CORPORATE GOVERNANCE AND EXECUTIVE REMUNERATION: REDISCOVERING MANAGERIAL POSITIONAL CONFLICT

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I INTRODUCTION

> Excessive CEO pay is the mad cow disease of American boardrooms. It moves from company to company, rendering directors incapable of applying common sense.
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> -- J Richard Finlay, Chairman, Center for Corporate and Public Governance.[1]

The recent succession of high profile corporate collapses, such as HIH and One.Tel in Australia and Enron and WorldCom in the United States, sent a clear Shakespearian message that there is often a misalignment between appearance and reality in the commercial world. It is interesting to note the extent to which executive remuneration appears as a subtext in many of these collapses.[2]

There is a tendency to view executive remuneration as a specialised topic, isolated from other areas of corporate law. Yet such segregation is misleading and may lead to dangerous tunnel vision. Executive remuneration presents traditional problems of corporate governance in a highly concentrated form. Nowhere else do the conflicts of interest in corporate governance lie so close to the surface.

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1 Cited in John A Byrne, 'How to Fix Corporate Governance', *Business Week* (New York), 6 May 2002, 68.

2 See, eg, Geoffrey P Miller, 'Catastrophic Financial Failures: Enron, HIH and More' (Speech delivered at the Ross Parsons Lecture 2002, *The Global Regulation of Banking and Insurance: From HIH to Enron*, University of Sydney Law School, Sydney, 11 July 2002), observing that excessive remuneration is one of a number of common characteristics shared by many of the companies that have recently collapsed.

Other areas of corporate law may also have important implications for executive remuneration, and it is therefore necessary to consider managerial compensation within this broader context. Professor Eisenberg has spoken of management's 'positional' conflict of interest,[3] due to the broad range of its discretions and relative autonomy within the public corporation. Failure to consider executive remuneration within the larger corporate framework can disguise the way in which management's broad discretions in other areas of corporate law may affect executive remuneration.[4]

The last decade saw a dramatic shift in the US towards performance-based pay, coupled with large option grants. This potent mix of remuneration devices contributed to huge pay rises for American chief executive officers ('CEOs').[5] Commercial practice in Australia, among other countries, followed suit in the adoption of performance-based pay and option grants.[6] The rhetoric accompanying this shift was that by aligning the interests of managers and shareholders, performance-based remuneration can constitute an effective constraint on management and a self-executing corporate governance mechanism.[7] While the collapse of Enron and WorldCom have led to much soul-searching about the *structure* of executive pay, the underlying rhetoric of performance-based pay has remained essentially intact.

The aim of this article is to question some of the basic assumptions underpinning that rhetoric. The article seeks to broaden the field of vision in executive remuneration by considering some ways in which managerial powers and discretions — namely positional conflict of interest — may interact with (and potentially subvert) the goals of performance-based pay, and permit corporate managers to promote their own interests and engage in rent extraction.[8]

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3 Melvin Aron Eisenberg, 'The Structure of Corporation Law' (1989) 89 *Columbia Law Review* 1461, 1471–2. According to Professor Eisenberg, positional conflicts by management involve 'an interest in maintaining and enhancing their positions even at the shareholders' expense'.

4 See generally Charles M Yablon and Jennifer Hill, 'Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?' (2000) 35 *Wake Forest Law Review* 83.

5 According to Standard & Poor's data, median CEO compensation in the US rose from US$1.8 million in 1992 to US$6.1 million in 2000, and there has been a 340 per cent rise in CEO compensation over a 10 year period in comparison with a 36 per cent rise for general employees: The Conference Board Commission on Public Trust and Private Enterprise, *Findings and Recommendations, Part 1: Executive Compensation*, Briefing Paper (2002) 4, <http://www.conference-board.org/PDF_free/756.pdf> at 2 October 2002. See also Tod Perry and Marc Zenner, 'CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?' (2000) 35 *Wake Forest Law Review* 123, 145; Charles M Yablon, 'Bonus Questions — Executive Compensation in the Era of Pay for Performance' (1999) 75 *Notre Dame Law Review* 271, 293–4.

6 See David Cay Johnston, 'American-Style Pay Moves Abroad: Importance of Stock Options Expands in a Global Economy', *New York Times* (New York), 3 September 1998, 1; Shaun Clyne, 'Modern Corporate Governance' (2000) 11 *Australian Journal of Corporate Law* 276, 280–2.

7 See Robert Dean Ellis, 'Equity Derivatives, Executive Compensation, and Agency Costs' (1998) 35 *Houston Law Review* 399, 402.

8 See, eg, Lucian Arye Bebchuk, Jesse M Fried and David I Walker, 'Managerial Power and Rent Extraction in the Design of Executive Compensation' (2002) 69 *University of Chicago Law Review* 751, who contrast the 'optimal contracting' approach to executive remuneration, which aims to align managerial and shareholder interests, with a 'managerial power' approach in which executives are able both to extract, and camouflage, 'rents'— namely pay that is 'in excess of the level that would be optimal

II PUBLIC BACKLASH AGAINST EXECUTIVE REMUNERATION IN AUSTRALIA

> [N]o stigma attaches to love of money in America, and provided it does not exceed the bounds imposed by public order, it is held in honor.
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> -- Alexis de Tocqueville.[9]

Executive remuneration has become a hot political topic in Australia, in the light of the escalation of executive pay and the emerging connection between high levels of executive pay and recent corporate collapses. According to a global survey by Towers Perrin in 2001, Australian CEOs were the third highest paid executives in the world, after the US and the UK, with the average Australian CEO's pay package increasing by 73 per cent in the two year period before the survey.[10]

It has been noted that community 'outrage' and the threat of reputational harm can itself provide an important constraint on executive pay.[11] The 'outrage factor' has been alive and well in the Australian community in recent years. It has been growing since 2000 when there was a public outcry about the payment of A$13.2 million — one of the largest severance payments in Australian commercial history — to George Trumbull, former CEO of AMP Ltd,[12] and the engineer of its disastrous takeover of GIO Insurance Ltd.[13] Severance and retirement packages are particularly controversial[14] since they create a tension with the view that executive pay should provide incentives for future performance.[15] Also, the problem of 'golden parachutes' for departing

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for shareholders': at 754.

9 Alexis de Tocqueville, *Democracy in America* (1848) cited in Alan Strudler and Eric W Orts, 'Moral Principle in the Law of Insider Trading' (1999) 78 *Texas Law Review* 375, 375.

10 See Sue Mitchell, 'Our CEOs Third Highest Earners', *Executive Salaries, Australian Financial Review* (Sydney), 16 November 2001, S4.

11 See Bebchuk, Fried and Walker, above n 8, 756.

12 At the time, the Premier of New South Wales, Mr Bob Carr, branded this and similar payments as 'obscene and vulgar' in contrast to the plight of workers, such as those at National Textiles, who, it then appeared, would lose their employee entitlements following that company's collapse. See Alison Kahler, 'Carr Scalds Corporate "Fat Cats"', *Australian Financial Review* (Sydney), 10 February 2000, 3.

13 See Kristen Svoboda, 'Corporate Governance Issues Arising from the 1998–1999 AMP-GIO Takeover' (2000) 18 *Company and Securities Law Journal* 395.

14 This issue is currently receiving much attention in the US as a result of an investigation by the Securities and Exchange Commission ('SEC') into the retirement package of Jack Welch, former CEO of General Electric Co. Mr Welch's retirement benefits (which included use of a Boeing 737 and a Manhattan apartment) were disclosed by his wife in divorce proceedings. See David Cay Johnston and Reed Abelson, 'GE's Ex-Chief to Pay for Perks, but the Question is: How Much?', *New York Times* (New York), 17 September 2002, C1.

15 There has been an increase in termination payments in Australia in recent years. See, eg, Damon Kitney and Lachlan Johnston, 'Has the Bubble Finally Burst?', *Executive Salaries, Australian Financial Review* (Sydney), 16 November 2001, S3, attributing an increase in termination payments in the prior year to the removal of underperforming executives at several blue-chip companies. Increased turnover of CEOs as a result of poor performance and greater shareholder activism is a global trend. See generally the recent empirical study on frequency of CEO succession: Chuck Lucier, Eric Spiegel and Rob Schuyt, 'Why CEOs Fall: The Causes and Consequences of Turnover at the Top' (2002) 28 *strategy + business*, <http://www.strategy-business.com> at 2 October 2002.

executives, based upon the unexpired portion of the employment contract, is exacerbated in Australia where longer employment contracts for executives are more common than in jurisdictions such as the US or UK.[16]

A number of other controversial examples of termination pay have followed since the Trumbull affair, including A$15 million payments granted by Coles Myer[17] and Lend Lease.[18] Also, in 2001, '[t]apping into a rich vein of community outrage', Kim Beazley, then leader of the federal Opposition, attacked a payment by Pacific Dunlop to its retiring CEO.[19] Finally, it appears that AMP Ltd's tradition of generous termination payments will be upheld with the recent announcement of the early departure of its CEO, Paul Batchelor.[20]

Another highly publicised incident concerning severance pay involved a proposed A$638 000 payment to the former chair of the demutualised NRMA Insurance, Nicholas Whitlam. Minority shareholders who objected to the payment sought to pass a special resolution at NRMA's annual general meeting requiring the board to seek shareholder approval for any such retirement payments. The resolution, which would have given shareholders greater control over the approval of retirement benefits, ultimately failed although a substantial number of shareholders voted in favour of it.[21]

The impact of globalisation, and the so-called 'global market in talent',[22] has also been apparent in the escalation of executive pay in Australia.[23] Whereas

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16 International Corporate Governance Network Sub-Committee on Executive Remuneration, *Executive Remuneration — The Caucus Race* (2002) [31], <http://www.icgn.org/documents/ICGNExecRem.pdf> at 2 October 2002.

17 The Australian Shareholders' Association ('ASA') attacked the severance package granted to the former CEO, Dennis Eck, branding it 'Trumbull-like'. See Richard Gluyas, 'Stan Gets Trumbull Trembles', *The Australian* (Sydney), 26 November 2001, 31.

18 Lend Lease was criticised for making the A$15 million severance payment to a senior executive who had only been with the firm for one year. See Anthony Hughes and Carolyn Cummins, 'L Lease Defends $15m Exec Payout', *Sydney Morning Herald* (Sydney), 25 September 2001, 23.

