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Controlling Executive Compensation Through the Tax Code

Gregg D. Polsky

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Controlling Executive Compensation Through the Tax Code

Gregg D. Polsky*

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I. Introduction

The topic of executive compensation has received a great deal of recent attention from the news media, courts, and policymakers. Newspapers have reported on the seemingly exorbitant pay packages of chief executive officers (CEOs) of high profile companies.¹ Disney's severance arrangement with its former CEO Michael Ovitz has made its way through the Delaware court

1. See, e.g., Jenny Anderson, *Goldman Chairman Gets a Bonus of \$53.4 Million*, N.Y. TIMES, Dec. 20, 2006, at C2 (reporting the \$53.4 million year-end bonus paid by Goldman Sachs to Lloyd C. Blankfein); Eric Dash, *Compensation Experts Offer Ways to Help Curb Executive Salaries*, N.Y. TIMES, Dec. 30, 2006, at C1 (describing the phenomenon of "runaway executive pay" and noting that CEO compensation has increased more than 600% in the past twenty-five years after proper adjustment for inflation); Mark A. Stein, *Highly Paid Chief is Paid \$210 Million to Go Away*, N.Y. TIMES, Jan. 6, 2007, at C2 (discussing the \$210 million severance package paid by Home Depot to its former CEO Robert L. Nardelli).

system.² The Securities and Exchange Commission recently promulgated lengthy new regulations aimed at improving the transparency of certain executive pay components.³ With the intent to limit executive compensation, Congress is currently considering a bill that would impose tax penalties on deferred compensation amounts in excess of \$1,000,000.⁴ And President George W. Bush, in a recent speech on Wall Street, exhorted boards of directors to "step up to their responsibilities" and ensure that "salaries and bonuses of CEOs [are] based on their success at improving their companies and bringing value to their shareholders."⁵

The topic of executive compensation has also generated significant academic discussion. For instance, in their highly influential book *Pay Without Performance*,⁶ Professors Lucian Bebchuk and Jesse Fried argue that significant corporate governance failures have led to unduly generous executive pay packages and propose fundamental reform measures to resolve these failures.⁷ Their arguments and proposals stimulated a whole wealth of academic literature.⁸

Yet in all of this discussion, there has not been any significant discussion or analysis of Congress's heretofore most direct attempt to control executive compensation amounts. In 1993, during another period of intense criticism of executive pay packages, Congress enacted § 162(m) of the Internal Revenue Code, which generally disallows public companies a deduction for nonperformance-based compensation in excess of \$1,000,000 paid to the CEO and the next three highest paid executives. The purpose of this legislation was to enhance shareholder wealth in two ways: by reducing the overall level of executive compensation and by influencing the composition of executive compensation arrangements in favor of components that were more sensitive to firm performance.⁹

2. See *In re The Walt Disney Co. Derivative Lit.*, 906 A.2d 27, 50 (Del. 2006) (concluding that the company's board of directors complied with its fiduciary duties to shareholders in negotiating and approving Ovitz's \$130 million severance package).

3. 17 C.F.R. § 229.402 (2006).

4. The Small Business and Work Opportunity Act of 2007, S. 349, 110th Cong. (2007).

5. Jim Rutenberg, *Bush Tells Wall St. to Rethink Pay Practices*, N.Y. TIMES, Feb. 1, 2007, at C11.

6. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

7. See *id.* at 1–12 (providing an overview of corporate governance concerns).

8. See William W. Bratton, *The Academic Tournament over Executive Compensation*, 93 CAL. L. REV. 1557, 1559 (2005) (describing the "academic tournament" stimulated by Bebchuk & Fried).

9. See Robert M. Halperin, Young K. Kwon & Shelley C. Rhoades-Catanach, *The*

During this time of mounting criticism of executive compensation norms, there is political pressure on Congress to take further measures to intervene in the relationship between the corporation and its managers. One such measure is the \$1,000,000 limit on deferred compensation described above.¹⁰ Other similar proposals are pending.¹¹ Before taking these new measures, however, Congress ought to first reflect upon the effectiveness of § 162(m) in achieving its intended results.

The primary goal of this Article is to evaluate the efficacy of § 162(m). I consider the likely effect of § 162(m) under the two currently prevailing (but opposing) views of how executive compensation arrangements are negotiated in the public company context.¹² Under one view (the arm's length model), the corporation's board of directors negotiates effectively on behalf of shareholders in setting management compensation.¹³ Under the other view (the managerial power model), as a result of structural biases and other problems, the board is captured by management and is therefore willing to overpay management.¹⁴ Under the managerial power model, the only meaningful constraint on directors and management is the risk that relevant outsiders would perceive the compensation amounts as egregious.¹⁵ To mute this constraint, the board and

Impact of Deductibility Limits on Compensation Contracts: A Theoretical Examination, 23 J. AM. TAX. ASS'N 52, 52 (Supp. 2001) (noting these objectives of § 162(m)); John Graham & Yonghan Julia Wu, *Executive Compensation, Interlocked Compensation Committees and the 162(m) Cap on Tax Deductibility* 7 (Jan. 2007) (unpublished working paper, on file with the Washington and Lee Law Review), available at <http://ssrn.com/abstract=959686> ("The legislation was enacted in response to the perceived excessive top executive pay, and intended to promote broader application of performance-based compensation . . .").

