relating to the 250 largest consulting companies in the U.S. shows that the executive compensation advising business is merely an insignificant share of the revenue of such consulting companies. However, if such consulting firms lose the pension plan advisory contracts, they will go out of business.<sup>32</sup> If the legislature wants to overcome this issue and require more independence of the consulting firms, one should keep in mind that the gain of independence will be paid with the cost of losing expertise relating to the firm and industry specific know-how. If the consulting companies are no longer able to provide advisory services for employee pension plans, they will lose firm-specific knowledge which they would have gained by providing such services. As a result, they will be less able to

<sup>26</sup> See *Charles M. Elson*, Executive Overcompensation – A Board-Based Solution, *Boston College Law Review* 34 (1993) 974.

<sup>27</sup> See *Hans Caspar von der Crone/Benedict Burg*, Salär-governance und Markt für Führungskräfte, II.2. (forthcoming); *von der Crone* (Fn. 10), 554 and 557–561; *Hans Caspar von der Crone*, Arbeitsteilung im Verwaltungsrat, in: Charlotte M. Baer (Ed.), *Verwaltungsrat und Geschäftsleitung*, SSPHW, Vol. 76, Bern 2006, 80–82; *Gächter* (Fn. 6), 128–135. In Delaware, compensation decisions of independent committees are protected by the business judgment rule; see e.g. *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006); see also *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); see also *Elson* (Fn. 26), 973.

<sup>28</sup> See *Lukas Handschin*, Treuepflicht des Verwaltungsrates bei der gesellschaftsinternen Entscheidungsfindung, in: Hans Caspar von der Crone/Roger Zäch/Dieter Zobl (Eds.), *Neuere Tendenzen im Gesellschaftsrecht*, FS Peter Forstmoser, Zurich 2003, 171–172 and 179–182; *Hans Caspar von der Crone/Antonio Carbonara/Larissa Marolda Martinez*, Corporate Governance und Führungsorganisation in der Aktiengesellschaft, *SJZ* 100 (2004) 409.

<sup>29</sup> See *Elson* (Fn. 26), 976.

<sup>30</sup> See generally *Geoffrey C. Hazard/Edward B. Rock*, A New Player in the Boardroom: The Emergence of the Independent Directors' Counsel, *The Business Lawyer* 59 (2004) 1389–1392 and 1395–1412.

<sup>31</sup> See *Elson* (Fn. 26), 979. However, the advisors should be careful to avoid personal liability; *BGE* 128 III 92; *BGE* 117 II 442; *Meier-Hayoz/Forstmoser* (Fn. 25), § 16 N 575–576.

<sup>32</sup> See Majority Staff of the United States House of Representatives Committee on Oversight and Government Reform, *Executive Pay: Conflicts of Interests Among Compensation Consultants* (2007), 4–5.

correctly assess the level of executive compensation that should be paid. A report of the U.S. Government shows that there is a positive correlation between the lack of independence of consultants and executive compensation.<sup>33</sup> Although the existence of correlation does not necessarily mean that there is also causation, such correlation is nonetheless troublesome. Another study, however, shows weaker empirical evidence about the same issue. Hence, other variables could play into the whole pay-setting process: bigger firms will hire consulting firms and pay higher executive compensation.<sup>34</sup> *Cadman, Carter & Hillegeist* took a larger sample in conducting their study, and their findings may therefore carry more weight in the sense that the outcome could be less influenced by chance. Based on the empirical research behind their study, the only significant variable which is positively correlated to the executive compensation is the firm size measured in terms of the natural logarithm of the assets; hence, the bigger the amount of assets, the higher the payments for the executives.<sup>35</sup>

Because of the tension between independence and expertise, a mandatory mix of inside and independent directors may be a good idea. This is also the solution which is regarded as best practice for Swiss public corporations.<sup>36</sup> Finally, if boards hire compensation consultants, it may be useful in most cases for the boards to bring the consultants to investor road shows. Through this, institutional investors can engage in better discussion about the important issues of executive compensation and can have their questions properly answered.<sup>37</sup> Thus, it is recommended that directors and executives of Swiss public corporations bring the consultants who designed the execu-

tive compensation policy and the related contracts to shareholder meetings or road shows with important investors.

### 3.1.2 Shareholders as Monitors of the Compensation of Executives and Directors

#### (i) Institutional Investors

The question of whether shareholders are good monitors is important for making future regulation. In principle, shareholders can remove directors if they do not like their decisions; they may theoretically put their own nominees on the ballot.<sup>38</sup> However, individually the shareholders might not be able to put directors on the ballot. The solution could be to form a coalition, for instance with mutual funds or hedge funds. Even though institutional investors do not have the resources to manage the company at a micro level, they can do it at a general level, i.e., by preventing or discouraging undesirable actions at annual shareholder meetings.<sup>39</sup> Since institutional investors cannot engage in micromanagement of the company, their only option is to strengthen the board in order to make it a stronger check upon management.<sup>40</sup> The pension funds with their specialized investor knowledge can better watch the companies and lower the cost of capital because agency costs will decrease with the monitoring activity. However, there are fundamental limits in the abilities of institutional investors which make them unsuitable as monitors. Some institutional investors, like the management, need quick returns and necessarily have short term incentives; otherwise the fund managers will not get paid well and will lose their jobs. Thus, at the level of the institutional investors, the same principal agent problem can occur.<sup>41</sup> *Coffee* makes the argument that institutional investors want to have a certain level of liquidity in order to prevent a bank-run situation when investors all want their money back at once. Because of this precautionary measure, the institutional investors will not invest heavily in a potentially distressed company. According to *Coffee*, the reason for this is that institutional investors cannot risk not

<sup>33</sup> See Committee on Oversight and Government Reform Report (Fn. 32), 6.

<sup>34</sup> See *Brian D. Cadman/Mary Ellen Carter/Stephen A. Hillegeist*, The Incentives of Compensation Consultants and CEO Pay (February 1, 2009), *Journal of Accounting and Economics* (forthcoming), available at SSRN: <<http://ssrn.com/abstract=1103682>>, 8 and 25–26.

<sup>35</sup> See *Cadman/Carter/Hillegeist* (Fn. 34), 35.

<sup>36</sup> See Swiss Code of Best Practice for Corporate Governance, Zurich 2007, N 11; *Meier-Hayoz/Forstmoser* (Fn. 25), § 16 N 393–409.; *Rolf Watter/Katja Roth Pellanda*, Geplante Neuerungen betreffend die Organisation des Verwaltungsrates, GesKR-Sondernummer 2008, Zurich 2008, 135–137.

<sup>37</sup> Interview with *Stephen L. Brown*, Dir. of Corporate Governance, TIAA-CREF and *Peter G. Reali III*, Sr. Corporate Governance Analyst, TIAA-CREF, N.Y., N.Y. (October 8, 2010).

<sup>38</sup> See Art. 698 Sec. 2 No. 1 CO.

<sup>39</sup> See *Bernard S. Black*, Agents Watching Agents: The Promise of Institutional Investor Voice, *U.C.L.A. Law Review* 39 (1992) 827–829 and 834–838.

<sup>40</sup> See *Black* (Fn. 39), 839–845.