19 Pacific Dunlop was criticised for making a A$2.54 million payment to its retiring CEO who had presided over the company during a period when net profit had dropped by 45 per cent: Margot Saville, 'Executives' Parting *is* Sweet Sorrow', *Sydney Morning Herald* (Sydney), 20–21 October 2001, 49.

20 See Adam Shand, 'Payoffs on Greed Street', *Australian Financial Review* (Sydney), 28–29 September 2002, 22.

21 The vote in favour of the resolution was approximately 30 per cent and Corporate Governance International recommended that its clients vote in favour of the resolution: 'Whitlam's Payout Up in the Air', *Australian Financial Review* (Sydney), 25 October 2001, 64. It was reported that the new chair of NRMA Insurance, James Strong, had vigorously lobbied institutional investors to vote against the resolution. See Ben Seeder and Morgan Mellish, 'NRMA Board Payouts Approved', *Australian Financial Review Weekend* (Sydney), 3–4 November 2001, 7; Anthony Hughes, 'Vote Clears Way for $638 000 Payment to Whitlam', *Sydney Morning Herald* (Sydney), 3–4 November 2001, 50.

22 See International Corporate Governance Network Sub-Committee on Executive Remuneration, above n 16, [20], which cites as some indication of a 'global market in talent', the appointment of non-national CEOs at a number of large Australian organisations including AMP, Westpac, Coles Myer and BHP Billiton (noting however that 'not all these examples have been deemed successes').

23 On the issue of globalisation, and the likelihood that there will be international convergence towards a US-style model of executive remuneration, see Brian R Cheffins and Randall S Thomas, 'Regulation and Globalization (Americanization) of Executive Pay' (Working Paper No 02-05, Vanderbilt University Law School, 2001), <http://www.ssrn.com/> at 2 October 2002; Susan Stabile, 'My Executive Makes More than Your Executive: Rationalizing Executive Pay in a Global Economy' (2001) 14 *New York International Law Review* 63.

Paul Anderson, the outgoing CEO of BHP Ltd reportedly earned A$7.8 million in 2000, the incoming CEO of the dual listed company, BHP Billiton, Brian Gilbertson, received a A$21 million remuneration package.[24]

Australia has not been alone in experiencing the impact of globalisation on executive remuneration. Germany, for example, historically had a very different corporate governance regime to the US model,[25] with far lower levels of executive pay. These traditional differences were evident in the high-profile merger of Daimler-Benz and Chrysler in 1998[26] where in the year prior to the merger the annual salary of the chairman of the German company, Jurgen Schrempp, was dramatically lower than that of his counterpart at Chrysler, Robert Eaton.[27] Since the time of the DaimlerChrysler merger however, there appears to have been a significant shift in the structure and levels of German managerial pay towards the US model.[28]

There have been several sources of the recent community outrage and shareholder dissatisfaction in Australia regarding executive pay. One such source is the perceived disparity between executive pay and corporate performance.[29] The events at National Australia Bank ('NAB') in 2001 are a good example.[30] Shareholders strongly criticised the bank when it was revealed that, in spite of the A$4 billion writedowns associated with the failed HomeSide venture, NAB's CEO, Frank Cicutto, had emerged as the second highest paid executive in

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24 Cathryn Jimenez, 'Well, Blowy Me Down, That's Some Pay Cheek', *The Australian* (Sydney), 17 October 2001, 35. Some research analysts criticised the executive remuneration arrangements at BHP Billiton, particularly the generous participation rights for Mr Gilbertson in share schemes, as showing 'a complete disregard for shareholders'. See Lenore Taylor, 'BHP Bonuses Under Attack', *Australian Financial Review* (Sydney), 26 September 2001, 41.

25 See Brian R Cheffins, 'The Metamorphosis of "Germany Inc": The Case of Executive Pay' (2001) 49 *American Journal of Comparative Law* 497; Jeffrey Gordon, 'Corporate Governance: Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany' (1999) 5 *Columbia Journal of European Law* 219.

26 See generally, Dennis E Logue and James K Seward, 'Anatomy of a Governance Transformation: The Case of Daimler-Benz' (1999) 62 *Law and Contemporary Problems* 87.

27 According to one report in the financial press, Jurgen Schrempp's income at this time was US$2 million per annum, compared with Robert Eaton's salary of US$70 million per annum: 'Fears Over Mega Takeover', *The Guardian* (London), 21 September 1998, 40. Cf Stabile, above n 23, 74, who presents a more modest salary of merely US$16.1 million for Robert Eaton during this period.

28 See generally Cheffins, above n 25. Post-merger, DaimlerChrysler overhauled its executive remuneration system so that it would be predominantly performance-based, and became the first German company to include stock options in executive pay packages: Stabile, above n 23, 74–6. According to Jurgen Schrempp, DaimlerChrysler created 'the first German company with a North American culture': Haig Simonian and Nikki Tait, 'US Executives Earn Much More', *Financial Times* (London), 3 August 1998, 22, cited in Lawrence A Cunningham, 'Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance' (1999) 84 *Cornell Law Review* 1133, 1175.

29 See Clyne, above n 6, 280; Neil Chenoweth, 'The Backlash Against the Unearned Bonus', *Australian Financial Review* (Sydney), 21 April 2001, 21.

30 There are a number of recent examples of this phenomenon. In November 2001, for instance, shareholders in David Jones Ltd and Coles Myer Ltd attacked the companies over remuneration practices, coupled with poor corporate performance. In the case of David Jones, for example, small shareholders tried to block the remuneration package of CEO, Peter Wilkinson, and voted against Mr Wilkinson's long-term 450 000 share incentive scheme. The package was ultimately passed, however, on the basis of proxies received. See Cathryn Jimenez, 'DJ Faithful Call for Cash Account', *The Australian* (Sydney), 27 November 2001, 23.

Australia, with a pay increase of approximately A$1 million between 2000 and 2001. Furthermore, a number of senior NAB executives in the US associated with the HomeSide debacle had nonetheless received large performance bonuses.[31]

In other cases, while corporate performance may have been good, the rhetoric of alignment of interests between management and shareholders lacked credibility. Although Adelaide Bank made a record profit for 2000–01, the board decided to increase its chief executive's salary by 30 per cent while refusing any increase in the dividend payment to shareholders.[32]

Another source of shareholder resentment relates to performance hurdles in option grants. Although traditionally absent from US executive option packages, performance hurdles have been a familiar feature of option grants in Australia for many years.[33] Nonetheless, these hurdles are often criticised as being inadequate. In 2001, shareholders of Goodman Fielder Ltd criticised the terms of an option package to the company's new managing director, on the basis that the structure of the option grant presented 'no real challenge'.[34]

Although shareholders are increasingly interested in the question of executive remuneration,[35] with the issue often generating heated debate at general meetings, the power of shareholders to challenge executive remuneration plans is generally weak.[36] To date it has been relatively rare for shareholder resolutions to succeed in blocking remuneration packages at Australian general meetings.[37] Litigation in this area has been infrequent and is generally more likely to be

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31 See generally, George Lekakis, 'NAB Payouts Irk Shareholders', *Australian Financial Review* (Sydney), 20 November 2001, 18.

32 George Lekakis, 'CEO Defends Pay Increase', *Australian Financial Review* (Sydney), 31 August 2001, 64.

33 See Mitchell, 'Our CEOs Third Highest Earners', above n 10, S4; Equity Strategies Report, *The Real World of Australian Option Plans* (2002) 1, stating that in the past 'option plan design and practice in the US was significantly less rigorous than that in Australia and the United Kingdom'.

34 See Sue Mitchell, 'Goodman Options Cause a Stir', *Australian Financial Review Weekend* (Sydney), 17–18 November 2001, 12; Cathryn Jimenez, 'Goodman's Board Paid Out on Pay', *The Weekend Australian* (Sydney), 17 November 2001, 31. Similar complaints were made in relation to the issue of two million options by Seven Network to its managing director of broadcast television, Maureen Plavsic. See Damon Kitney, 'Stokes in Stoush over Options', *Australian Financial Review Weekend* (Sydney), 27–28 October 2001, 8.

35 For a survey of the attitudes and views of shareholders to executive remuneration, see Albie Brooks et al, 'Issues Associated with Chief Executive Officer Remuneration: Shareholders' Perspectives' (1999) 17 *Company and Securities Law Journal* 360.

36 See Randall S Thomas and Kenneth J Martin, 'Litigating Challenges to Executive Pay: An Exercise in Futility?' (2001) 79 *Washington University Law Quarterly* 569, stating that corporate law offers shareholders three basic ways to challenge executive compensation — by voting, selling or suing. Each method has considerable hurdles and drawbacks.

37 For example, although in the case of Goodman Fielder shareholders blocked approval of an options package to the CEO on a vote by show of hands, the resolution was ultimately approved by 98.3 per cent of shares voted in a poll. See Mitchell, 'Goodman Options Cause a Stir', above n 34; Jimenez, 'Goodman's Board Paid Out on Pay', above n 34. Also, at Network Seven, the controversial issuance of options to Maureen Plavsic was ultimately approved in spite of the fact that three institutional shareholders and the ASA voted against the package: Kitney, above n 34.

successful in the close corporation context.[38]

Nonetheless, a number of superannuation funds in Australia have recently indicated that they intend to take a more activist stance against large executive option grants in forthcoming annual general meetings.[39] Also, institutional shareholders in Australia played an important role in lobbying for more stringent disclosure requirements for executive remuneration,[40] which were introduced under the *Company Law Review Act 1998* (Cth).[41] At a global level too, fund managers are subjecting executive remuneration to greater scrutiny. The International Corporate Governance Network ('ICGN'), which represents approximately US$10 trillion in assets, recently proposed a 10 point code of conduct to improve transparency and accountability in relation to executive pay, including a recommendation that investing institutions increase their level of analysis of remuneration structures.[42]

In some instances management has clearly responded to the possibility of shareholder or general community backlash relating to executive pay.[43] For example, following the revelation by Qantas that up to 2000 workers would be retrenched and a call for a wage freeze for remaining workers, the company's CEO announced that senior executives would forgo their right to substantial performance bonuses.[44]

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38 Thomas and Martin, above n 36, 571, 586 ff. For an interesting discussion of some recent shareholder suits in the US, such as *Brehm v Eisner,* 746 A 2d 244 (Del, 2000) in relation to Walt Disney Co, see Deborah A DeMott, 'Shareholder Challenges to Executive Remuneration' (2000) 74 *Australian Law Journal* 576, 578–580 and Thomas and Martin at 596–9. In the Australian context, see Clyne, above n 6, 296, blaming the fact that shareholders must overcome 'insurmountable hurdles' to seek relief for the low level of judicial review of excessive executive remuneration.