10. See *supra* note 4 and accompanying text (describing a Congressional proposal to impose tax penalties on deferred compensation amounts in excess of \$1,000,000).

11. See, e.g., H.R. 1257, 110th Cong. (2007) (requiring that shareholders be allowed to vote on executive compensation arrangements); H.R. 3260, 110th Cong. (2007) (denying company deductions for executive compensation in excess of twenty-five multiplied by the salary of the company's lowest paid worker); S. 2, 110th Cong. (2007) (expanding the scope of employees whose pay is subject to § 162(m)).

12. This Article does not specifically address whether the twin goals of § 162(m) (i.e., reducing the level of executive pay and increasing the performance-sensitivity of such pay) are worthwhile legislative pursuits. As discussed in more detail below, under the arm's length model, § 162(m) is unnecessary to achieve optimal compensation arrangements. Under the managerial power model, pay is generally too high and too performance-insensitive; accordingly, under that model the goals of § 162(m) are beneficial. The question under the managerial power model is whether the goals of § 162(m) can realistically be achieved in light of how the provision actually operates.

13. See BEBCHUK & FRIED, *supra* note 6, at 17–20 (describing the arm's length model).

14. See *id.* at 61–80 (describing the managerial power model).

15. See *id.* at 65 ("Whether directors and managers will be deterred from adopting a given compensation arrangement depends on the extent to which it will be viewed by relevant

management collude to disguise and understate the true value of executive compensation, according to adherents of the managerial power model.¹⁶

Ultimately, this Article concludes that, under either model, § 162(m) is likely ineffective. Instead of increasing shareholder wealth by limiting executive compensation and aligning executive incentives, § 162(m) probably has the opposite effect of decreasing shareholder wealth. Under the managerial power model, this perverse result is possibly even more pronounced.

In addition to predicting the likely effect of § 162(m), this Article considers empirical studies of its actual impact since its enactment almost fifteen years ago. Most of the evidence is consistent with predictions under both models, while other evidence is more consistent with one or the other model under certain conditions.

Finally, the Article describes some unintended incidental effects of the provision. Section 162(m) discourages the use of certain compensation structures that are arguably more efficient, while favoring other flawed structures. It encourages the use of formulaic bonus arrangements, which themselves encourage accounting manipulation. Furthermore, the scope of § 162(m) is expanding through legislative inaction because the provision is not adjusted for inflation.

This Article proceeds as follows: Part II describes the historical treatment of executive compensation under the Code and then discusses the background behind, and the operation of, § 162(m). Part III discusses the agency problems inherent in the executive/firm relationship and the two competing models of how executive compensation arrangements are negotiated. Part IV predicts the likely effects of § 162(m) under each of the competing models. Part V then considers the results of empirical studies of § 162(m). Part VI describes some unintended incidental consequences of the provision. Part VII concludes.

II. Taxation of Executive Compensation

A. Historical Tax Treatment of Executive Compensation

The Code allows a deduction only for "reasonable" compensation paid to employees.¹⁷ While the text of the statute suggests that all compensation paid to an employee must be evaluated for its reasonableness, in practice this is not the case. In fact, the reasonableness factor is almost exclusively used by the

outsiders as unjustified or even abusive or egregious.").

16. *Id.* at 67–70.

17. I.R.C. § 162(a) (2000).

IRS to deny deductions for payments that are in substance gifts or dividends but are disguised as compensation.¹⁸

For example, if a doctor subject to a 40% marginal tax rate wanted to make a \$10,000 gift to her college-aged son, the doctor could overpay the son \$10,000 for work performed for her medical practice and attempt to deduct the amount. If this strategy were successful, the \$10,000 excess "salary" would save the doctor \$4,000 in taxes.¹⁹ If the son were in a taxable position,²⁰ the overpayment would increase the son's taxes;²¹ however, so long as the son's marginal tax rate was less than 40%, the family unit's aggregate tax liability is reduced at the expense of the fisc.²² The IRS would attack this strategy by arguing that the son's compensation was unreasonably high, which, if successful, would result in the denial of the doctor's deduction.