<sup>41</sup> See *Coffee* (Fn. 23), 1324–1326; *Lipton/Savitt* (Fn. 8), 744.

being able to sell, e.g., their 30% ownership in a public company. At the first sign of trouble in a company, the institutional investor has the incentive to liquidate his investment in order to prevent losses or illiquidity, rather than exercise votes in order to try and improve the company's situation.<sup>42</sup> However, *Coffee's* rationale does not seem persuasive because institutional investors can afford to be less liquid since some of them can also have long term goals. Therefore, they are able to choose the voice-strategy instead of exiting. Even if the liquidity argument does apply, institutional investors can bolster their liquidity quite easily, for example by borrowing funds. Generally, over the last years, hedge funds have been able to take over companies with very low use of equity capital. They can buy or lend a share and hedge it. Thus, institutional investors will be able to vote with little value at risk if they are correctly hedged.<sup>43</sup>

#### (ii) Shareholders' Committee

*Forstmoser/Hostettler/Vogt* discuss the introduction of shareholder committees as a possibly more efficient monitoring device vis-à-vis the board of directors.<sup>44</sup> They have identified two alternative models which could act as a possible missing link between the annual shareholder meeting and the board of directors. In their first model, the "executive model", a few appointed shareholders would form a board similar to the board of directors. Majority shareholders, which do not need to be (or are not) directors, would represent the shareholders in a committee. They would have privileged access to the informa-

tion and documents of the corporation. The members of the shareholder committee would have the same fiduciary duties (and in particular the duties to observe secrecy) as the members of the board of directors. The second model – the "owner model" – is basically the bundling of the shareholder voice and the empowerment of majority shareholders. It would serve as an institutionalized way of communication between the directors and majority shareholders. This model is more or less what the best practice in public corporations should be because directors should know what their majority shareholders think.<sup>45</sup> However, one has to be cautious when using these two models. Shareholders in such a committee might indeed have higher degree of independence than the directors but they could also have a lack of expertise despite potentially greater access to information. Appointing shareholders with expert knowledge could ease the problem regarding know-how, but these committee members would still lack firm-specific expertise.<sup>46</sup> Furthermore, even shareholders with expertise can have the same conflict of interests as the managers of a corporation; for instance, certain institutional shareholders may wish to be allies of the management.<sup>47</sup> They might have a particularly strong incentive to be friendly to executives when the corporation uses a pension plan offered by the same institutional investor. In such a case, the benefits of becoming a shareholder activist are lower than the costs which are incurred as a consequence of contesting management and losing profitable pension plan assignments from the company. Another reason why the monitoring ability of institutional investors may be diminished is that there is no benefit in acting individually as an activist shareholder while free riders can gain profits out of this individual activism – this

<sup>42</sup> See *Coffee* (Fn. 23), 1329–1330. *Coffee* uses the semi-strong version of the Efficient Capital Market Hypothesis, i.e., the market price of a share reflects all publicly available information; nonpublic available information is not included in the share price; see furthermore *Ronald J. Gilson/Reinier H. Kraakman*, *The Mechanisms of Market Efficiency*, *Virginia Law Review* 70 (1984) 555–567.

<sup>43</sup> See *Marcel Kahan/Edward B. Rock*, *Hedge Funds in Corporate Governance and Corporate Control*, *University of Pennsylvania Law Review* 155 (2007) 1028–1056 and 1062–1069; however, letting hedge funds act as activist shareholders can also lead to short-term-thinking since they sometimes maximize short-term gains.

<sup>44</sup> See *Peter Forstmoser/Stephan Hostettler/Hans-Ueli Vogt*, *Aktionärsausschüsse als mögliche Neuerung in der AG, Vorschlag für eine eigentümerorientierte Belebung und Verbesserung der Aktionärsdemokratie*, *Neue Zürcher Zeitung* (January 27, 2011), 31; *Forstmoser* (Fn. 13), 26. See also *Watter/Roth Pellanda* (Fn. 24), 91–92 mentioning the institutional shareholders' committee.

<sup>45</sup> *Id.*

<sup>46</sup> See *Jeffrey N. Gordon*, *The Rise of Independent Directors*, *Stanford Law Review* 59 (2007) 1490–1500. *Gordon* discusses the tension between independence and expertise in the board of directors. The same considerations can also apply to shareholder committees which work in a similar way as boards of directors. However, shareholder committees would probably participate in a dialogue about less complicated matters, but cf. *Forstmoser* (Fn. 13), 26.

<sup>47</sup> A similar problem could occur if one appoints employees to such a committee because employees may want to keep good relations with their bosses; but cf. *Jonathan Michie/Christine Oughton*, *Employee Participation and Ownership Rights*, *Journal of Corporate Law Studies* 2 (2002) 150–152.

is similar to the collective action problem discussed above in relation to non-institutional shareholders. Furthermore, not all institutional investors have the same incentives; e.g., some government controlled mutual or pension funds can have political incentives. Governmental control can result in manipulating management in troubled companies solely to prevent the public lay-off of many employees which could politically disadvantage the people behind funds operated by government officials.<sup>48</sup>

### (iii) Information Processing Costs

In general, it is difficult to be a monitor because there is asymmetric information and because it takes effort to process complex information. However, despite the potential problems identified earlier, if costs are low and benefits are high, institutional investors can be good monitors as long as the subject is about general rules or matters. However, they may still be ineffective when it comes to deciding very specific matters which are highly complex. A possible solution might be to require the companies to have clear, simple and better disclosure of compensation agreements. *Gordon* has proposed guidelines for a Compensation Discussion and Analysis (CD&A):<sup>49</sup> First, the CD&A should provide standardized information. With standardization, the costs for preparing the information (from the perspective of the company) and to understand the information (from the perspective of a shareholder) will be lower. Second, one should provide justification of compensation practices to the shareholders. The company should be required to address any questions which the shareholders may have. With this degree of standardization, the summary compensation table in the CD&A provides information about five people: the CEO, CFO, vice chair-

man and the two second highest paid executives.<sup>50</sup> The rationale behind this choice of disclosure is that the compensation of top-level executives is the most important issue. A possible loophole is that it lies in the discretionary power of the board of directors to define which employees qualify as executives.<sup>51</sup> To illustrate: at Citigroup, commodity trader Andrew Hall bet on changes of the price of oil while it was being shipped. As soon as the oil tankers entered the waters of the U.S., the worth of the oil increased greatly. Hall made a \$100 million bonus in just one year.<sup>52</sup> People like Hall are not included in the CD&A; neither would they be included in the proposed Swiss regulation.<sup>53</sup> For the shareholders, it is vital to include people who make important decisions like “do we go into this business?” in the compensation table. Everyone on a level below this, in contrast, is under the responsibility of the CEOs.<sup>54</sup> *Gordon's* ideas have been included into today's Item 402 of Regulation S-K.<sup>55</sup>

Another issue is the question of how much stock-ownership can set incentives for the managers, i.e., how much will a manager gain or lose if the stock price fluctuates by one dollar?<sup>56</sup> The investor should be able to see the marginal exposure of an executive's compensation to the stock of the firm. There is no way to see that in today's compensation disclosure. It is very time-consuming to analyze the executive's marginal exposure to stock with a case-by-case analysis. Shareholders do not excel in this type of analysis. Institutional investors in the U.S. ship this kind of analysis out to proxy advisor companies. In most cases, proxy advisors like RiskMetrics Group and its competitors make voting decisions for the institutional shareholders.<sup>57</sup> The existence of proxy advisor firms is troubling because important shareholders delegate their decisions to them; this creates the impression that shareholders are bad monitors. Given that insti-

<sup>48</sup> See *Coffee* (Fn. 23), 1323. Take Opel in Germany as an example where the layoff of employees was used as a negotiation tactic; *Peter Rásonyi*, Firmenrettung nach Rezept, Hohe Hürden für deutsche Staatsbürgschaften und Kredite, *Neue Zürcher Zeitung* (March 3, 2009), 12. See also a Swiss example where it was difficult to conduct a necessary restructuring process: *Sonja Wuhrmann*, Der Fall Swissair – ein Fall Schweiz, *Psychodynamische Mechanismen eines Desasters*, *Neue Zürcher Zeitung* (April 11, 2002), 15.