39 See Anthony Hughes, 'Building Super Fund to Vote Against Executive Option Packages', *Sydney Morning Herald* (Sydney), 12 September 2002, 21.

40 See Jennifer Hill, 'Remuneration Disclosure in Australia' (Research Paper No 1/1996, Australian Investment Managers Association, 1996).

41 *Corporations Act 2001* (Cth) s 300A; Australian Securities and Investments Commission, Practice Note 68, *New Financial Reporting and Procedural Requirements* (1998), <http://www.cpd.com.au/newcorp/asic/pn/pn068.pdf> at 2 October 2002. For background to the changes to Australia's disclosure regime for director and executive remuneration, see Brooks et al, above n 35, 366–9; Clyne, above n 6; Michael Quinn, 'The Unchangeables — Director and Executive Remuneration Disclosure in Australia' (1999) 10 *Australian Journal of Corporate Law* 89. In spite of the introduction of more rigorous disclosure requirements under s 300A, problems still remain concerning disclosure of the value of options. The Australian Accounting Standards Board ('AASB') is currently developing a disclosure standard for stock options, and in its CLERP 9 issues paper, the government affirmed that would amend the *Corporations Act 2001* (Cth) to require explicitly that the value of stock options must be disclosed: Department of the Treasury, *Corporate Disclosure: Strengthening the Financial Reporting Framework* (2002) ('CLERP 9') 109, <http://www.treasury.gov.au/contentitem.asp?pageId=035&ContentID=403> at 30 September 2002. See also the Labor Party's Corporations Amendment (Improving Corporate Governance) Bill 2002 (Cth), cl 8.

42 See Sara Calian, 'Global Panel Targets Executive Pay', *Wall Street Journal* (New York), 20 September 2002, C16. See also International Corporate Governance Network Sub-Committee on Executive Remuneration, above n 16.

43 Paradoxically, however, some members of the business community have blamed the new disclosure regime as contributing to the escalation of executive salaries: Sue Mitchell, 'Greater Disclosure has Led to Pay Boom', *Executive Salaries, Australian Financial Review* (Sydney), 16 November 2001, S2.

44 Darren Goodsir, 'Qantas Chief Gives Up $500 000 Bonus', *Sydney Morning Herald* (Sydney), 17–18 November 2001, 10. Also executives at the Seven Network announced that they had voluntarily agreed to

The most recent example of the potential power of the 'outrage factor' in Australia is in relation to option schemes. In August 2002, soon after a statement by the Commonwealth Bank that it would suspend its executive option scheme,[45] Paul Batchelor, the CEO of AMP, announced that he intended to seek an extension of the vesting date for his option package.[46] Such was the public backlash in response to this announcement, that Mr Batchelor reversed his decision the following day.[47]

III EXECUTIVE REMUNERATION AND CORPORATE THEORY

> Money, it's a crime. Share it fairly, but don't take a slice of my pie.
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> -- Pink Floyd.[48]

Corporate law has employed at least three basic techniques in attempting to control the conflicts of interest that exist in relation to executive remuneration. The first of these is self-constraint (with judicial enforcement) via fiduciary duties. The second technique involves eliminating or controlling conflicts of interest through corporate governance techniques, such as the use of independent directors, remuneration committees and greater control by shareholders. It is unsurprising that the mantra of 'arm's-length dealing' reverberates through contemporary corporate governance practices. The final way of dealing with the problem has been to accept the existence of managerial self-interest, but to try to align that self-interest with the interests of shareholders. This technique does not attempt to overcome managerial self-interest, but rather to harness it for the benefit of shareholders.

At an international level, led by US corporate governance models, the spotlight has shifted away from the first regulatory mechanism in the last decade towards the other two techniques. The second technique underpins many of the recent corporate governance reforms recommended by the New York Stock Exchange ('NYSE') Corporate Accountability and Listing Standards

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a pay cut, following an 81 per cent decline in company profits. See Cosima Marriner, 'Seven Bosses Cut Own Pay 10pc', *Sydney Morning Herald* (Sydney), 27 October 2001, 49. Southern Cross reversed a proposal to introduce a scheme increasing the retirement benefits for non-executive directors, following criticism and strong opposition of the proposal by institutional investors. Annie Lawson, 'Southern Cross Backs Away From Director Pay Plan', *Sydney Morning Herald* (Sydney), 2 November 2001, 21.

45 See Annabel Hepworth, 'CBA's Incentive Cut Could Snowball', *Australian Financial Review* (Sydney), 22 August 2002, 5; 'Murray Takes the PM's Hint', *Australian Financial Review* (Sydney), 22 August 2002, 80. There was widespread support for the Commonwealth Bank's decision, with the Prime Minister urging the rest of the corporate sector to follow suit. Katharine Murphy and Tony Boyd, 'CBA Action on Options Praised', *Australian Financial Review* (Sydney), 23 August 2002, 5.

46 See Tony Boyd and Brett Clegg, 'AMP Defends Options as Profit Dives', *Australian Financial Review* (Sydney), 23 August 2002, 1; 'Wallis Should Put His Foot Down', *Australian Financial Review* (Sydney), 23 August 2002, 76.

47 See Jennifer Hewett, 'Searching for Options', *Sydney Morning Herald* (Sydney), 24–25 August 2002, 45.

48 'Money', *Dark Side of the Moon* (1973).

Committee,[49] which were ratified by the board of directors of the NYSE on 1 August 2002. The NYSE reforms, for example, place great emphasis on the independent director as a 'cleansing agent'[50] in corporate governance. The reforms require listed companies to have a majority of independent directors,[51] and to have a compensation committee composed entirely of independent directors.[52] There is also a provision increasing shareholder control over equity compensation plans.[53]

The third 'alignment of interests' technique represents a particularly important paradigm shift in the theory underpinning executive remuneration.[54] This paradigm shift provided the foundation for the rise of performance-based pay and option grants as a component of executive remuneration. The device of tying CEO compensation to increases in share prices or to other accounting-based performance targets was viewed as an effective way of aligning managerial and shareholder interests, and providing management with the incentive to take risks.[55] An additional virtue of performance-based pay was that it operated as a 'self-executing' governance technique, without the need for shareholder supervision or judicial enforcement.[56] And performance-based pay held out the promise of remuneration according to 'just deserts'. It was represented as a legitimising device, which would reward the deserving and penalise the unworthy in corporate management. This paradigm shift reflected an even more fundamental shift in corporate theory from an entity theory of the corporation to a nexus of contracts model, which is now viewed as orthodoxy.[57]

Two main factors drove the rise to dominance of performance-based pay coupled with option grants. These were, first, the fact that US tax laws gave

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49 New York Stock Exchange, *Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee* (2002), <http://www.nyse.com/pdfs/corp_govreport.pdf> at 11 October 2002. According to the NYSE, the purpose of the reforms, which introduce a range of strict mandatory corporate governance rules, is 'to restore the essential trust needed on behalf of the investing public in a strong securities market and a strong economy': New York Stock Exchange, 'NYSE Board Releases Report of Corporate Accountability and Listing Standards Committee' (Press Release, 6 June 2002), <http://www.nyse.com/press/NT00565884.html> at 23 September 2002.

50 On the historical role of independent directors, see James D Cox, 'Corporate Governance in the United States: The Evolving Role of the Independent Board' in Low Chee Keong (ed), *Corporate Governance: An Asia-Pacific Critique* (2002) 379, 388, stating that '[t]he most noticeable aspect of American corporate governance is the law's repeated resort to the independent director as a cleansing agent, particularly when the transaction is one rife with the possibility of opportunistic behaviour by the controlling stockholders or senior executive officers'.

51 New York Stock Exchange, *Report*, above n 49, Recommendation 1.

52 Ibid Recommendation 5. The definition of 'independent director' was also tightened under the proposals: ibid Recommendation 2.

53 Ibid Recommendation 8.

54 A pivotal article in this paradigm shift was Michael C Jensen and Kevin J Murphy, 'CEO Incentives — It's Not How Much You Pay, But How' (1990) 68(3) *Harvard Business Review* 138. See also Yablon, 'Bonus Questions', above n 5, 279–80.

55 See Eric L Johnson, 'Waste Not, Want Not: An Analysis of Stock Option Plans, Executive Compensation, and the Proper Standard of Waste' (2000) 26 *Journal of Corporate Law* 145, 148.

56 Ellis, above n 7, 402.

57 See, eg, Ellis, above n 7, 400; Linda J Barris, 'The Overcompensation Problem: A Collective Approach to Controlling Executive Pay' (1992) 68 *Indiana Law Journal* 59, 63; Richard L Shorten, 'An Overview of the Revolt Against Executive Compensation' (1992) 45 *Rutgers Law Review* 121, 122–3.

favourable treatment to performance-based remuneration, and secondly, the absence of any legal requirement to charge fixed price options against company earnings.[58] Option grants constituted a large proportion of executive salary increases[59] and, during the technology industry boom, enabled start-up companies, with few assets, to compete with established listed companies in attracting executives.[60]

The paradigm shift of the last decade has, however, been criticised for some time by a number of commentators at both a theoretical level, and at a practical level. In terms of corporate theory, the alignment of interests model of executive remuneration is based upon a shareholder-centred theory of the corporation. Yet, in recent years, some academic commentators have questioned the appropriateness of a shareholder-centred model of the corporation, and suggested that a more inclusive model, recognising the contribution of a wider range of actors, including employees, more closely reflects the modern corporation.[61] It has been argued that a narrow focus on shareholder returns under performance-based pay is undesirable, since improving shareholder wealth does not necessarily improve social wealth[62] and can create perverse incentives towards short-termism.[63]

Also, a shareholder-centred model of the corporation is by no means universally adopted in comparative corporate governance. Professor Brian Cheffins has noted, for example, that in Germany the concept of profit maximisation for shareholders 'has typically not been an overriding priority'. Rather the German corporate system traditionally aimed to balance the interests of the various constituencies associated with the corporation.[64] Although in recent years there has been increasing convergence between the US and German systems,[65] post-Enron and WorldCom there has been considerable backlash in

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58 DeMott, above n 38.