A similar tax avoidance strategy is sometimes used by closely held corporations where the principal shareholders are also the principal employees. If the shareholders/employees take cash out of the company through payment of dividends, the corporation gets no deduction for the dividends.²³ On the other hand, if the shareholders/employees take cash out of the company through payment of salaries and bonuses, the corporation is allowed a deduction for the compensation payments (provided that the corporation's characterizations of the payments are respected).²⁴ Recognizing this, the IRS attempts to protect the

18. See 1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS* ¶ 22.2.1 (3d ed. 1999) (noting that the IRS "almost never" uses the reasonableness condition to deny deductions for salary unless the risk of disguised gift or dividend is present).

19. The deduction would absorb \$10,000 of otherwise taxed income, which at the 40% marginal tax rate would have resulted in an increased tax liability of \$4,000. To keep the analysis of this hypothetical simple, I ignore the impact of federal employment taxes, which can, in certain circumstances, be a significant consideration.

20. The son might not be in a taxable position because he might not have income that exceeds the sum of his standard deduction, personal exemption, and other deductions (e.g., the deduction for higher education expenses in § 222). In addition, the son may have credits (such as the HOPE and Lifetime Learning credits for education expenses) that could absorb any remaining tax liability.

21. If the doctor had simply gifted the \$10,000, the son would not pay tax on the amount because I.R.C. § 102 excludes gifts from gross income.

22. For example, assume that the son is in the 15% marginal tax bracket. If the doctor simply gifted the \$10,000, the doctor would pay \$4,000 of tax on the \$10,000 because she receives no deduction. The son would not owe any tax because he has received a gift. If the overpayment strategy is successful, the doctor would owe no tax on the \$10,000 (because she receives a deduction which offsets the income) while the son would owe \$1,500 in additional tax (i.e., \$10,000 x 15%). If the overpayment strategy is successful, the family unit saves \$2,500 in taxes (i.e., \$4,000 - \$1,500).

23. I.R.C. § 311(a) (2000).

24. The benefits of bailing out corporate earnings through payments characterized as

tax base by ensuring that purported salary payments to shareholder/employees are not in substance disguised dividends, relying on the reasonableness factor to do the heavy lifting in this regard. A critical factor in the reasonableness analysis in the corporate context is therefore the degree of overlap between the employees and the shareholders.²⁵ If the corporation has four 25% shareholders who each perform similar services for the corporation, the risk of disguised dividends is very high. If, on the other hand, only one of the four shareholders is an employee of the corporation, the risk of disguised dividends is very low because the nonemployee shareholders would generally be unwilling to allow the one employee/shareholder to siphon off their share of some of the corporate earnings for his exclusive benefit.²⁶

In the public company context, concerns about disguised gifts or dividends are simply not present, and therefore there is no need for the IRS to scrutinize the level of executive compensation to protect the tax base. One could certainly argue that executive compensation is not set by an arm's length process and, therefore, that part of executive pay constitutes "rents" extracted by management as a result of this flawed process.²⁷ However, even these rents would generally constitute an ordinary and necessary expense that should be deductible by the corporation in arriving at corporate taxable income.²⁸ These rents are simply a cost of doing business as a public company where ownership and control are separate by virtue of administrative necessity.²⁹ Conceptually, therefore, compensation paid to executives of public companies ought to be deductible in full, even if part of the compensation can properly be characterized as rents.³⁰ This is consistent with the general practice of the IRS

compensation instead of dividends have been reduced by the tax rate cut on dividends enacted in 2003, see I.R.C. § 1(h)(11), which is scheduled to expire on December 31, 2010. Pub. L. No. 109-222, § 102, 119 Stat. 365 (2003). For analysis of this impact of the dividend tax rate cut, see Alan L. Feld, *Dividends Reconsidered*, 101 TAX NOTES 1117 (2003).

25. See PAUL R. MCDANIEL, MARTIN J. MCMAHON, JR. & DANIEL L. SIMMONS, *FEDERAL INCOME TAXATION OF CORPORATIONS* 228 (3d ed. 2006) (noting the importance of proportionality in this context).

26. This assumes that the four shareholders are unrelated. If the shareholders are related, then there is a risk that the transaction is a disguised dividend combined with a disguised gift (from the donor/shareholder who would be entitled to the dividend to the donee/employee who receives the "compensation").

27. See generally BEBCHUK & FRIED, *supra* note 6 (discussing the corporate governance concerns implicated by executive compensation arrangements).

28. See I.R.C. § 162(a).

29. Alternatively, one could characterize the rent extraction as theft by the executives. Since theft losses are deductible, Treas. Reg. § 1.165-1(d)(3) (1996), the payment of these rents by the corporation would still be deductible under this view.