<sup>49</sup> See *Jeffrey N. Gordon*, Executive Compensation: If There's a Problem, What's the Remedy? The Case for “Compensation Discussion and Analysis”, *The Journal of Corporation Law* 30 (2005) 675–702.

<sup>50</sup> See Code of Federal Regulations respectively 17 CFR § 229.402 (Item 402).

<sup>51</sup> See the instructions to 402(a)(3) of 17 CFR § 229.402.

<sup>52</sup> See *David Segal*, Trader's \$100 Million Payday Poses Quandary for Regulator, *The New York Times* (August 2, 2009), A2.

<sup>53</sup> See *supra* Fn. 15.

<sup>54</sup> However, the design of golden parachute agreements is one exception to this rule, see *infra* Part III.2.

<sup>55</sup> See 17 CFR § 229.402.

<sup>56</sup> See *Robert J. Jackson, Jr.*, Private Equity and Executive Compensation (forthcoming), 24–26.

<sup>57</sup> See *Coffee* (Fn. 23), 1358; *Lipton/Savitt* (Fn. 8), 753.

tutional shareholders are currently reliant upon proxy advisors to make voting decisions, we should create rules that take into consideration this factor and allow shareholders to exercise voting power themselves. The rules should reduce the amount of work which shareholders must do to successfully exercise their voting power, because shareholders are not good at processing information and do not have the ability to do a lot of research. Despite their superior resources as compared to individual shareholders, institutional investors do not have unlimited manpower to do research for the thousands of firms in which they invest. For instance, TIAA-CREF, one of the biggest investment funds in the U.S., has to make ca. 13,000 say on pay decisions in the year 2011 with a staff of only seven people.<sup>58</sup> For some Swiss pension funds it might be easier since they usually just invest in a few stocks (e.g., the SMI listed shares). However, the problem of processing complex disclosure remains.

The disclosure regime in Switzerland regarding executive compensation is codified in Art. 663b<sup>bis</sup> and Art. 663c Sec. 3 CO.<sup>59</sup> Additionally, cross-border listed Swiss public corporations also comply with foreign CD&A rules (e.g., U.S. rules) within the same disclosure report, whenever possible.<sup>60</sup> However, in Switzerland, similar problems occur as in the U.S. Disclosure is in some respects too complex; yet in other respects it is not comprehensive enough. As mentioned, individuals such as Andrew Hall would not appear in the disclosure under current rules because he probably would not be an executive. Therefore, it is difficult to find the right balance between simple disclosure which is understandable by the average investor, and a report that discloses information that is actually material and relevant. For an outsider (and even for insiders of the corporation) it is extremely difficult to understand how to set executive compensation incentives for the company in question. Hence, it is hard to tell what kind of actions and performance the executives and directors should get rewarded for. Furthermore, how should shareholders monitor executives and directors based on a report which, as discussed, is very complex to understand? This argument links to the concept of the rationally

apathetic shareholder who does not vote in an informed manner as long as everything appears right or at least acceptable to the shareholder.<sup>61</sup> Consequently, non-apathetic shareholders would perhaps need to rely on a consultant or proxy advisor firm who explains complex compensation matters. Pursuant to such delegation, yet another principal agent problem, this time between the advisor and the shareholder, could be created because the advisor's primary interest is to generate advisory fees; reducing agency costs in the corporation is only a secondary interest. On the other hand, the shareholders primarily want to make an informed decision that reduces agency costs in the corporation.<sup>62</sup> Because of the principal-agent problem just identified, the costs which are supposedly reduced via monitoring (in the form of agency costs in the context) will reappear in another form. In other words, if a shareholder must pay high fees to an advisory firm in order to obtain effective monitoring (with the aim of lowering agency costs), the money he saves on the latter is simply spent on the former. The shareholders have to find out which alternative results in the best benefit for them; if the advisory fees (i.e., monitoring costs) exceed the agency costs caused by the executives, the shareholders are better off not hiring the advisors (et vice versa).

#### (iv) Moral Hazard Problem

Another reason why shareholders might not be the best monitors is the fact that the bigger the company gets, the more serious the moral hazard problem. This is especially true for systemically-important financial intermediaries or companies.<sup>63</sup> If a risky business strategy adopted by such a company turns out well, the shareholders can only benefit. In the worst case scenario, the government has to bailout the financial intermediary in order to prevent collateral damage. Thus, a shareholder may in fact prefer the more risky approach. This moral hazard problem creates possible

<sup>58</sup> See supra Fn. 37.

<sup>59</sup> See generally *Watter/Maizar* (Fn. 15), 352–359; see also *Böckli* (Fn. 6), § 8 N 526–560.

<sup>60</sup> See e.g. the UBS, Annual Report, Zurich/Basel 2010, 198–240.

<sup>61</sup> See supra II.2 at the end.

<sup>62</sup> See supra II.3.1.1.

<sup>63</sup> See *Rüdiger Fahlenbrach/René M. Stultz*, Bank CEO Incentives and the Credit Crisis, NBER Working Paper 15212, <<http://www.nber.org/papers/w15212>> (2009) 4. However, their statistical data is not solid enough because it demonstrates only a low correlation between a few variables in table 5.

social costs for taxpayers.<sup>64</sup> This problem is imminent if the shareholders of a corporation and the taxpayers are not the same people; e.g., when the taxpayers are Swiss, yet it is foreigners who own the majority of a systemically relevant corporation (and who must therefore foot the bill for any bailout).

### 3.1.3 Shareholder Approval of Say on Pay

§ 951 of the Dodd-Frank Act gives shareholders of public companies in the U.S. a non-binding advisory vote, i.e., “say-on-pay”, and for the approval of golden parachute agreements. Giving an advisory vote may provide institutional investors with more power over how board members behave. Without the advisory vote, it would be difficult to express dissent. Furthermore, it is generally difficult for independent directors to confront directors about salaries. Therefore, one advantage of feedback from the shareholders is that the independent directors may have better leverage resulting from such feedback. They can rely on the votes of the shareholders to support their proposed changes to executive compensation. An advisory vote therefore helps to set executive compensation inside the boardroom and provides a form of feedback at the annual shareholder meeting. If shareholders do not have this advisory vote, the next best alternative for them would be to vote the directors off. But this would generally not be in the interest of the firm. Why should shareholders refuse to re-elect a director just because his compensation is viewed as too high, if he is in fact doing a good job running the company? This would seem unreasonable and would possibly result in a loss of shareholder value. If the directors disregard the advisory vote of the shareholders and do not deliver justification for high compensation, it will force shareholders to vote directors off. For this reason, the advisory say on pay vote creates an escalation process of conflict resolution. The implementation of the advisory vote can create an ongoing dialogue between important investors and the corporation.