59 Whereas option grants constituted 27 per cent of median CEO compensation in the US in 1992, the figure had risen to 60 per cent by 2000. See The Conference Board Commission on Public Trust and Private Enterprise, above n 5, 4.

60 Ibid 5; Clyne, above n 6, 280.

61 See, eg, Professors Blair and Stout, who advocate a model of the corporation based upon teamwork: Margaret M Blair and Lynn A Stout, 'A Team Production Theory of Corporate Law' (1999) 85 *Virginia Law Review* 247. See also Margaret M Blair, 'Post-Enron Reflections on Comparative Corporate Governance' (Working Paper No 31663, Georgetown University Law Centre, 2002); William W Bratton, 'Enron and the Dark Side of Shareholder Value' (Public Law Research Paper No 35, George Washington University, 2002).

62 Margaret M Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (1995) 12.

63 See Joshua A Kreinberg, 'Reaching Beyond Performance Compensation in Attempts to Own the Corporate Executive' (1995) 45 *Duke Law Journal* 138; Alfred F Conard, 'Theses for a Corporate Reformation' (1986) 19 *University of California Davis Law Review* 259, 276–9; Martin Lipton, 'Corporate Governance in the Age of Finance Corporatism' (1987) 136 *University of Pennsylvania Law Review* 1, 7–8; Martin Lipton and Jay Lorsch, 'A Modest Proposal for Improved Corporate Governance' (1993) 48 *Business Law* 59, 66–7. See also Jennifer Arlen and Reinier Kraakman, 'Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes' (1997) 72 *New York University Law Review* 687, 703, arguing that structuring remuneration on the basis of short-term profits may lead to higher levels of corporate crime.

64 Cheffins, above n 25, 500–1.

65 Ibid 497–8.

Europe against the US model of corporate governance[66] and it is therefore difficult to predict the extent to which convergence will continue.[67]

Under the alignment of interests model of executive remuneration, the actual level of pay is immaterial.[68] It is ironic that a remuneration technique, which was designed to achieve greater managerial accountability, ushered in an era of unparalleled increases in executive pay. Critics of the escalating levels of executive remuneration have argued that excessive remuneration can be damaging to worker morale,[69] and indeed to the economy as a whole.[70] Also, massive inequality in the distribution of wealth in society can lead to a loss of social cohesion[71] and result in political backlash.[72]

It has also become apparent, even to commentators who support the theoretical foundation of the alignment of interests model of executive remuneration, that as a result of structural deficiencies, there is often a significant gap between the rhetoric and the practical operation of many performance-based pay schemes.[73] Common structural deficiencies in many remuneration packages include a weak link between pay and performance with low, and easily achievable, targets[74] and insufficient downside risk for poor performance.[75]

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66 See James Pressley, 'EU Says "No" to US Rules', *Australian Financial Review* (Sydney), 27 June 2002, 13. See also Blair, 'Post-Enron Reflections', above n 61. Corporate scandals, such as Enron and WorldCom, have, however, had a significant impact in tightening corporate governance rules in the US, eg, the enactment of the *Sarbanes-Oxley Act of 2002*, Pub L No 107–204, 116 Stat 745 (2002).

67 See, eg, Cheffins and Thomas, above n 23, noting that variables such as legal regulation and business culture are important constraints on convergence.

68 See Jensen and Murphy, above n 54, 151.

69 See International Corporate Governance Network Sub-Committee on Executive Remuneration, above n 16, [45]; Charles M Yablon, 'Overcompensating: The Corporate Lawyer and Executive Pay' (1992) 92 *Columbia Law Review* 1867, 1877.

70 Kreinberg, above n 63, 144–6; John E Parkinson *Corporate Power and Responsibility: Issues in the Theory of Company Law* (1993) 201–2.

71 The Federal Reserve Bank of New York CEO, William McDonough, recently warned of the dangers in this regard, describing the escalation in executive pay as 'terribly bad social policy and perhaps even bad morals': Luke Collins, 'Top Banker Questions Morality of Executive Pay', *Australian Financial Review* (Sydney), 13 September 2002, 32.

72 See Eric W Orts, 'The Future of the Enterprise Organization' (1998) 96 *Michigan Law Review* 1947, 1965–6; Mark J Roe, 'Backlash' (1998) 98 *Columbia Law Review* 217.

73 Recognition of this fact underlies public outrage in many of the commercial scenarios discussed in Part II above.

74 See Kreinberg, above n 63, 150. This alleged defect lay at the heart of shareholder criticism of remuneration packages at Goodman Fielder and Seven Network. At Goodman Fielder, shareholders criticised the terms of the Goodman Fielder option package to its new CEO, Tom Park, in 2001, on the basis that Mr Park could exercise the first one million tranche of the five million option package at a price of A$1.27, if Goodman's share price reached a target of A$1.70, even if it took 10 years to achieve this target. At Seven Network, a proposed grant of two million options to the managing director of broadcast television was criticised on the basis that the options were in the money (with a strike price of A$6.60, compared to a share price at the time of issue of A$6.95) and had a relatively short vesting period. See the references above nn 34, 37.

75 The recent market slowdown has made this aspect of many packages more apparent. See generally, 'Special Report: Executive Remuneration', *Business Week* (New York), 16 April 2001. In the Australian context, see John Fickling and Geof Stapledon, 'Board Composition and Pay in the Top 100 Companies' (Paper presented at the Conference of Major Superannuation Funds, 29 March 2001) 31, <http://www.institutionalanalysis.com/publications/fulltext/CMSFReport-WEBLK.pdf> at 23 September 2002.

There is also scepticism about the existence of a causal connection between pay and performance, and whether increased corporate profits are actually attributable to exceptional performance by executives. David Knott, chairman of the Australian Securities and Investments Commission ('ASIC'), recently made this point, stating '[t]he market price of shares, as the past decade has shown, is influenced significantly by external factors that have little to do with management performance'.[76] Corporate managers have sometimes queried whether there is a direct connection between firm performance and their own performance when profits are below expectations.[77] Recently, however, some senior members of the business community[78] acknowledged that use of option grants and benchmarking executive pay against shareholder returns can generate an 'unearned windfall'[79] in certain circumstances.

There has also been specific criticism of the use of options as a form of remuneration, on the basis that options may not offer rational or long term incentives toward improved performance.[80] This is as a result of what might be termed 'the supermodel syndrome' in executive remuneration.[81] As the current Australian commercial environment shows, corporate executives, like supermodels, have a potentially short shelf-life.[82] In an era of takeovers and increased pressure from institutional investors,[83] this may provide incentives to increase corporate profitability during their tenure (for example, by downsizing the workforce) rather than focusing on the long-term health of the organisation.[84]

There is increasing concern about the highly dilutive effects of option grants

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76 According to David Knott, these external factors include 'sentiment and interest rates': David Knott, 'Corporate Governance — Principles, Promotion and Practice' (Speech delivered at the Monash Governance Research Unit (Inaugural Lecture), Melbourne, 16 July 2002) 10, <http://www.asic.gov.au> at 6 October 2002.

77 See, eg, the comments of Jill Ker Conway, Lend Lease: 'You cannot respond to ... a downturn by cutting remuneration commensurately. It just does not work. A job is a job and it has to be done whether earnings are up or down': *Executive Salaries, Australian Financial Review* (Sydney), 16 November 2001, S2. The International Corporate Governance Network Sub-Committee on Executive Remuneration, above n 16, [38] recognises this phenomenon, stating that 'there is an implicit assumption that a rise in share price is somehow all due to the superior skills of the executives, whereas a fall is a consequence of a malign external influence'.

78 See Australian Shareholders' Association, 'The Cost of Options' (Media Release, 11 July 2002). The business leaders who called for reconsideration of the configuration of executive remuneration packages on this basis included Hugh Morgan (WMC), David Crawford (BHP Billiton and Lend Lease) and Dick Warburton (Reserve Bank and David Jones).

79 Clyne, above n 6, 283.

80 See Jennifer Reingold, 'The Folly of Jumbo Stock Options', *Business Week* (New York), 22 December 1997, 36.

81 See Jennifer Hill, 'Public Beginnings, Private Ends — Should Corporate Law Privilege the Interests of Shareholders?' in Fiona MacMillan (ed), *International Corporate Law Annual* (2000) vol 1, 17, 30–3 ff.

82 See Lucier, Spiegel and Schuyt, above n 15.

83 This reflects strong competitive pressures on institutions and their fund managers, who may also be driven to maximise short-term profits. See generally, Lipton, above n 63, 7–8; Martin Lipton, Theodore Mirvis and Steven A Rosenblum, 'Book Review: Corporate Governance in the Era of Institutional Ownership' (1995) 70 *New York University Law Review* 1144, 1147–8; Edward B Rock, 'The Logic and (Uncertain) Significance of Institutional Shareholder Activism' (1991) 79 *Georgetown Law Journal* 445.

84 Hugh Morgan (WMC) recently recognised this danger. See Australian Shareholders' Association, above n 78.

and the misleading picture which they may present of a company's profitability. This has led to growing pressure for reforms to ensure that options are treated as expenses in corporate accounts.[85] In the US, a number of companies have announced that they will voluntarily expense options against company profits.[86] Also, the Commission on Public Trust and Private Enterprise of the influential Conference Board, has recently recommended treating fixed price stock options as an expense against earnings.[87] However, two members of the Commission dissented from this recommendation for interesting reasons. One of the bases on which Commissioner Andrew S Grove, chairman of Intel Corp, dissented was that expensing options would merely create new opportunities for manipulation of earnings.[88] Commissioner Paul A Volcker went even further, arguing that rather than introducing reforms to ensure that fixed price options are expensed against earnings in the US, they should be resisted altogether as a component of executive pay in public companies.[89]

The introduction of a legal requirement to expense executive options now appears inevitable in Australia. In its CLERP 9 issues paper, the government expressed support for the adoption by the Australian Accounting Standards Board ('AASB') of the International Accounting Standards Board ('IASB') standard to require expensing of share options.[90]

IV EXECUTIVE REMUNERATION, POSITIONAL CONFLICT AND DISCLOSURE

> A great man always considers the timing before he acts.
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> -- Chinese proverb.[91]

There has thus been a growing recognition that the structure of many performance-based executive pay packages has been deficient and has used

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85 See, eg, Knott, above n 76.