30. Other considerations support this conclusion. It would be administratively quite

to scrutinize compensation arrangements for corporate executives only in the closely held context where there is a significant overlap between those individuals who work for the company and those individuals who own shares in the company.³¹

B. Enactment of § 162(m)

In 1993, in response to public outcry over the level and performance-insensitivity of executive pay, Congress added § 162(m) to the Code.³² While this provision was sometimes justified by its proponents as denying a "subsidy" for excessive executive pay, most proponents properly characterized it as a penalty for what they considered the illegitimate compensation practices of public companies.³³ Section 162(m) was intended both to reduce the overall level of executive compensation and to make such compensation more sensitive to firm performance.³⁴

It is clear that § 162(m) is not grounded in tax policy considerations; as noted above, executive compensation ought to be deductible in full regardless of whether some portion constitutes rents.³⁵ Rather, the provision is simply a penalty that is administered through the tax code.³⁶

difficult to distinguish between the compensation versus rent portions of an executive's remuneration. In addition, depending on the incidence of the corporate tax, denying the deduction for the rent portion might only add to the agency cost borne by shareholders: The shareholders first overpay for executive services and then they may incur the brunt of the extra corporate tax attributable to denying the deduction for such overpayment.

31. See 1 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS* ¶ 22.2.2 (3d ed. 1999) (noting that "[v]irtually all reasonable compensation cases involve family corporations or other closely held enterprises").

32. See Ryan Miske, Note, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1686 (2004) (noting that § 162(m) was enacted "after the populist outrage over executive compensation reached a high during the 1992 presidential race").

33. Allowing a corporate deduction for executive compensation, even where part of the pay consists of rents, is not a subsidy. As noted above, even the rent portion of the compensation ought to be deductible in arriving at corporate taxable income because the rents are a cost of doing business. See *supra* notes 29–30 and accompanying text. As a result, disallowing the deduction is not properly characterized as the withdrawal of a subsidy; instead, disallowing the deduction is best viewed as the imposition of a penalty.

34. *Supra* note 9 and accompanying text.

35. *Supra* notes 29–30 and accompanying text.

36. Section 162(m) and similar provisions (e.g., § 280G (denying deductions for excessive golden parachute payments) and § 162(l) (denying deductions for fines paid)) are thus analogous to the whole host of tax expenditures, provisions in the Code which are designed to subsidize favored activities. The classic example of a tax expenditure might be the home

In general, § 162(m) disallows a deduction for certain compensation ("nonqualified" compensation) in excess of \$1,000,000 paid by public companies to its CEO and next three highest paid executives. The \$1,000,000 limit is applied annually.³⁷ For purposes of § 162(m), qualified compensation is not subject to the \$1,000,000 limit.³⁸ Qualified compensation is remuneration that is paid pursuant to a plan that (i) provides for payments based on objective performance goals, (ii) is approved by an independent compensation committee of the board, and (iii) is approved by a majority of the shareholders after disclosure of the material terms of the compensation arrangement.³⁹ With respect to stock options and stock appreciation rights,⁴⁰ they are generally considered qualified compensation if they are not "in-the-money"⁴¹ at the time of grant, provided that the independent director and

mortgage interest deduction, which allows a deduction for an otherwise nondeductible expense in order to subsidize the activity of borrowing to purchase owner-occupied housing. "Negative" tax expenditures, like § 162(m), are designed to penalize disfavored behavior.

37. I.R.C. § 162(m)(1) (2000). Technically, the statute applies to compensation earned by the CEO and any other employee whose compensation "is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the 4 highest compensated officers for the taxable year (other than the chief executive officer)". I.R.C. § 162(m)(3) (emphasis added). Because the SEC's recently issued rules relating to executive compensation now require the reporting of compensation earned by the CEO, the CFO, and the next three highest compensated executives, the IRS has indicated that it will interpret § 162(m)(3) to apply only to compensation earned by the CEO and the next *three* highest compensated executives. See U.S. DEP'T OF THE TREASURY, INTERNAL REVENUE SERVICE BULLETIN, NOTICE 2007-49 (2007), available at http://www.irs.gov/irb/2007-25_irb/ar12.html ("The IRS will interpret the term 'covered employee' for purposes of § 162(m) to mean any employee [whose total compensation] is required to be reported to shareholders under the Exchange Act by reason of such employee being among the 3 highest compensated officers . . .").

38. I.R.C. § 162(m)(4)(C).

39. *Id.*

40. A stock option is the right to purchase a share of stock at a specified "exercise price" (usually the fair market value on the date of grant) during a specified period of time (usually ten years from grant). A stock appreciation right (SAR) gives the holder the right to a payment measured by the difference between the fair market value of the stock on the date of exercise and a specified price (usually the fair market value of the stock on the date of grant). SARs usually have a term of ten years. Because employees usually sell the stock received immediately upon option exercise, stock options and SARs are functionally equivalent from the standpoint of the employee. From the employer's perspective, SARs (unlike stock options) do not dilute the number of shares outstanding. Both stock options and SARs usually vest over time, meaning that they become exercisable only after a specified period of employment with the firm.