Providing shareholders of Swiss companies limited by shares with a say on pay vote would create similar possibilities for ongoing dialogue. Moreover, in contrast to the U.S., where shareholders only have a non-binding advisory vote for the compensation of

executives, in Switzerland the advisory vote is also being discussed in relation to director compensation.<sup>65</sup> In terms of form, using an advisory vote as opposed to a binding vote is probably the better approach. Instead of demanding a mandatory regime where the shareholder vote is conclusive, an advisory vote would give the advantage of combining the feedback value of the shareholder vote and simultaneously preserving the flexibility of the board of directors in matters regarding compensation. According to the latest versions of the draft, there is the following default rule: shareholders at the annual shareholder meeting must approve the compensation of the board of directors (although they can choose to opt out of this regime).<sup>66</sup> The rationale for the mandatory approval vote is the idea that setting their own compensation is always a matter in which the directors are conflicted; shareholder approval eliminates this conflict.<sup>67</sup> Even though this is a valid point, shareholders may not be the most effective or rational actors when it comes to executive compensation because they may not understand the underlying incentive structure or need to sufficiently compensate executives for correct business strategies. Therefore, it is better to preserve the flexibility of the directors and combine it with the feedback of an advisory vote about compensation.

### 3.2 Incentive Alignment

Incentive alignment of principals (i.e., shareholders) and agents (i.e., directors and executives) can partially be achieved by requiring the latter to hold equity in the company. In order to achieve the incentive alignment, the stock ownership of each director has to be significant. Hence, this would make it expensive to hire directors and executives in the sense that one must allocate substantial ownership of the company to them. A company can address this problem by spreading equity compensation over a number of years (e.g., five years), and limiting equity compen-

<sup>65</sup> See *supra* Fn. 4.

<sup>66</sup> See *Bühler* (Fn. 4), 257–267.

<sup>67</sup> See Art. 731k and Art. 731l CO in the 2010 draft by the Council of States, BBl 2010, 8317–8318; see also *von der Crone/Burg* (Fn. 27), II.1.c); see also BGE 127 III 333–336; BGE 126 III 363–364; *Meier-Hayoz/Forstmoser* (Fn. 25), § 16 N 244–248; *von der Crone/Carbonara/Martínez* (Fn. 28), 410–412.

<sup>64</sup> See *Lucian Bebchuk/Holger Spamann*, *Regulating Bankers’ Pay*, *The Georgetown Law Journal* 98 (2010) 255–257.

sation to the form of restricted stock.<sup>68</sup> But if managers can only receive restricted stock, how should they pay their mortgages and taxes? Thus, although it may be better purely for incentive alignment purposes to award only equity compensation, it is necessary to provide part of the compensation in the form of cash in order to avoid managers from having liquidity problems. Giving directors five-year terms can create the incentive that the directors hope to get re-elected for another five years even though this is a very long tenure. Requiring the directors and executives to hold a substantial share of their firm, may make them more motivated. But this measure, combining long tenures in the board and forcing managers to hold a lot of stock, will also make it harder for shareholders to get rid of bad directors and executives. Thus, it reduces the incentives for them to do what the shareholders want, particularly since a longer term potentially leads to more enjoyment of “perks” stemming from their high position in the company.<sup>69</sup> Another issue is that when the end of each term approaches, directors become more sensitive to managerial influence (since the management will choose whether or not to re-elect them), thus, it weakens the bargaining power of the directors in the pay-setting process with the executives. There are possible solutions to this; for example, the directors could set the date of compensation-related negotiations in the middle of a term rather than at the end. Another solution would be to provide for staggered boards so that the pressure mentioned above influences only a portion of the directors at any given time.

The Federal Council proposes in his versions of the new CO annual elections of the board of directors as a better solution.<sup>70</sup> However, this is not necessarily the right approach. If directors only have a one year term and the turnover of directors is very

high, this may cause a loss of firm-specific expertise if knowledgeable directors are not re-elected. In this case, freshly appointed directors could have the view that executives know how to run the firm better – this is clearly not ideal in a scenario where directors are supposed to be a restraint on management.<sup>71</sup> Another issue is that if the director has only a very short term, he may be motivated to have a very short-term outlook. He will only be interested in driving the stock price up (even if at the long-term expense of the company) until the point when he is able to sell.<sup>72</sup> However, one possible solution to this problem is to have the restriction on the stock extend to beyond their departure (i.e., even if they leave the company) – this would reduce the incentives to maximize only short-term profits.

### 3.3 Compensation as a Screening Device vs. Anchoring

Posner suggests that compensation could work as a kind of screening device to evaluate whether potential executives are committed to a firm. A company should basically offer an interesting job which the executive wants to do simply because he wants to work; i.e., the executive would work because of his intrinsic motivation. Extrinsic incentives (especially performance-based compensation elements) could suppress or even replace the intrinsic motivation because the manager will focus his performance to reach the extrinsically influenced performance goals (even if the goals are not optimal).<sup>73</sup> The organization can therefore use the compensation as a screening element to attract people who want to work because of intrinsic rather than extrinsic motivations. The compensation is therefore a tool to screen all candidates for their

<sup>68</sup> See *Elson* (Fn. 26), 983–995. This would also be consistent with the findings in personal and organizational economics which suggest that one should delay payment in contracts where the performance of an employee is hard to monitor; *Robert M. Hutchens*, A Test of Lazear's Theory of Delayed Payment Contracts, *The New Economics of Personnel* 5 (1987) S167.

<sup>69</sup> See *Jensen/Meckling* (Fn. 7), 318–319 for the formal proof of this proposition.

<sup>70</sup> See Art. 700 Sec. 1 CO as found in BBl 2010, 8311; see also the earlier draft of the revision of company and accounting legislation in Art. 710 Sec. 1 CO as proposed in BBl 2008, 1781; see generally *Bühler* (Fn. 4), 263–264 and 267–268.

<sup>71</sup> Regarding the bias of independent directors, see generally *Markus Schimmer/Lisa Hopfmüller/Lukas Müller*, Mit dem Strategieausschuss zur effektiven Unternehmensaufsicht – Zum Prinzip der symmetrischen Überwachung, in: *Sven Kunisch/Christian Welling/Ramona Schmitt* (Eds.), *Strategische Führung auf dem Prüfstand*, Berlin 2010, 35–64.

<sup>72</sup> He could possibly abstain from investing in research and development projects to cut costs. This strategy will boost short-term profits at the cost of long-term shareholder value.

<sup>73</sup> *Bruno S. Frey/Margit Osterloh/Matthias Benz*, Grenzen variabler Leistungslöhne, Die Rolle intrinsischer Motivation, in: *Peter J. Jost* (Ed.), *Die Prinzipal-Agenten-Theorie in der Betriebswirtschaftslehre*, Stuttgart 2001, 563–73; see *Posner* (Fn. 12), 1018–1019.

level of intrinsic motivation. If a candidate passes this screen, theoretically it would make them more committed to the objectives of the organization.