86 For example, in July 2002, the Coca-Cola Company made an announcement to this effect, and a number of other US corporations, including Washington Post Co and Bank One Co followed suit: Coca-Cola Company, 'The Coca-Cola Company will Expense All Stock Options' (Press Release, 14 July 2002), <www2.coca-cola.com/presscenter> at 2 October 2002.

87 See The Conference Board Commission on Public Trust and Private Enterprise, above n 5, 5; Ken Brown and Joann S Lublin, 'Overhaul for Stock Options — Business Group Backs Tougher Rules, Curbs for Executive Pay', *Wall Street Journal* (New York), 17 September 2002, C13.

88 The Conference Board Commission on Public Trust and Private Enterprise, above n 5, 13.

89 Commissioner Volcker stated, 'Given both the very large capricious element inherent in the returns from fixed price stock options and the distorted incentives for management, I believe the use of such options should be strongly discouraged for public companies. There are far better alternatives for seeking and achieving an appropriate alignment of shareholder and management interests': ibid 12.

90 Department of the Treasury, *Corporate Disclosure: Strengthening the Financial Reporting Framework* (2002) ('CLERP 9'), <http://www.treasury.gov.au/contentitem.asp?pageId=035&ContentID=403> at 30 September 2002. Proposal 15 provides that 'the IASB standard requiring expensing of share options will have the force of law on adoption by the AASB, expected to be in the second half of 2003'. See also David Jones, 'The Right Option?', *Business Review Weekly* (Melbourne), 19 September 2002, 45.

91 Robert Andrew, Mary Biggs and Michael Seidel, *The Columbia World of Quotations* (1996) [1816].

inappropriate benchmarks.[92] This has led to a trend in finetuning of executive remuneration schemes. A widely held view is that the alignment of interests between management and shareholders is both desirable and possible — the devil is simply in the detail. Australia and the UK appear to have been well ahead of the US in finetuning option plans to include performance hurdles, although US organisations are now increasingly incorporating such restrictions.[93]

Nonetheless, several studies in the last few years have suggested that the problems with performance-based pay go well beyond mere structure, and that even carefully structured remuneration packages will frequently provide corporate managers with incentives to use their strategic advantage within the company to prefer their own interests over those of the shareholders.

It therefore appears that the 'positional' conflict, of which Professor Eisenberg spoke,[94] is alive and well in the area of executive remuneration. Commentators have noted management's strategic advantage in the pay-setting process itself.[95] Neither increased use of independent directors on compensation committees, nor specialist compensation consultants,[96] is a complete panacea to management's strategic superiority in the pay-setting arena. Management's influence can ensure that pay packages are tailored to prevailing markets. During a bear market, for example, it is common to see a higher portion of fixed salary to options, than in a bull market. Management's influence can also ensure that pay packages are tailored to take account of the prevailing law[97] and community attitudes.[98]

Furthermore, even when executive compensation packages are structured to incorporate a genuine element of risk, management can be insulated from its effects in a variety of ways. For example, downside risk has often been obviated by the repricing of options. Falling share prices in the US have led to a trend in favourable option repricings or swaps.[99] It is interesting to note that an

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92 Such as the notorious market capitalisation benchmark used at One.Tel: Knott, above n 76, 10.

93 Equity Strategies Report, above n 33, 6. One of the dangers engendered by such finetuning, however, is that executive remuneration packages are becoming ever more complicated and abstruse. See International Corporate Governance Network Sub-Committee on Executive Remuneration, above n 16, [43]. This is particularly problematic, given the trend towards greater use of shareholder approval in relation to executive remuneration issues.

94 Eisenberg, above n 3, 1471–2.

95 See generally Bebchuk, Fried and Walker, above n 8, 764 ff; Richard L Shorten, 'An Overview of the Revolt Against Executive Compensation' (1992) 45 *Rutgers Law Review* 121, 128–132; Geoffrey S Rehnert, 'The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs' (1985) 37 *Stanford Law Review* 1147, 1150, 1153; Jennifer Hill, 'What Reward Have Ye? Disclosure of Director and Executive Remuneration in Australia' (1996) 14 *Company and Securities Law Journal* 232, 235.

96 See generally Yablon, 'Overcompensating', above n 69. Compensation consultants, who are generally retained by management, raise similar problems regarding independence and legitimacy to those currently under consideration in the context of auditors.

97 The Conference Board Commission on Public Trust and Private Enterprise, above n 5, 6, recognised, for example, that tighter controls on options will probably result in a reduction in fixed-price options, matched by an increase in cash and shares as components of executive remuneration.

98 See, eg, Neil Chenoweth, 'Choice Aplenty as Companies Review Executive Rewards', *Australian Financial Review* (Sydney), 25 September 2002, 6, claiming that 'Australia's more savvy companies are already moving away from options into other remuneration channels, such as restricted shares, or partly-paid shares, which do not attract quite so much shareholder scrutiny and ire'.

99 See Louis Lavelle with Frederick F Jesperson, 'Executive Pay: Special Report', *Business Week* (New York), 15 April 2002; Byrne, above n 1.

amendment to the Australian Stock Exchange ('ASX') Listing Rules attempts to address this problem, by requiring shareholder consent as a precondition to option repricing.[100] The report of the Conference Board's Commission on Public Trust and Private Enterprise has recently recommended that approval by shareholders should be required under US law for all actions which could dilute their investment, including option repricing.[101]

Another development which potentially undermines risk in performance-based pay has been the rise of derivatives trading and hedging techniques. A number of US commentators have noted that it is possible for executives to neutralise the incentive effects of performance-based pay, and protect themselves from downside risk, by entering the derivatives market.[102] This development potentially undermines not only the incentive policy of performance-based pay but also the 'just deserts' policy.

Studies have also recognised the danger that some performance indicators, such as share price, in executive remuneration could create perverse incentives for management to engage in misrepresentation of firm performance.[103] It was recognised, for example, that large bonus entitlements might lead to 'income smoothing' practices.[104] Interestingly, in the recent Towers Perrin report on international executive remuneration practices, Australia was one of only two countries in the world, where the rate of annual bonus to salary was higher than in the US.[105] Management's discretion in relation to a range of corporate transactions, such as share buy-backs, may also be used to bolster share price.[106]

The prevalence of stock options could also provide incentives to manipulate the market price of the company's shares.[107] The problem is particularly acute where the strike price for exercise of the option is set at the share price at the date of its issue (which has traditionally been the practice in the US, though not in Australia). In such circumstances, the most desirable and profit maximising scenario for any CEO is for the stock price to be relatively low at the time of issuance of the options, and relatively high at the exercise date.

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100 ASX, Listing Rule 6.23. The Listing Rule was introduced in its current form on 30 September 2001.

101 The Conference Board Commission on Public Trust and Private Enterprise, above n 5, 6.

102 See David M Schizer, 'Executives and Hedging: The Fragile Legal Foundations of Incentive Compatibility' (2000) 100 *Columbia Law Review* 440; Eli Ofek and David Yermack, 'Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership?' (2000) 55 *Journal of Finance* 1367; Ellis, above n 7, 402–3; Steven A Bank, 'Devaluing Reform: The Derivatives Market and Executive Compensation' (1995) 7 *DePaul Business Law Journal* 301, 303. See also Paul U Ali and Geof Stapledon, 'Having Your Options and Eating Them Too: Fences, Zero-Cost Collars and Executive Share Options' (2000) 18 *Company and Securities Law Journal* 277.

103 See, eg, Gerald L Salamon and E Dan Smith, 'Corporate Control and Managerial Misrepresentation of Firm Performance' [1979] *Bell Journal of Economics* 319.

104 See Yablon and Hill, above n 4, 86–7; Robert W Holthausen, David F Larcker and Richard Sloan, 'Annual Bonus Schemes and the Manipulation of Earnings' (1995) 19 *Journal of Accounting and Economics* 29; Paul M Healy, 'The Effect of Bonus Schemes on Accounting Decisions' (1985) 7 *Journal of Accounting and Economics* 85; Michael S Weisbach, 'Outside Directors and CEO Turnover' (1988) 20 *Journal of Financial Economics* 431, 459.

105 See Towers Perrin, *Worldwide Total Remuneration* (2001–2002); Cheffins and Thomas, above n 23, 3–4.

106 See Clyne, above n 6, 283.

107 See Jennifer G Hill, 'Deconstructing Sunbeam — Contemporary Issues in Corporate Governance' (1999) 67 *University of Cincinnati Law Review* 1099, 1124, 1127.

An interesting study by Professors David Aboody and Ron Kasznik[108] suggested that not only do CEOs have the incentive to manipulate stock price for the purposes of option grants, but that they also have the capacity to achieve such manipulation by relatively subtle means, as a result of their positional advantage with respect to voluntary disclosure of corporate information.

The Aboody and Kasznik study comprised a sample of 572 companies that made option grants on fixed and predictable schedules throughout the period 1992–96. The study found that, during the period leading up to a major option issue, these companies' earnings forecasts were substantially less optimistic than those of the same firms in periods when no option grants were made. On the basis of stock price investigation, they found that companies with scheduled awards shortly before earnings announcements had, on average, abnormally negative returns in the period prior to the announcement, which was again consistent with the view that the CEOs of these companies were managing expectations downwards. Aboody and Kasznik also did an actual study of earnings announcements and found that CEOs who received stock options prior to the announcement were more likely to issue bad news forecasts, and less likely to issue good news forecasts than those who only received options after the earnings announcements. The underlying message of the Aboody and Kasznik study is consistent with an earlier study by Professor David Yermack[109] which found that, in the context of option grants made on an unscheduled basis, CEO stock option awards were followed by significantly positive abnormal returns, and a study by Professors Keith Chauvin and Catherine Shenoy,[110] which found abnormal stock price decreases in the 10 day period immediately prior to an option grant date.