41. An option is not in-the-money if the exercise price is equal to or greater than the fair market value of the underlying stock at the time of grant.

shareholder approval requirements are met with respect to the plan under which the options or rights are granted.⁴²

Prior to the enactment of § 162(m), executive bonuses were generally paid at the discretion of the board of directors. In order for bonus arrangements to qualify under § 162(m), they must be objectively determinable.⁴³ However, the regulations provide that boards may retain "negative discretion"—i.e., the ability to reduce bonus amounts that are derived from objective formulas—without impairing the qualified status of the bonus plan.⁴⁴

Under current compensation practices, the most common types of nonqualified compensation that trigger § 162(m) are salaries and discretionary bonuses.⁴⁵ Amounts paid under objective bonus plans (either with or without negative discretion of the board) and stock option grants are the most common types of qualified compensation.⁴⁶

III. Two Models of Executive Compensation

This Part will describe the two competing (though not wholly contradictory) views of how executive compensation is negotiated.⁴⁷ Under

42. With respect to the stock option plan, shareholders need only approve the total number of options subject to the plan, the maximum number of options that an employee may receive under the plan, and the terms of the options.

43. See Treas. Reg. § 1.162-27(e)(2)(ii) (1996) ("A formula or standard is objective if a third party having knowledge of the relevant performance results could calculate the amount to be paid to the employee. In addition, a formula or standard must specify the individual employees or class of employees to which it applies.").

44. Treas. Reg. § 1.162-27(e)(2)(iii)(A).

45. See Nancy L. Rose & Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation*, 20 J. LAB. ECON. 138, 141 (2002) (discussing the effects of § 162(m) on executive compensation).

46. See *id.* (discussing qualified performance-based compensation).

47. See Bebchuk and Fried, in an article co-authored with David Walker, describe the relationship between the two models as follows:

Although the managerial power approach is conceptually quite different from the [arm's length] approach, the former is not proposed as a complete replacement for the latter. One can take the view that compensation arrangements are shaped both by managerial power and by what would be optimal. The managerial power approach merely implies that compensation practices cannot be adequately explained by optimal contracting alone. Rather, practices might be adopted that deviate significantly from those suggested by optimal contracting. Under the managerial power approach, compensation practices can be fully understood only with careful attention to the role of managerial power.

Lucian A. Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 755 (2002).

one view, executives negotiate their pay with a board of directors that strives to get the best deal possible for shareholders, thereby maximizing firm value.⁴⁸ Under the other, executives negotiate with a compliant board of directors that is willing to overpay management as long as it will not raise red flags to relevant outsiders.⁴⁹ Before describing these two models in more detail, the agency problems inherent in the executive-firm relationship are discussed.

A. Agency Costs

In any employment relationship, there exist conflicts of interest between the parties. The most significant is usually the problem of shirking.⁵⁰ All else (e.g., pay) being equal, employees would generally desire to give less effort, to the detriment of the employer. If this problem is significant, the employer could (ex ante) negotiate for some or all of the employee's pay to be based on some performance metric, thus increasing the alignment of the employer and employee's interests.⁵¹ The employee would presumably require a higher amount of total compensation with this new compensation mix because: (i) the adjusted compensation mix no longer allows the employee to impose the full cost of shirking on the employer and (ii) the adjustment to the compensation arrangement will often shift risk from the employer to the employee, who is generally more risk-averse than the employer.⁵²

48. See BEBCHUK & FRIED, *supra* note 6, at 17–20 (describing the arm's length model). Negotiating the best deal for shareholders does not necessarily mean obtaining the executive's services for the cheapest price. It may mean negotiating compensation structures that help to align the executive's interests with the shareholders' interests. See *id.* at 19 (suggesting one way to align such interests is to base the CEO's compensation in part on increasing shareholder value).

49. See *id.* at 61–79 (describing the managerial power model).

50. See Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1620–23 (2005) (describing the problem of shirking by employees).

51. See *id.* (discussing solutions for the problem of shirking).

52. See *id.* If the employee could perfectly and costlessly hedge this additional risk by, for example, purchasing a financial derivative, then this factor would be negated. In the public company executive context, there are significant contractual, securities law, and tax law constraints that either prohibit hedging strategies or make them unduly costly to implement. See David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 459–93 (2000) (describing the existing contractual, securities law, and tax barriers to hedging); see also Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP., 49, 55 (2003) ("Press accounts sometimes claim that executives can effectively hedge or unwind the risk of their options through financial transactions (involving derivatives) with investment banks. But we know of no evidence showing that this practice is widespread, and our many conversations with knowledgeable practitioners suggest that this practice is quite rare."). As a result, this Article ignores the