*Posner* assumes that the CEO is, of all the employees of a company, the most difficult one to control because his performance is difficult to monitor.<sup>74</sup> He contrasts companies with government agencies and other non-business organizations. Because of the lack of competition which product and capital markets would provide in the private sector, agency costs are usually presumed to be higher in the governmental setting than in private and profit-maximizing organizations.<sup>75</sup> This view is misguided because it ignores the fact that noncommercial organizations have tools for limiting agency costs which business firms do not have (e.g., there are several supervisors in the government such as commissions, supervisory boards, judges, and the sovereign).<sup>76</sup> Moreover, people attracted to the highest level of governmental jobs are normally committed individuals. *Posner* claims that such organizations are able to create a high-commitment culture in which the executives work hard, often "for rather meager pay, because they internalize the goals of their principal."<sup>77</sup> Offering low pay, as discussed above, could accordingly "be a screening device for quality, by eliminating from the applicant pool persons who are not highly committed to the employer's mission."<sup>78</sup> However, it may be risky to adopt the approach of offering low compensation to attract committed people; one could imagine that many excellent candidates will choose instead to go to the firms offering a higher salary.<sup>79</sup> Moreover, the effect of offering low executive compensation might also be to deter potential investors. They could have the impression that only average directors or executives could possibly get attracted by such a low level of payment. Finally, the knowledge about how much a director or an executive in a similar position earns anchors the aspiration level of a candidate.<sup>80</sup> Anchoring

is the biased decision-making process where a person makes a decision based on initial parameters.<sup>81</sup> Moreover, people who read about the distribution of compensation tend to selectively hear more about the peers who earn more money than themselves and more or less ignore those who earn less. In the end, this could lead to higher negotiated compensations and salaries if the bargaining partners are also anchored by the same cognitive bias because executives will drive each others' compensation up by their aspirations to outdo their peers.<sup>82</sup> Due to this anchoring mentality, it is even more apparent that a competent director would avoid the company offering a lower salary than its peers. In sum, one can see that offering low compensation as a "screening device" to try and attract committed individuals is likely to backfire because in many cases, taking this approach would discourage competent applicants who believe that their work would be better rewarded elsewhere.

### III. Compensation Arrangements in Mergers and Acquisitions

#### 1. Say on Golden Parachute Agreements

There exist a variety of possible compensation agreements in merger and acquisition situations. Golden parachutes are the kind of compensation agreements which have caused the most public consternation.<sup>83</sup> A golden parachute is the compensa-

<sup>74</sup> See *Posner* (Fn. 12), 1018–1019.

<sup>75</sup> See *Posner* (Fn. 12), 1018–1019.

<sup>76</sup> See *Posner* (Fn. 12), 1018–1019. See also *Rost et al.*, The Corporate Governance of Benedictine Abbeys, What Can Stock Corporations Learn From Monasteries?, *Journal of Management History* 16 (2010) 97–103.

<sup>77</sup> *Posner* (Fn. 12), 1019.

<sup>78</sup> *Posner* (Fn. 12), 1019; see also *Inauen et al.*, *management revue* 21 (2010) 48–54.

<sup>79</sup> See supra Part II.3.1.2 at the end.

<sup>80</sup> But cf. *von der Crone/Burg* (Fn. 27), III.

<sup>81</sup> See *Amos Tversky/Daniel Kahneman*, Judgment under Uncertainty: Heuristics and Biases, *Science*, New Series 185 (1974) 1128; *Richard E. Kopelman/Anne L. Davis*, A Demonstration of the Anchoring Effect, *Decision Sciences Journal of Innovative Education* 2 (2004) 203; similar *Beat M. Barthold/Marc Widmer*, Regulierung der variablen Vergütung?, Eine Bewertung der schweizerischen Regulierungsbestrebungen im Vergütungsbereich, *AJP* 18 (2009) 1394–1395.

<sup>82</sup> See *Scott Highhouse et al.*, What Makes a Salary Seem Reasonable? Frequency Context Effects on Starting-salary Expectations, *Journal of Occupational and Organizational Psychology* 76 (2003), 79.

<sup>83</sup> See generally *Daniel Daeniker/Alexander Nikitine*, Golden Handshakes, Golden Parachutes und ähnliche Vereinbarungen bei M&A-Transaktionen, in: *Rudolf Tschäni* (Ed.), "Mergers & Acquisitions IX", Vol. 79, Zurich 2007; see also *Böckli* (Fn. 6), § 13 N 246a–259; *Peter Nobel*, Finanzmarktrecht und internationale Standards, 3<sup>rd</sup> Ed., Bern 2010, § 10 N 112 and N 534; *BSK BEHG-Tschäni/Iffland/Diem*, Art. 29 N 24–29; *Arie Gerszt*, "Goldene Fallschirme" im Schweizerischen Recht, Nr. 103 der

tion for an employee in the case that his employment contract is terminated after the change of control in a company.<sup>84</sup> According to § 951 of the Dodd-Frank Act and the rules promulgated by the Securities and Exchange Commission ("SEC"), companies will now be required to provide the shareholders with additional information about golden parachute agreements.<sup>85</sup> The Dodd-Frank Act distinguishes mainly two types of golden parachutes: (1) payments which are negotiated ex ante in an employment contract of an executive and (2) payments which are not negotiated in advance to a takeover ("gratuity payments"). In the latter case, the managers do not know if they will receive a payment in the takeover until after the takeover has occurred.<sup>86</sup>

The justification for granting golden parachutes originates from the idea of encouraging the manager to engage in an efficient corporate transaction.<sup>87</sup> Managers of the target would, according to this theory, resist selling the firm or the division which they control if they do not get compensated for the possible loss of their job. For instance, the executives have to give up the private benefits of control and the future income they would have if they must leave the company. Giving up these benefits can be an obstacle to the takeover because the executives might use their discretionary power to work against a merger. The CEO and the board could adopt a variety of takeover defense measures which would raise the costs for a possible takeover. Thus, golden parachutes do probably facilitate the market for corporate control<sup>88</sup> because useful takeover

transactions will occur more easily without the resistance of executives who may lose their jobs.<sup>89</sup> If this assumption is true, shareholders should have an advisory approval vote about golden parachutes since it is essential for the future development of the shareholder value of the company. However, gratuity payment parachutes do not facilitate possible takeover transaction because the managers do not know whether they will receive the golden parachute ex ante.<sup>90</sup>

The shareholders of the target company want the executives to agree and to work towards a shareholder-value-increasing takeover despite the fact that they are risking the loss of their jobs. Golden parachute compensations which facilitate a takeover and provide the CEO of the target a severance payment are made because they are part of the executive's compensation contract.<sup>91</sup> This type of payment is the subject of the shareholder advisory approval in § 14A(a)(1) of the amended SEA. The new Rule 14a-21(c) does not require a separate shareholder advisory vote to approve golden parachute compensations if each golden parachute compensation arrangement has already been disclosed in a manner complying with the new Item 402(t)<sup>92</sup> and if the disclosures of the golden parachutes were subject to a previous say on pay advisory vote.<sup>93</sup>

The second type of golden parachute – the gratuity payment – shall be approved by the shareholders according to § 14A(b)(2) of the amended SEA and SEC-promulgated regulation.<sup>94</sup> In a takeover situa-

Reihe Diskussionspapiere des Forschungsinstituts für Arbeit und Arbeitsrecht an der Universität St. Gallen (June 2004), available at: <<http://www.faa.unisg.ch/publikationen/diskussionspapiere/dp103.pdf>>.