Studies of this kind suggest that management's strategic superiority within the corporation — its positional conflict — may enable it to distort the goals and indicia of performance-based pay itself. As in the case of hedging, these studies potentially undermine the 'just deserts' rationale of performance-based pay. The studies suggest a paradox — namely that performance-based pay, a form of remuneration which was touted as a panacea for the problem of misalignment of interests between management and shareholders, has itself become a new source of interest misalignment.[111]

Yet, a key issue in this regard is how much autonomy and discretion executives actually have in regard to disclosure of corporate information. The positional conflict argument assumes that management has a high level of

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108 David Aboody and Ron Kasznik, 'CEO Stock Option Awards and Corporate Voluntary Disclosures' (2000) 29 *Journal of Accounting and Economics* 73.

109 David Yermack, 'Good Timing: CEO Stock Option Awards and Company News Announcements' (1997) 52 *Journal of Finance* 449, 455–7. However, the fact that the option grants in Yermack's study were on an unscheduled, unpredictable basis might suggest that, rather than manipulation of disclosure by CEOs, they were merely manipulating the timing of option grants to maximise returns to them. This is consistent with a finding of Aboody and Kasznik that, for companies with variable award schedules, there was no evidence of pre-award manipulation of disclosure.

110 Keith W Chauvin and Catherine Shenoy, 'Stock Price Decreases Prior to Executive Stock Option Grants' (2001) 7 *Journal of Corporate Finance* 53.

111 See generally Yablon and Hill, above n 4.

autonomy and discretion in relation to the timing of corporate disclosures. Do the legal rules in Australia and in the US relating to disclosure support this assumption?

Under US corporate law, there has traditionally been no duty on corporate managers to disclose material information, either immediately or, even necessarily, promptly.[112] While under Delaware corporate law management owes shareholders a duty of 'complete candour', this is not a general obligation but is limited to the circumstances where management seeks shareholder approval or action.[113]

In the area of securities law, disclosure of information is viewed as a necessary precondition to an efficient market[114] and one of the underlying regulatory goals of the Securities and Exchange Commission ('SEC') is to ensure a level playing field in access to information.[115] Yet, in spite of commitment to the ideal of informational efficiency, US law has never adopted a continuous disclosure regime. Rather, the traditional US model of disclosure under securities law required publicly traded corporations to make significant periodic disclosures in the annual report, and less detailed disclosures on a quarterly basis.[116] Following Enron and WorldCom, however, US law appears to be moving further in the direction of a higher standard of disclosure.[117]

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112 On the vexed issue of whether such a duty might exist under US securities law, see Yablon and Hill, above n 4, 106 ff.

113 See, eg, *Malone v Brincat,* 722 A 2d 5, 11–12 (Del, 1998). This doctrine is analogous to the principles discussed in the Australian case, *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452.

114 See, eg, Marcel Kahan, 'Securities Laws and the Social Costs of "Inaccurate" Stock Prices' (1992) 41 *Duke Law Journal* 977, 985.

115 See S Vaidya Nathan, 'A Century in Retrospect: SEC, Setting Regulatory Benchmarks Worldwide', *Business Line Intelligence Wire,* 10 October 1999 (1999 WL 24407272).

116 Other circumstances, such as the solicitation of proxies, may trigger specialised disclosure requirements.

117 In December 2001, the chairman of the SEC stated that a system of 'current' disclosure, rather than periodic disclosure, would be needed to restore investor confidence in the US: Harvey L Pitt, 'How to Prevent Future Enrons' (Public Statement by SEC Chairman, 11 December 2001), <www.sec.gov/news/speech/spch530.htm> at 2 October 2002. The SEC has recently proposed new rules which would mandate accelerated disclosure of a larger number of significant corporate events: *Proposed Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date* [Release Nos 33-8106; 34-46084; File No S7-22-02] 19 June 2002, <www.sec.gov/rules/proposed/33-8106.htm> at 2 October 2002. It proposed a rule change which would substantially increase the number and type of events that trigger an immediate public disclosure obligation under Form 8-K. Among the new triggering events would be, inter alia: (1) entry into or termination of a material agreement not made in the ordinary course of business; (2) creation of a direct or contingent financial obligation that is material to the company, or events triggering such an material financial obligation; (3) a change in a rating agency decision, issuance of a credit watch or change in a company outlook; (4) any material impairment; and (5) conclusion or notice that security holders no longer should rely on the company's previously issued financial statements or a related audit report. The time in which to make such filings after occurrence of such an event would be reduced from five business days to two business days.

In its release, the SEC asks whether this targeted approach to disclosure of specifically delineated events should be replaced by 'a broad principle requiring companies to report highly important corporate events, leaving the company to determine the trigger for and scope of the necessary disclosure' and 'if so, how should we define the types of events requiring disclosure?' These recent proposals indicate that the SEC, while expanding corporate disclosure obligations, continues to do so in a targeted way linked to the occurrence of specific events and seems disinclined to move to a more general obligation of continuous disclosure for all 'highly important' corporate events.

Concerns in the US about the existence of an uneven playing field, when selective briefings to analysts occurred between quarterly disclosure dates, led to the introduction in 2000 of Regulation FD (Fair Dealing),[118] which requires listed companies to disclose any material non-public information to the market, if it is disclosed to analysts.[119] However, rather than leading to greater general dissemination of corporate information, it has been argued that Regulation FD may have had a chilling effect and led to less information in the marketplace by discouraging companies from briefing analysts.[120]

In theory, therefore, under US securities law, it is possible for management to be in possession of material non-public information for a period of time, during which there is neither an obligation, nor a prohibition, relating to the disclosure of that information. In this situation corporate managers have a positional advantage, possessing a broad discretion as to whether or not they disclose the information on a voluntary basis.

At first glance it would appear that Australian corporate managers have less autonomy and discretion with regard to corporate disclosures than their US counterparts, as a result of Australia's adoption of a continuous disclosure regime in 1994.[121]

The centrepiece of the continuous disclosure regime is ASX Listing Rule 3.1,

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118 US Securities and Exchange Commission, *Final Rule: Selective Disclosure and Insider Trading*, 17 CFR Parts 240, 243, 249, <http://www.sec.gov/rules/final/33-7881.htm> at 2 October 2002. The SEC's executive summary of the rule at the time of its introduction stated that:

> Regulation FD (Fair Disclosure) is a new issuer disclosure rule that addresses selective disclosure. The regulation provides that when an issuer, or person acting on its behalf, discloses material non-public information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of this information. The timing of the required public disclosure depends on whether the selective disclosure was intentional or unintentional; for an intentional selective disclosure, the issuer must make public disclosure simultaneously; for a non-intentional disclosure, the issuer must make public disclosure promptly.

119 This has also been a controversial issue in Australia. See, eg, ASIC, *Heard it on the Grapevine ... Disclosure of Information to Investors and Compliance with Continuous Disclosure and Insider Trading Provisions*, Draft ASIC Guidance and Discussion Paper (1999).

120 See Jeffrey Lawrence, 'The Global Chill of Regulation FD' (2000) 18 *Company and Securities Law Journal* 526, 527–8; James D Cox, 'United States Introduces Fair Disclosure and Insider Trading Reforms' (2001) 75 *Australian Law Journal* 286; PriceWaterhouseCoopers and Weil, Gotshal and Manges LLP, *Navigating Fair Disclosure* (2001).

121 For background to the introduction of the continuous disclosure regime, see Mark Blair, 'Australia's Continuous Disclosure Regime: Proposals for Change' (1992) 2 *Australian Journal of Corporate Law* 54; Peta Spender, 'The Legal Relationship between the Australian Stock Exchange and Listed Companies' (1995) 13 *Company and Securities Law Journal* 240, 268–74; W J Koeck, 'Continuous Disclosure' (1995) 13 *Company and Securities Law Journal* 485. See also Mark Blair and Ian M Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in Gordon Walker, Brent Fisse and Ian Ramsay (eds), *Securities Regulation in Australia and New Zealand* (2nd ed, 1998) 55, 65, who state that 'there is no strong evidence that the continuous disclosure reforms had any significant impact on the efficiency of the Australian share market or on the disclosure policies of listed companies'.

which provides that:

> Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information.[122]

On its face, ASX Listing Rule 3.1 appears to impose an obligation on corporate managers to disclose all material facts about their companies as soon as they become aware of them. Nonetheless, in practice, it appears that management still retains considerable discretion about timing of disclosure. For a start, the broad scope of the disclosure requirement is narrowed by the presence of carve-outs, which exempt certain information from the disclosure net.[123] The carve-outs represent a competing policy to that of ensuring an informed market. They recognise the need to preserve confidentiality in certain circumstances for the protection of the company and its shareholders. The 'incomplete proposal or negotiation' provision within the carve-outs, for example, is an acknowledgement that premature disclosure of negotiations may 'kill the deal'. Nonetheless, it is a potential safe harbour, which provides management itself with the ability to determine the timing of disclosure.[124]

The continuous disclosure regime has been subject to criticism, on the basis that the Listing Rule requirements are ambiguous and that the continuous disclosure rules do not necessarily create a level playing field. The chairman of ASIC, David Knott, recently stated that there is 'a perceived lack of clarity in the way the present disclosure test works in practice'.[125] It has been argued that ambiguities in the continuous disclosure rule have resulted in a number of companies adopting an overly technical interpretation of the rule, ignoring its spirit.[126]

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122 See also Australian Stock Exchange, Guidance Note 8, *Continuous Disclosure: Listing Rule 3.1* (2002).

123 ASX Listing Rule 3.1 stipulates that the disclosure obligation does not apply to particular information, while each of the following applies:

- 3.1.1 A reasonable person would not expect the information to be disclosed.
- 3.1.2 The information is confidential.
- 3.1.3 One or more of the following applies.
  - a) It would be a breach of a law to disclose the information.
  - b) The information concerns an incomplete proposal or negotiation.
  - c) The information comprises matters of supposition or is insufficiently definite to warrant disclosure.
  - d) The information is generated for the internal management purposes of the entity.
  - e) The information is a trade secret.

On the scope of the carve-outs, see generally R P Austin, 'Continuous Disclosure: An Overview of the Exceptions' (1998) 50 *Australian Company Secretary* 313.