For example, assume that MGM is negotiating with Tom Cruise to star in an upcoming movie and that MGM would be willing to pay Cruise \$20,000,000 cash. Also assume that Cruise would be willing to accept \$20,000,000 cash. However, MGM is concerned that, if it were to pay only cash, Cruise would give less than optimal effort in making and promoting the movie. If MGM instead offers Cruise nontransferable royalty rights in the movie that have an objective ex ante fair market value of \$20,000,000, he would likely value those rights as worth less than \$20,000,000 cash because he could no longer shirk at the sole expense of MGM and because the cash is for the most part risk-free,⁵³ while the royalty rights may ultimately turn out to be worth much less than \$20,000,000.⁵⁴ By making Cruise effectively a partner in producing the movie, risk is shifted from MGM (a more efficient risk-bearer) to Cruise (a less efficient risk-bearer).⁵⁵ As a result, we might expect to see the parties strike a bargain where some amount of compensation is cash and some is performance-based and where the total expected value of the compensation exceeds \$20,000,000. Such an arrangement would maximize the expected value to the parties after taking into account the possibility of shirking and their respective preferences regarding risk.

In an arm's length arrangement (such as the MGM/Cruise contract), we would expect that the parties would reach the optimal mix of performance and nonperformance based compensation. As a result, lawmakers do not have much interest in regulating the MGM/Cruise compensation arrangement, a deal struck between two sophisticated parties,

possibility of executive hedging.

53. Of course, if the cash payment is deferred until after Cruise performs, Cruise is subject to the risk that MGM will become bankrupt or insolvent before he is paid. Even if Cruise is paid simultaneously with or before performance, Cruise will risk incurring opportunity costs if MGM goes bankrupt between the time he agrees to do the movie and the time he realizes that MGM will not fully perform under the agreement (because Cruise could not agree to appear in any other movies during the time he is required to work on MGM's). If MGM is quite solvent, these risks are insignificant.

54. The royalty rights could also turn out to be worth much more than \$20,000,000.

55. MGM is more efficient at bearing risk for a variety of reasons. First, MGM makes more movies than Cruise; therefore, its investment in the particular movie is more diversified than Cruise's. Second, MGM's owners (i.e., the owners of Disney) are themselves able to diversify by making investments in other companies. Cruise, meanwhile, has a relatively large, undiversified investment in the movie. He will devote substantial time and effort in making the movie, and the movie may have a significant impact on his reputation and future income-producing capacity.

even though some might think that Cruise is grossly overpaid.⁵⁶ Policy makers are content to let the market work.⁵⁷

In the senior executive/firm context, another significant agency problem involves the willingness of corporate policy-makers to cause the firm to take on additional risk.⁵⁸ Managers are typically more risk-averse than shareholders of the firm with respect to firm-specific risk because managers make an undiversified investment of human capital in the firm. If the firm does very poorly, managers will lose their job and status, and their reputation and future income-producing capacity could be adversely affected. Meanwhile, shareholders can readily diversify their firm-specific risk by investing in other firms; they are therefore much less risk-averse than managers.⁵⁹ As a result, managers might choose projects that entail a level of risk that is sub-optimal from the shareholders' perspective. In addition, managers might choose to finance projects using equity or existing cash instead of debt even though debt-financing (which is more risky than equity-financing)⁶⁰ might best increase firm value.

Like the problem of shirking, risk-based agency costs can, in theory, be ameliorated by substituting performance-based compensation for cash. If an executive is paid only cash, she will get the amount of cash she is due, no matter how well the firm performs, so long as it does not become insolvent. In this regard, the executive is akin to an unsecured creditor, which is subject only to insolvency risk but does not participate in corporate growth to any extent. By giving the executive performance-based compensation, the executive now does participate in corporate growth.⁶¹ As a result, the executive is more likely to promote a corporate policy of optimal risk-taking.

56. Of course, policymakers might be concerned about redistributing wealth. Historically, such redistributive efforts in the United States have focused on relative amounts of wealth (or income) and not on their source (e.g., entrepreneurial efforts, investment returns, inheritance, luck, or a favorable employment contract).

57. In the senior executive/firm context, it may be questioned whether shirking in fact is a significant problem. Do CEOs respond to performance-sensitive pay with increased effort? And, if so, do increases in CEO effort at the margin translate into increased firm performance after taking into account the additional compensation required by the CEO to offset the additional risk incurred by her in accepting performance-sensitive pay in lieu of cash? For discussion of these issues, see Bainbridge, *supra* note 50, at 1632–35.

58. *See id.* at 1621.

59. *See* Melvin A. Eisenberg & Brett H. McDonnell, *Expectation Damages and the Theory of Overreliance*, 54 HASTINGS L.J. 1335, 1366 n.36 (2003).

60. Debt-financing increases the leverage of the firm, which increases the reward to shareholders if the company is profitable enough to service the debt. On the flip side, increasing leverage increases the risk of firm insolvency or bankruptcy.