<sup>84</sup> See *Daeniker/Nikitine* (Fn. 83), 122–123.

<sup>85</sup> § 951 of the Dodd-Frank Act amends the Securities and Exchange Act of 1934 (SEA) with § 14A.

<sup>86</sup> See *Shareholder Approval of Executive Compensation and Golden Parachute, Compensation*; Final Rule, Release Nos. 33–9178; 34–63768, 76 Federal Register, 6024 (February 2, 2011). This doctrine has its source in *Lucian Bebchuk/Jesse M. Fried/David I. Walker*, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, *The University of Chicago Law Review* 69 (2002) 834–837.

<sup>87</sup> See *Bebchuk/Fried/Walker* (Fn. 86), 834–837.

<sup>88</sup> See *Manne* (Fn. 22), 112–114; *Lucian A. Bebchuk/Alma Cohen/Charles C. Y. Wang*, *Golden Parachutes and the Wealth of Shareholders* (December 1, 2010), *Harvard Law and Economics Discussion Paper No. 683*, available at SSRN: <<http://ssrn.com/abstract=1718488>>, 10 and 24–

26. This idea does not seem to be a part of the Swiss doctrine. The Swiss doctrine views golden parachutes as an illegal defensive measures in takeover battles; see e.g. Swiss Takeover Board, *Empfehlung 0249/05*, Saia-Burgess Electronics AG, August 23, 2005, E. 1.3; BSK BEHG-*Tschäni/Iffland/Diem*, Art. 29 N 24.

<sup>89</sup> But see *Lucian Bebchuk/Fried/Walker* (Fn. 86), 834. See also *Lane Daley/Chandra Subramanian*, *Free Cash Flow, Golden Parachutes, and the Discipline of Takeover Activity*, *Journal of Business Finance and Accounting* 27 (2000) 1, 3–4; they find that companies with golden parachutes tend to overinvest and take too many risks.

<sup>90</sup> See supra Fn. 86.

<sup>91</sup> See *Bebchuk/Fried/Walker* (Fn. 86), 834.

<sup>92</sup> A sample and the instruction to the new Item 402(t) of Regulation S-K can be found in 76 Federal Register, 6043–6044 (February 2, 2011).

<sup>93</sup> See also § 14A(a)(1) of the amended SEA.

<sup>94</sup> Without the SEC's new rules it was not clear which golden parachute agreements would be covered by § 14A(b)(1) of the amended SEA and which agreements would be subject to § 14A(b)(2) of the amended SEA. § 14A(b) of the

tion, the shareholders must be provided with all disclosure of the proposed gratuity payments according to the new Item 402(t) of Regulation S-K.<sup>95</sup> If a previously approved golden parachute agreement will be amended or changed, a separate vote will also be necessary.<sup>96</sup> The separation between the approval of the severance payment disclosure and the vote about the "acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of an issuer"<sup>97</sup> makes sense. Indeed, there could be situations where the shareholders want to approve the takeover transaction but they also want to have the possibility to say no to the disclosed golden parachute.

The doctrine in Switzerland takes an entirely different view of golden parachutes. The Swiss doctrine sees severance payments as a defensive measure.<sup>98</sup> The incentive to facilitate takeovers is neither the subject of any discussion nor mention in the doctrine. Golden parachutes are taboo, especially in takeover situations.<sup>99</sup> Such golden parachutes will be disallowed if they have the effect of making a takeover more difficult, even if the subjective intention behind the golden parachute is not to impede the takeover.<sup>100</sup> A golden parachute agreement is also impermissible if it is an obvious violation of the corporation law.<sup>101</sup>

amended SEA was ambiguous because of the "unless" clause at the end of § 14A(b)(2).

<sup>95</sup> These elements are: the names of the CEO, the CFO and the three highest paid executives and all the cash, equity, pension, perquisites, tax reimbursements, other sources of income and the total amount in US\$; see the new Item 402(t)(2) of the Regulation S-K; see also § 14A(b)(1) of the amended SEA.

<sup>96</sup> See § 14A(b)(2) of the amended SEA and the SEC Rule 14a-21(c).

<sup>97</sup> § 14A(b)(1) of the amended SEA.

<sup>98</sup> See *Böckli* (Fn. 6), § 8 N 546-550.

<sup>99</sup> See e.g. *Böckli* (Fn. 6), § 7 N 205-205a; BSK BEHG-*Tschäni/Iffland/Diem*, Art. 29 N 19-24; *Rudolf Tschäni*, M&A-Transaktionen nach Schweizer Recht, Zurich/Basel/Geneva 2003, 9. Kapitel N 26; *Dieter Zobl/Stefan Kramer*, Schweizerisches Kapitalmarktrecht, Zurich/Basel/Geneva 2004, N 322-324.

<sup>100</sup> According to the Swiss Takeover Board, it is not necessary that a board makes a defensive measure for the subjective purpose of defense; it is sufficient that a measure is from an objective point of view adequate to aggravate or prevent a defensive measure; see Swiss Takeover Board, Empfehlung 0249/05, Saia-Burgess Electronics AG, August 23, 2005, E. 1.1.2; BSK BEHG-*Tschäni/Iffland/Diem*, Art. 29 N 19.

<sup>101</sup> See Swiss Takeover Board, Empfehlung 0249/05, Saia-Burgess Electronics AG, August 23, 2005, E. 1.3.2; Swiss Takeover Board, Empfehlung 0343/03, Implenia AG, De-

The Swiss doctrine sees golden parachutes as diametrically opposed to the interests of the corporation and thereby violating the duty of care and loyalty.<sup>102</sup> However, this interpretation could create a conflict with the maximization of shareholder value if one is more persuaded by the American view on the utility of golden parachutes discussed in the paragraph above. Based on the conclusions drawn from the U.S. doctrine, the prohibition of golden parachute compensation agreements as proposed in the draft of the Committee for Legal Affairs of the Council of States in Switzerland is troublesome as long as there is no research about the actual impact of golden parachute agreements on the shareholder value of Swiss public corporations.<sup>103</sup> Although broadly a prohibition, this draft makes it possible to grant golden parachutes in exceptional circumstances as long as these agreements are in the company's interest.<sup>104</sup> A manager who wants such an agreement may use arguments stemming from the U.S. doctrine, although it is unclear whether golden parachutes in Switzerland would work in the same way as in the U.S., considering the institutional setting unique to each country. It could be that there is similar beneficial effect in Switzerland when taking into consideration the Swiss market for corporate control and the circumstances of the Swiss corporation law and economy. If one takes the position that Switzerland is relatively similar to the U.S., then the prohibition of golden parachutes could reduce the force of the market for corporate control and therefore decrease incentives for the management to engage in efficient takeovers. Thus, this reduces the alignment of the incentives of the shareholders and the management according to the principal agent theory.<sup>105</sup> The better solution would be to require a say on all gratuity golden parachute agreements in the takeover situation, and to require disclosure of material elements of the golden parachute agreements if they have not been subject to a prior vote during an annual shareholder meeting.

ember 20, 2007, E. 2.1.1.4; BSK BEHG-*Tschäni/Iffland/Diem*, Art. 29 N 27.