124 See, eg, Malcolm Maiden, 'More is Needed to Check the Dot.Com Mania', *The Age* (Melbourne), 7 February 2000, 1, stating that 'the existing blanket waiver for deals that are being negotiated denies investors price-sensitive information'.

125 Knott, above n 76, 1.

126 See, eg, John Durie, 'Disclosure: Business Risks Tougher Rules', *Australian Financial Review* (Sydney), 8 March 2002, 76. See also comments by Jillian Segal, then Deputy Chair of ASIC, in a 2001 address: 'My view is that we are still fighting a war on disclosure. I believe that the problem is that prompt disclosure is not an integral part of our corporate culture': Jillian Segal, 'Everything the Company Director Must Know about Corporate Financial Disclosure and Continuous Disclosure' (Speech delivered to the Australian Institute of Company Directors, Sydney, 31 October 2001).

Enforcement of the continuous disclosure regime has also been a topical issue. In spite of the expansion, under the *Financial Services Reform Act 2001* (Cth), of the civil penalty provisions to cover market misconduct offences, including continuous disclosure breaches,[127] ASIC's chairman argued that the regulator lacked effective enforcement powers, lobbying for the ability to impose administrative fines on corporations in breach of their continuous disclosure obligations.[128]

A 2001 research report[129] on the continuous disclosure regime also concluded that there was evidence of lack of candour by many companies in their disclosure activities, particularly companies in the new technology area.

The controversial proposal by the ASX to reform Listing Rule 3.1 appears to be an acknowledgment that the rule does not literally ensure continuous disclosure of information to the market, and currently provides a considerable degree of autonomy and discretion to corporate management as to the timing of disclosure. The central aim of the proposed reforms is to address the problem of rumours and speculation creating a false market (or perhaps, an accurate market) before management has released price-sensitive information.[130]

A number of the reform proposals in CLERP 9 (released on 18 September 2002) address concerns about the enforcement of Australia's continuous disclosure regime. For example, it proposes a major increase in the maximum penalty for contravention of the continuous disclosure regime by corporations.[131] Acceding to ASIC's claim that its enforcement powers were too limited, CLERP 9 permits the regulator to impose financial penalties and issue infringement notices for breaches of the continuous disclosure regime,[132] and supports the ability of the ASX to require companies to respond publicly to market speculation in certain circumstances.[133]

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127 See generally Grant Moodie and Ian M Ramsay, 'The Expansion of Civil Penalties under the *Corporations Act*' (2002) 30 *Australian Business Law Review* 61.

128 Knott, above n 76, 12.

129 Anne-Marie Neagle and Natasha Tsykin, *'Please Explain': ASX Share Price Queries and the Australian Continuous Disclosure Regime,* Research Report, Centre for Corporate Law and Securities Regulation, University of Melbourne (2001). *Contra* Peter Klinger, 'Australia Scores High Marks on Disclosure', *Australian Financial Review* (Sydney), 16 November 2001, 19, describing a 2001 report by Standard & Poor's, which found that in the Asia-Pacific area, disclosure by Australian companies was equal to regional best practice.

130 Australian Stock Exchange, *Enhanced Disclosure — Executive Summary of ASX Proposals* (2002).

131 CLERP 9, above n 41, Proposal 21, which states that the maximum civil penalty for a contravention of the continuous disclosure regime by a body corporate will rise from $200 000 to $1 million.

132 CLERP 9, above n 41, Proposal 22.

133 CLERP 9, above n 41, Proposal 27.

V EXECUTIVE REMUNERATION AND CORPORATE COLLAPSE

> Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding common sense business practices ... As a result, I fear that we are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting. Management may be giving way to manipulation; integrity may be losing out to illusion.
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> -- Arthur Levitt, ex-Chairman, SEC.[134]

Executive remuneration has been a critical issue in a number of recent corporate scandals and collapses, including Sunbeam, Enron, WorldCom and One.Tel. These cases of corporate governance failure suggest that the dangers, which some commentators and the Aboody and Kasznik study identified in relation to executive remuneration, were far from theoretical or exceptional. These corporate collapses confirm that, as a result of management's positional conflict of interest and its powers and discretions over financial reporting and disclosure, performance-based pay packages may provide executives with incentives to maximise their own wealth at the expense of the company, its shareholders and other stakeholders. Finetuning of performance-based pay packages may reduce, but is unlikely to eliminate, these dangers.

The events at Sunbeam in 1998,[135] which were treated by many as an aberration at the time, represented a warning signal for later corporate collapses. In mid-1998, after a period of escalating share price and apparently strong performance by Sunbeam under the redoubtable Al Dunlap,[136] the financial journal, *Barron's*, published an article alleging that accounting gimmickry had created the illusion of profit at Sunbeam in the previous year.[137] A few days later, Sunbeam's board, discovering that sales for the next quarter were US$60 million below expectations, removed Dunlap as CEO. Reverberations from these events have continued since that time. On 4 September 2002, Al Dunlap entered into a settlement of fraud charges brought by the SEC, in which he was permanently banned from acting as a director or officer of any public company and fined US$500 000.[138]

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134 Arthur Levitt, 'The Numbers Game' (Speech delivered at the New York University Center for Law and Business, New York, 28 September 1998).

135 See generally Hill, 'Deconstructing Sunbeam', above n 107.

136 Some of Al Dunlap's soubriquets were 'Chainsaw Al' and 'Rambo in Pinstripes': 'Al Dunlap: Exit Bad Guy', *The Economist* (London), 20 June 1998, 70

137 Jonathan R Laing, 'Dangerous Games: Did "Chainsaw Al" Manufacture Sunbeam's Earnings Last Year?', *Barron's* (New York), 8 June 1998, 17. See also John A Byrne, 'How Al Dunlap Self-Destructed: The Inside Story of What Drove Sunbeam's Board to Act', *Business Week* (New York), 6 July 1998, 58. Although at the time Sunbeam's auditor, Arthur Andersen, reassured Sunbeam's board as to the accuracy and reliability of the accounts, it reversed its position soon afterwards. Arthur Andersen then commenced a special audit of Sunbeam's financial statements with the assistance of Deloitte & Touche, and in October 1998, Sunbeam issued a restatement of earnings for the period of Dunlap's tenure as CEO. See Martha Brannigan, 'Shareholder Scoreboard', *Wall Street Journal* (New York), 25 February 1999, R7.

138 Also, in January 2002, Dunlap and other directors settled a shareholder suit. Settlement included a US$15

An array of reputable corporate governance mechanisms was employed at Sunbeam to ensure that managerial interests were aligned with shareholder interests, and Dunlap proclaimed that he was 'in lock step with the shareholders'.[139] His salary was predominantly performance-based and directors' salaries were paid entirely in shares.[140]

Nonetheless, a closer examination of Al Dunlap's remuneration suggests that it may have been affected by both positional conflict and perverse incentives. Dunlap's strategic power within the corporation was evident in the setting of his pay. Although Dunlap initially entered into a three year contract with Sunbeam,[141] eighteen months later he negotiated a new contract with the board, in spite of some disappointing financial results. Under this new contract, his base salary was doubled and he received one of the ten largest option grants in corporate history to that time.[142] Although five of the seven directors on the Sunbeam board were independent outside directors,[143] Al Dunlap exercised a high level of control as a result of his power to select the majority of board members, his dual position as CEO and chairman of the board,[144] and a charismatic and dominating personality.[145] The position at Sunbeam accorded with a number of empirical studies which suggest that, paradoxically, compensation for CEOs tends to be greater in firms with a high percentage of outside directors,[146] and that the level of a CEO's pay is directly related to the level of influence that the CEO has over the board.[147]

Other manifestations of positional conflict and perverse incentives to manipulate share price were apparent at Sunbeam. For example, in early 1998, Al Dunlap surprised Wall Street by embarking on a growth strategy in which

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million payment. See Luke Collins, 'Chainsaw Al Banned from Boardrooms', *Australian Financial Review* (Sydney), 6 September 2002, 52.

139 Joann S Lublin and Martha Brannigan, 'Sunbeam Names Albert Dunlap as Chief, Betting He Can Pull Off a Turnaround', *Wall Street Journal* (New York), 19 July 1996, B2.

140 Directors of Sunbeam were also required, as a precondition to joining the board, to purchase a prescribed level of stock in Sunbeam, thereby ensuring that they would 'think like shareholders'.

141 Dunlap's original contract with Sunbeam comprised an annual salary of US$1 million, together with options to purchase 2.5 million shares and one million shares of restricted stock: Lublin and Brannigan, above n 139.

142 Dunlap received 3.75 million options under this deal: Daniel Kadlec, 'Is That You, Al? A Famous Cost-Cutter Decides to Build, not Sell', *Time* (New York), 16 March 1998, 44.

143 See generally Hill, 'Deconstructing Sunbeam', above n 107, 1105.

144 Separation of the roles of CEO and chairman of the board is far more common in Australia than in the US. See, eg, Egon Zehnder International Survey, *Board of Directors Global Study* (2000) 12, Table 23, finding that 94 per cent of Australian responding companies separated the role of CEO and chairman, compared to 42 per cent in the US.

145 For an interesting analysis of this style of corporate leadership, see Michael Maccoby, 'Narcissistic Leaders: The Incredible Pros, the Inevitable Cons' (2000) 78(1) *Harvard Business Review* 69. According to Maccoby, narcissistic leaders have 'compelling, even gripping, visions for companies, and they have an ability to attract followers': at 72.

146 Sanjai Bhagat and Bernard Black, 'Board Composition and Firm Performance: The Uneasy Case for Majority-Independent Boards' (1998) 1053 *Practicing Law Institute Corporate Law and Practice Course Handbook Series* 95, 104.

147 The level of influence increases when the CEO is also chairman of the board, and the board is predominantly composed of outside directors. See Uma V Sridharan, 'CEO Influence and Executive Compensation' (1996) 31 *Financial Review* 51.