61. As noted above, this Article ignores the prospect of executive hedging strategies due

Certain performance-based structures are better than others in ameliorating the risk-based agency costs. For example, options are quite beneficial in this regard. As noted above, executives are more risk-averse than shareholders because of their large and undiversified human capital investment in the firm. Option-holders, on the other hand, are more risk-preferring because, while they participate in share increases above the exercise price, they do not suffer from share decreases below the exercise price (no matter how great).⁶² As a result, compensatory options should, in theory, counteract the effect of executive risk-averseness. On the other hand, formulaic-based bonus arrangements may not be as useful in ameliorating the risk-based agency costs. Researchers have found that these bonus arrangements typically "result in a greater penalty for extreme negative performance and a smaller reward for extreme positive performance."⁶³ Thus, these arrangements will not be as helpful in counteracting executive risk-averseness.

In summary, while shirking and risk-based agency costs push at the margin in favor of greater performance-based compensation relative to cash compensation, the executive's risk-averseness pushes in the other direction. As such, determining the optimal level of performance-based compensation relative to salary is a difficult task.

B. The Arm's Length Model

Under the arm's length model, the board of directors negotiates, on behalf of shareholders, just as effectively as the parties in the hypothetical MGM/Cruise arrangement. Under this model, the market will take into account the competing factors, ultimately resulting in the optimal overall level of executive compensation as well as the optimal mix of performance-based compensation and salary.⁶⁴

to legal constraints that make them difficult or impossible to implement. *See supra* note 52.

62. Option holders are more risk-preferring than stockholders because, while option holders participate in corporate growth above the exercise price just like shareholders, they (unlike shareholders) do not suffer from reductions in stock price below the exercise price. Thus, compensatory options may balance out to some extent the impact of executive risk-averseness.

63. Austin Reitenga et al., *CEO Bonus Pay, Tax Policy, and Earnings Management*, 24 J. AM. TAX. ASS'N 1, 2 (Supp. 2002). This results from the fact that most objective bonus arrangements use a formula whereby the bonus is based on results within 80% to 120% of the targeted performance. As a result, performance above 120% does not increase the bonus payment, while performance below 80% results in no bonus.

64. In light of the cozy relationship between boards and management, the arm's length model might appear naive. However, it must be remembered that the market should in theory

C. The Managerial Power Model

On the other side of the spectrum is the managerial power model, which is based on the assumption that primarily because of structural bias, directors do not bargain at arm's length with managers.⁶⁵ As a result, the model suggests that executive compensation structures are more generous and less performance-sensitive than those that would be the product of arm's length bargaining. The structural bias results primarily from the fact that directors are often, as a de facto matter, appointed by management.⁶⁶ In addition, because management and directors work closely together and often run in the same social circles, it is argued that directors do not negotiate as hard as they would with truly adverse parties.⁶⁷ Finally, because directors are part-time independent contractors, they are unwilling to devote the time necessary to effectively negotiate and design executive compensation structures, according to adherents of the managerial power model.⁶⁸

Under the managerial power model, the only significant constraint to excessive management compensation is the risk of outrage "shared by those outsiders whose views matter most to [the directors and executives]."⁶⁹ Adherents of the managerial power view argue that, to ameliorate this risk, directors and management devote considerable energy in devising ways to camouflage the real value of executive compensation arrangements.⁷⁰

react adversely to poorly structured or overgenerous executive compensation structures. As a result, all else being equal, capital should flow into firms with "good" compensation arrangements and away from ones with "bad" compensation arrangements, resulting in corresponding changes to market price of firms. Such a market reaction would act as a check in keeping the parties honest in negotiating executive pay. Whether this in fact occurs has been the subject of vigorous debate. Compare Bainbridge, *supra* note 50, at 1635–37 (arguing that the absence of contractual constraints on managerial power in the IPO context "is an important—an unanswered—strike against the managerial power model"), with BEBCHUK & FRIED, *supra* note 6, at 53–58 (arguing that while the market does exert influence, this influence does not prevent results that depart from those obtained through arm's length bargaining).

65. See BEBCHUK & FRIED, *supra* note 6, at 61–65 (describing the managerial power model).

66. See *id.* at 25 (arguing that while a desire to be reelected should encourage directors to be attentive to shareholder needs, the reality is that the director slate proposed by company managers is almost never challenged).

67. See *id.* at 31–34.

68. See *id.* at 36–37.

69. See *id.* at 66.

70. See *id.* at 67 ("The main costs to directors and managers of adopting compensation arrangements that favor managers, then, depend mainly not on how costly the arrangements actually are to shareholders, but on how costly the arrangements are *perceived* to be by important outsiders.").