<sup>102</sup> See Art. 717 CO; BSK BEHG-*Tschäni/Iffland/Diem*, Art. 29 N 27.

<sup>103</sup> See e.g. Art. 731m Sec. 1 CO as published in BBI 2010, 8318-8319; see generally *Bühler* (Fn. 4), 274.

<sup>104</sup> See Art. 731m Sec. 2 CO as cited in BBI 2010, 8139.

<sup>105</sup> But cf. *Lipton/Savitt* (Fn. 8), 749-752; see Swiss Takeover Board, Empfehlung 0249/05, Saia-Burgess Electronics AG, August 23, 2005, E. 1.3.

This additional transparency would improve monitoring and it would lessen the undesirable incentives for the directors and executives to obstruct takeovers.

## 2. Extend Disclosure to a Broader Group of Individuals

Even if one agrees that golden parachutes should not be banned entirely, it is not clear which golden parachute agreements should be disclosed. Should it only be those of the top five executives or should there also be a broader group of individuals whose parachute agreements ought to be disclosed? Providing the figures for more people would certainly help shareholders obtain the information necessary to exercise their voting rights if the company had to disclose whether mid-level executives have the same type of golden parachutes, or how they are designed and triggered. There are at least two types of clauses in an employee's contract which make an agreement a golden parachute; (1) change of control clause, (2) the condition that the manager loses his job (or that he gets demoted). If only one of these two types of clauses is included, the golden parachute is single triggered; the contract is double triggered if both conditions have to be met in order to receive the compensation.<sup>106</sup> The idea behind including the mid-level executives in the disclosure is that the shareholders know whether the upper-level executives have the same incentives as the mid-level executives have. According to *Segal*, employees often have double triggered parachutes and top executives have single triggered parachutes. Such a situation is not always ideal because it creates conflicting incentives which will result in inefficiencies within these hierarchies;<sup>107</sup> shareholders should have the opportunity to verify whether such a situation exists. Because

of this, disclosure of golden parachutes should be extended in a reasonable and understandable manner to a broader group of individuals. However, there are many mid-level executives, and extensive disclosure could create information overkill. Disclosure regarding this issue should therefore be succinct, in a way that explains whether the mid-level employees have the same model of contracts as the top-level executives, or in which ways the contracts are materially different from those of the top-level executives.

## IV. Unintended Incentive Effects of Taxation and Salary Caps

The Congress of the U.S. intended to reduce excessive compensation in public companies with high taxation of such payments. Congress therefore enacted § 162(m) of the Internal Revenue Code (I.R.C.). According to its title, "Certain Excessive Employee Remuneration", it imposes taxes on executive pay. Congress introduced a cap of one million dollars; if executive pay exceeds one million dollars, the company will lose the tax deduction on the amount exceeding one million U.S. dollars.<sup>108</sup> But there is an exception: performance-based compensation, as opposed to cash compensation, can always be tax deductible.<sup>109</sup> In order to make such expenses deductible, companies must satisfy the conditions in § 162(m) I.R.C. This Section requires that there be objective performance goals, that the compensation committee consist entirely of outside directors, that there be shareholder approval of the compensation, and that the outside directors certify that the executives have reached the performance goals.<sup>110</sup> However, I.R.C. § 162(m) has led to unintended consequences despite the aspirations of the drafters; executive pay has actually risen since the enactment of the aforementioned Section.<sup>111</sup> One explanation for this result is the possible psycho-

<sup>106</sup> See Shareholder Approval of Executive Compensation and Golden Parachute Compensation, Proposed Rule, Release Nos. 33-9153, 34-63124, 75 Federal Register 66590, 66600 (October 28, 2010); see also the final rule with modifications and amendments of the proposed rules: Shareholder Approval of Executive Compensation and Golden Parachute, Compensation; Final Rule, Release Nos. 33-9178; 34-63768, 76 Federal Register, 6010-6047 (February 2, 2011); *Daeniker/Nikitine* (Fn. 83); 122-123.

<sup>107</sup> See *Michael Segal*, Partner in the Executive Compensation and Benefits practice, Wachtell, Lipton, Rosen & Katz, Address at the Evening Speaker Series of the Columbia Business and Law Association, Columbia Law School, New York, N.Y. (October 26, 2010).

<sup>108</sup> See I.R.C. § 162(m)(1); *William A. Klein et al.*, Federal Income Taxation, 15<sup>th</sup> Ed., New York, 2009, 558.

<sup>109</sup> See I.R.C. § 162(m)(4)(C).

<sup>110</sup> See I.R.C. § 162(m) and Staff of the Joint Committee on Taxation, 109th Congress, Present Law and Background Relating to Executive Compensation (2006), 4.

<sup>111</sup> See Staff of the Joint Committee on Taxation (Fn. 110), 1-9; *Todd Perry/Marc Zenner*, Pay for Performance? Government Regulation and the Structure of Compensation Contracts, *Journal of Financial Economics* 62 (2001) 457-459 and 486-487; *James S. Wallace/Kenneth R. Ferris*, IRC Section 162(m) and the Law of Unintended Conse-

logical effect of the fact that Congress chose to set the compensation cap at one million US\$. Because Congress chose this figure, executives who received lower sums may have felt empowered to demand compensation of one million dollars.<sup>112</sup> Furthermore, although I.R.C. § 162(m) did lead to increased stock option based compensation, for a long time, it was permissible to issue stock options without recognizing any expense in the income statement if the issuer followed the Generally Accepted Accounting Principles.<sup>113</sup> This led to investors not having a clear picture of the actual value of the compensation being paid (one can obviously see that it is harder to value stock compensation than cash compensation). In addition, if a risk-averse executive is to be paid in stock rather than cash compensation, he would tend to demand higher compensation since stock payments are riskier to him than cash payments.<sup>114</sup>

The Swiss parliamentary initiative No. 10.460, which was submitted to the Swiss Council of States on June 22, 2010, seeks to disallow tax deduction of compensation exceeding three million Swiss Francs in a newly proposed Art. 677 CO ("Tantiemen-Modell").<sup>115</sup> This provision also seeks to ban payments exceeding three million Swiss Francs if the company will not pay certain dividends as specified in the law. Note that the part of the proposed rule discussed here only comes into play if a company generates profits. If the company suffers losses or does not have retained earnings, it cannot pay the specified

amount of dividends and therefore cannot pay compensations exceeding three million Swiss Francs.<sup>116</sup> Tax deduction is less relevant if the company does not generate any profits. Quite apart from the issue that the CO should not contain taxation provisions,<sup>117</sup> it is questionable whether this is the right initiative. It is conceivable that this initiative may lead to an analogous outcome to that resulting from the similarly constructed I.R.C. § 162(m); namely, incentivizing managers to ask for a higher fixed payment because the parliament has "legitimated" payments of up to three million Swiss Francs.