Sunbeam paid US$1.8 billion in a single day to acquire a number of companies. Although several analysts believed that Sunbeam had 'grossly overpaid' for the acquisitions, the transactions initially pushed Sunbeam's share price 24 per cent higher.[148] A less acceptable method of affecting share price involved the accounting manipulation identified by *Barron's*. According to *Barron's*, Sunbeam's stated profit at that time of US$109.4 million was in fact composed of approximately US$120 million in artificial profit boosters.[149]

A similar picture emerges at Enron and WorldCom.[150] Enron under Kenneth Lay, like Sunbeam under Al Dunlap, was the embodiment of a shareholder-centred company.[151] On the face of it Enron appeared to operate in accordance with corporate governance best practice.[152] It had experienced board members with sophisticated expertise in accounting, derivatives and structured finance,[153] and a committee structure which included a Finance Committee, Audit and Compliance Committee, and Compensation Committee.[154] Yet, the procedural safeguards at Enron, such as the company's code of conduct, were regularly waived by Enron's board, which permitted transactions involving serious conflicts of interest, to occur.[155] In the Australian context, the recent decision of Santow J in *Australian Securities & Investments Commission v Adler*[156] identified a similar bypassing of procedural safeguards at HIH Insurance Ltd.[157]

Enron paid an extravagant salary to its CEO, Kenneth Lay. The recent US Senate Report on *The Role of the Board of Directors in Enron's Collapse* records that his total compensation in 2000 exceeded US$140 million, including US$123 million in exercising stock options.[158] Enron also demonstrated the limits of the Compensation Committee as a buffer against excessive remuneration. The US Senate Committee criticises the fact that the main function of the company's Compensation Committee appeared to be ensuring that Enron's pay matched that of its competitors, rather than constituting a check on pay structures.[159]

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148 Kadlec, above n 142, 44.

149 Specifically, *Barron's* alleged that Sunbeam had used a technique known as 'channel stuffing', in which earnings of one quarter are artificially inflated at the expense of later quarters.

150 For a range of other common features in these companies, see Miller, above n 2.

151 See Bratton, above n 61, 77, commenting that Enron represents the re-enactment of old pathologies, such as fraudulent financials, 'on a stage set by the contemporary shareholder value maximization norm'.

152 Enron did, however, have a board of 15 members, which is unusually large for contemporary boards.

153 Report prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, *The Role of the Board of Directors in Enron's Collapse* (2002) 8.

154 Ibid 9.

155 Ibid 24.

156 *Re HIH Insurance Ltd (in prov liq) and HIH Casualty & General Insurance Ltd (in prov liq); Australian Securities & Investments Commission v Adler* (2002) 41 ACSR 72.

157 Ibid 172.

158 This amount was almost 10 times the pay of the average American CEO: Report prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, above n 153, 52. Mr Lay also withdrew US$77 million in cash under a line of credit from the company in a single year, which he replaced with stock: at 54.

159 See also Rehnert, above n 95, 1153, stating that the role of the compensation committee in the US is typically limited to reviewing remuneration proposals recommended by top executives, who as 'rational, utility-maximising individuals ... will continue to propose remuneration plans to their executive compensation committees that maximize their income'.

After the company's collapse, it also emerged that Enron paid its executives huge performance-based bonuses in 2001, based upon their success in reaching certain stock price targets.[160] It was subsequently shown that these targets were reached via manipulation of accounts, which had the effect of inflating Enron's profits by up to US$1 billion.[161] When the news of the Enron bonuses emerged, a former federal white-collar crime prosecutor was reported as saying, '[t]he levels of compensation that we are talking about here would certainly seem to be a powerful incentive for anyone to do anything'.[162] There is also evidence suggesting that the structure of executive remuneration provided the incentives for the multi-billion dollar accounting fraud at WorldCom.[163]

Finally, in the Australian context, executive remuneration featured as a critical element in the collapse of One.Tel.[164] In September 2000, it was revealed in One.Tel's annual report that the joint CEOs, Jodee Rich and Brad Keeling, had received cash bonuses of A$6.9 million each on top of their annual salaries of A$560 000. The bonus payments, which were tied to the questionable benchmark of One.Tel's market capitalisation,[165] triggered predictable public outrage and caused the One.Tel share price to plummet.[166]

The bonus payments were problematic from a corporate governance perspective, and demonstrate positional conflict. It seems, for example, that the bonuses were suggested by the CEOs themselves, that the remuneration committee had met only once in the prior year, that there was no discussion by the board about the reasonableness of the payments and no advice from independent external compensation consultants.[167] Whereas the board representatives of the major shareholders were aware of the bonus structure, most shareholders only learned about the existence of the bonuses after they had been paid. It appears that the board did not consider obtaining shareholder consent to

160 In 2001, Enron executives received approximately US$430 million in annual bonuses under Enron's normal bonus plan. In addition, a special program called the Performance Unit Plan paid additional bonuses of US$320 million to approximately 65 Enron executives, in exchange for meeting certain stock performance targets: Report prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, above n 153, 54.

161 Kurt Eichenwald, 'Enron's Many Strands: Executive Compensation', *New York Times* (New York), 1 March 2002, 1.

162 Ibid. Members of Enron's Compensation Committee, however, stated that it had not occurred to them that perverse incentives might exist for executives to manipulate earnings to increase the company stock price: Report prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, above n 153, 54.

163 See Peter Henderson, 'WorldCom Finds $3.8 billion Error, Fires CFO', Reuters, 25 June 2002; Luke Collins, '$6.6 billion Fraud Rocks Markets', *Australian Financial Review* (Sydney), 27 June 2002, 1; Alan Kohler, '$US100m Reasons to Cook the Books', *Australian Financial Review* (Sydney), 27 June 2002, 1.

164 The Board of National Textiles also received bonuses of A$103 000 prior to the company's collapse. See generally, Joellen Riley, 'Bargaining for Security: Lessons for Employees from the World of Corporate Finance' (2002) forthcoming *Journal of Industrial Relations*.

165 See International Corporate Governance Network Sub-Committee on Executive Remuneration, above n 16, [27], which notes '[m]arket capitalisations may be, as we have seen, ephemeral'.

166 Paul Barry, *Rich Kids: How the Murdochs and Packers Lost $950 million in One.Tel* (2002) 210, 364.

167 Christine Lacy, 'Board Didn't Approve Bonuses', *Australian Financial Review* (Sydney), 23 April 2002, 3; Sue Mitchell, 'Lessons from the One.Tel Saga', *Australian Financial Review* (Sydney), 16 November 2000.

the bonuses under s 211 of the *Corporations Act 2001* (Cth),[168] on the basis that it considered the bonuses to be 'reasonable'.[169]

One.Tel is also a good example of how excessive remuneration can cause political backlash. Following the collapse of One.Tel, the Prime Minister announced on 4 June 2001 that the government intended to introduce a Bill providing, in certain circumstances, for forfeiture of bonuses paid to directors and officers of failed companies. Although the proposed Bill stalled at the time,[170] the government has recently reaffirmed its commitment to introduce a claw-back provision that would enable liquidators to recover 'unreasonable payments' made to directors of failed companies.[171] The issue of forfeiture of bonuses was also addressed in the US in the *Sarbanes-Oxley Act of 2002*,[172] which became operative on 30 July 2002. Section 403 provides for forfeiture of bonuses or incentive-based remuneration received by the CEO and CFO in the event that the corporation is required to restate its financial results, as a result of misconduct and non-compliance with financial reporting requirements.

VI CONCLUSION

> Nature will find a way.
>
> -- Michael Crichton, *Jurassic Park* (1990).

The revolution in executive remuneration over the last decade was based upon the premise that it is possible to harness the accepted wealth-maximising desires of corporate executives[173] by aligning their interests with those of shareholders. There was an assumption that markets, generally, and performance-based pay particularly, could constrain managerial self-interest and result in CEOs being

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168 *Corporations Act 2001* (Cth) s211(1)(b) exempts remuneration from the general requirement of shareholder consent under the related party transaction provisions, only if

> to give the remuneration would be reasonable given:
>
> (i) the circumstances of the public company or entity giving the remuneration; and
>
> (ii) the related party's circumstances (including the responsibilities involved in the office or employment).

See generally, Andrew Defina, Thomas C Harris and Ian M Ramsay, 'What is Reasonable Remuneration for Corporate Officers? An Empirical Investigation into the Relationship between Pay and Performance in the Largest Australian Companies' (1994) 12 *Company and Securities Law Journal* 341.

169 See, eg, Annabel Hepworth and Christine Lacy, '"Expert" Adler Defends Bonuses', *Australian Financial Review* (Sydney), 20 March 2002, 1.

170 See Commonwealth, *Parliamentary Debates,* Senate, 27 September 2001, 27 463, where the Democrats criticise the government for its ability to produce a border protection Act overnight, but having still failed to produce a Bill to recover such bonus payments, four months after the Prime Minister's original commitment.

171 For background to the proposed legislation, see Tony Walker and Chelsey Martin, 'Costello Targets Executive Excess', *Australian Financial Review* (Sydney), 23 September 2002, 3.

172 Pub L No 107-204, 116 Stat 745 (2002).

173 See, eg, Herbert Hovenkamp, 'Positivism in Law and Economics' (1990) 78 *Calgary Law Review* 815, 830, stating 'we assume that people are both rational and self-interested, and that when people are engaged in business, rational self-interest translates into dollars'.

paid according to their 'just deserts'.

Arguably however, these assumptions failed to take into account the broader corporate ecosystem, in which management's positional conflict can result in an ability to distort the indicia of performance-based pay. It seems that economics may have taken the wealth-maximising incentives of individuals seriously, but not seriously enough.

There is thus an inherent tension between the concept of positional conflict of interest and the underlying tenets of performance-based pay. Performance-based pay assumes that markets and appropriately designed remuneration contracts can constrain corporate managers, forcing them to act '*as if* they had the interests shareholders' interests at heart'.[174] Positional conflict of interest, on the other hand, assumes that management can control markets[175] and has the strategic power to prefer its own interests to those of shareholders.

There is currently a major reassessment of executive pay occurring in a number of countries. There is a trend towards greater finetuning of executive pay packages and greater involvement by shareholders. Yet the regulatory lesson of positional conflict is that, while these may be desirable developments, they are by no means fail-safe corporate governance mechanisms in relation to excessive remuneration.

174 Henry N Butler, 'The Contractual Theory of the Corporation' (1989) 11 *George Mason University Law Review* 99, 122.

175 See, eg, Mary Stokes, 'Company Law and Legal Theory' in William Twining (ed), *Legal Theory and Common Law* (1986) 155.