Another possible solution has been proposed by *Schweiger et al.* in the form of Art. 731n CO ("Alternativmodell").<sup>118</sup> This provision only applies to public corporations and it allows slightly more flexibility in granting "very high compensations."<sup>119</sup> There is a three million Swiss Francs salary cap if the company either cannot generate profits or if the share capital and the general reserves are impaired.<sup>120</sup> Though, under this model, it would be possible to make an exception of this salary cap if the shareholders approve such "very high compensation."<sup>121</sup> However, it is doubtful whether rationally apathetic voting shareholders are competent enough to assess whether the salary cap in the proposed Art. 731n CO according to the "Alternativmodell" is an efficient solution.<sup>122</sup> The directors could easily represent to a rationally apathetic shareholder that the corporation has to pay higher salaries in order to prevent employees from leaving to work for the corporation's competitors. It is hard for such shareholders to verify whether the directors are asking for a truly legitimate approval of the very high compensation.

A third proposed model ("Bundesrätliches Kombinationsmodell"), submitted by the Federal Ministers, is substantively the same as the "Alternativmodell" except that it adds Sec. 4<sup>bis</sup> to Art. 731n CO. Moreover, this third model would apply to all stock corporations.<sup>123</sup> According to this Section, shareholders must

quences (November 2006), available at SSRN: <<http://ssrn.com/abstract=942667>> for a discussion.

<sup>112</sup> See Staff of the Joint Committee on Taxation (Fn. 110), 7; *Meredith R. Conway*, Cornell Journal of Law and Public Policy 17 (2008) 405–406; *David G. Harris/Jane R. Livingstone*, Federal Tax Legislation as an Implicit Contracting Cost Benchmark: The Definition of Excessive Executive Compensation, *The Accounting Review* 77 (2002) 998.

<sup>113</sup> See Müller (Fn. 14), 530. The Statement of Financial Accounting No. 123 and the Accounting Principles Board Opinion 25 in particular made this permissible till 2004. See also *Wallace/Ferris* (Fn. 111), 8. This was possible when the intrinsic value of the stock option satisfied the following equation: Stock price – Strike Price = \$0.

<sup>114</sup> See generally *Daniel Kahneman/Amos Tversky*, Prospect Theory: An Analysis of Decision under Risk, *Econometrica* 47 (1979) 263–292.

<sup>115</sup> For a general discussion of today's Art. 677 CO, including legislative history, see *Roland Ruedin*, Rémunération de l'administrateur de société anonyme, in: Robert Waldburger/Charlotte M. Baer/Ursula Nobel/Benno Bernet (Eds.), *Wirtschaftsrecht zu Beginn des 21. Jahrhunderts*, FS Peter Nobel, Bern 2005, 321–332.

<sup>116</sup> See Art. 731n Sec. 4 of the Draft of the "Kombinationsmodell" of the Federal Ministers, BBl 2011, 250–252.

<sup>117</sup> See BBl 2011, 248.

<sup>118</sup> See BBl 2011, 249.

<sup>119</sup> A "very high compensation" according to the proposed Art. 731n CO is any compensation exceeding the amount of three million Swiss Francs.

<sup>120</sup> See Art. 731n Sec. 2 CO as in BBl 2011, 252.

<sup>121</sup> See Art. 731n CO as in BBl 2011, 252.

<sup>122</sup> See BBl 2011, 245–247.

<sup>123</sup> See BBl 2011, 249–253.

approve very high compensation in all cases (whether or not the company generates profits). The third model should arguably not be implemented because the same deficiencies as in the "Alternativmodell" occur. In addition, this model also contains the additional problem that the shareholder vote would be conclusive rather than advisory. As discussed above, this would be an undesirable result if one assumes that shareholders are rationally apathetic.

In all of the three models above,<sup>124</sup> there is a tax burden. Excessive compensation is not tax deductible because it is regarded as share of profits instead of regular salary payment.<sup>125</sup> Therefore, the additional tax burden makes the incentive setting more costly for shareholders. It is illogical to impose a tax on possibly social welfare creating incentives. This leads to the question, implicitly discussed at various points in this Article, whether the government should punish executive compensation in this manner at all. As a matter of fact, high levels of CEO compensation could be socially valuable, to such an extent that it should not be "discouraged" by tax penalties. CEOs can create jobs which will lead to further income tax revenues. Why should the government disallow the deduction of socially valuable corporate expenditures? In advance of enacting these kinds of capital retention and taxation laws, it should be determined if the demand for harsh taxation of excessive executive payments is socially desirable. It will be hard to undo changes in the Code as soon as they have been enacted; thus, it will take time to correct provisions that turn out to be socially costly.<sup>126</sup>

## V. Conclusion and Ideas for Future Regulation

*Posner*, a staunch believer in the free market and a main protagonist of the law and economics discipline,

surprises one with the following statement: "In the wake of the financial crisis there is almost certainly going to be some regulation of executive compensation – it has begun in the form of conditions in the recent bailouts of insolvent financial firms. The question is not whether, but how best, to limit executive compensation."<sup>127</sup> The regulation of executive compensation should empower shareholders, according to the legal and economic theories discussed in this article. Providing shareholders with a say on pay does not solve all problems regarding excessive executive compensation. However, this article provides a few hints for future regulation. In essence, the following reform measures ought to be considered: First, the full disclosure of compensation for all upper-level and mid-level executives and directors is required in order to reduce agency costs. Second, public corporations should be required to pay executives and directors a substantial part of the compensation in the form of long-term restricted stock in the corporation. The executives should also be prohibited from hedging or selling the stock for a specified number of years.<sup>128</sup> Third and on a related point, executives and directors may receive a substantial payment of their compensation only at the end of their term, and such compensation should be linked to the future performance of the company.<sup>129</sup> Reforms should aim to set incentives for long-term planning of company operations. Finally, shareholder monitoring should become more affordable and should be made more effective and easily exercisable. Proper regulation of executive compensation would balance two key aims: (1) allowing shareholders to delegate business decisions to management and to incentivize maximization of the long-term value of the corporation, and (2) providing shareholders with the tools to restrain managerial behavior when necessary.

<sup>124</sup> See <<http://www.parlament.ch/d/dokumentation/dossiers/abzockerei/Documents/vorlage-2-vergleich-d.pdf>> for a synopsis of these models.

<sup>125</sup> See BBl 2011, 248: "Der Bundesrat ist der Ansicht, dass Vergütungen ab einem gewissen Ausmass – gemäss Tantiemen-Modell ab der Grenze von drei Millionen Franken – aktien- und steuerrechtlich beziehungsweise rechnungslegungstechnisch eine Gewinnbeteiligung/-verwendung und deshalb keinen geschäftsmässig begründeten Aufwand darstellen."

<sup>126</sup> See e.g. I.R.C. § 162(m) from the 1992 which is stuck in the law since.

<sup>127</sup> See *Posner* (Fn. 12), 1047; but cf. *Lipton/Savitt* (Fn. 8), 751–752.

<sup>128</sup> See *Posner* (Fn. 12), 1046; see also *Marc Ryser/Rolf H. Weber*, Hedging durch Spitzenkräfte aus börsen- und aktienrechtlicher Sicht, *GesKR* 4 (2010) 298–302.

<sup>129</sup> The company could perhaps grant restricted stock; see *Sanjai Bhagat/Roberta Romano*, Reforming Executive Compensation: Simplicity, Transparency and Committing to the Long-term, *European Company and Financial Law Review* 7 (2010) 282–295.