IV. Effect of Section § 162(m) Under Each Model

A. Arm's Length Model

Under this model, the amount and mix of compensation would generally⁷¹ be optimal without any intervention by policymakers. In the absence of § 162(m), the parties would take into account the competing issues of (i) shirking and risk-based agency costs and (ii) manager risk-averseness, and they would arrive at the optimal (i.e., shareholder-wealth maximizing) compensation arrangement. The agency costs push in favor of performance-based compensation, which shifts additional firm specific risk to the manager. Because of the manager's risk-averseness, the manager will demand a higher market value of performance-based compensation vis-à-vis cash.⁷² Under the arm's length model, these factors would ultimately result in an equilibrium, with some mix of incentive (risky) compensation and cash compensation to maximize firm value.

Section 162(m), which presumably was based on Congress's perception that the arm's length model is not accurate, upsets this balance. The provision pushes in favor of riskier incentive compensation by making salary (and other nonqualified compensation) more expensive once the \$1,000,000 threshold is reached.⁷³ At the margin, this creates a wedge between the type of compensation that executives prefer to receive and the type of compensation that the firm is willing to pay. How the burden of this wedge is borne is a function of the parties' bargain. If the result is that the executive simply accepts the riskier compensation without any adjustment in the market value of the compensation, then the executive has borne it by taking on more risk than he or she would like without any compensation. If the result is that the firm pays the executive a higher market value of riskier compensation to compensate the executive in full for taking on the extra undesired risk, then the firm has borne the burden of the § 162(m) wedge. Finally, the parties could share the

71. As described below, under the implicit contracting costs theory, the arm's length model could result in underpayment of management. This theory suggests that intense public scrutiny of management compensation precludes public companies from designing efficient compensation arrangements. See *infra* notes 116–18 and accompanying text (describing the implicit contracting costs theory).

72. Due to significant legal constraints on potential executive hedging strategies, this Article assumes that they will not be implemented. See *supra* note 52 and accompanying text.

73. The amount of the increase in the cost of nonqualified compensation above \$1,000,000 is a function of the corporation's marginal tax rate. If t is the marginal tax rate of the company, denying the deduction will increase the after-tax cost of nonqualified compensation in excess of \$1,000,000 (the excess compensation) by an amount equal to the product of (i) the amount of the excess compensation and (ii) the ratio of $t/(1 - t)$.

burden of § 162(m). In that case, the executive would receive a higher market value of compensation than he or she would have received in the absence of § 162(m), but the higher value is insufficient to offset fully the burden of taking on the additional risk. The effects of § 162(m) under the arm's length model are considered in more detail below.

1. Avoidance

If it were costless to avoid § 162(m) by, for example, disguising cash compensation as performance-based, we would expect arm's length parties to do exactly that. This would allow the parties to avoid the § 162(m) wedge and to retain, in substance, an optimal compensation design without losing deductions under § 162(m).

In fact, there are two possible circumvention strategies, though they are not entirely costless. First, companies may require the executive to defer receipt of any nonperformance-based compensation in excess of \$1,000,000 until she retires from the company.⁷⁴ Because § 162(m) only applies to compensation received by current employees,⁷⁵ the entire amount paid would be deductible by the employer at the time of payment. The costs of implementing this deferral strategy stem primarily from the fact that, because the excess compensation is retained by the company (instead of being paid out to the executive currently), the executive places the excess compensation at the risk of the company's insolvency or bankruptcy.⁷⁶ In addition, the executive loses liquidity because she currently cannot spend the excess compensation, but

74. Upon retirement, the company will pay the executive the amount deferred plus a specified investment return thereon. The investment return is necessary to account for the time-value of money. Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation*, 85 N.C. L. REV. 571, 576 (2007).

75. I.R.C. § 162(m)(3) (2000) (stating that covered employees include only those who are employees of the company as of the close of the taxable year). A similar deferral strategy would be for the executive to defer receipt of the compensation until the time when the covered employee's nonqualified compensation falls below the \$1,000,000 threshold. Recently enacted § 409A would now impose potentially significant tax costs on this strategy. See I.R.C. § 409A(a)(1) & (2) (requiring immediate income realization for deferred compensation arrangement that allow for contingent distributions that are not triggered by the employee's separation from service, disability, death, change in the ownership of the employer, or the occurrence of an unforeseeable emergency).

76. In order for the deferral to be effective for federal income tax purposes, the amounts deferred must remain subject to the claims of the employer's creditors. See Treas. Reg. § 1.83-3(e) (1996); Gregg D. Polsky & Brant J. Hellwig, *Taxing the Promise to Pay*, 89 MINN. L. REV. 1092, 1139 (2005). Had the executive been paid the cash currently, the executive's compensation would no longer be subject to the risk of employer bankruptcy or insolvency.

this is not likely a significant cost because one would expect that executives whose pay is subject to § 162(m) (i.e., senior executives with annual nonqualified compensation in excess of \$1,000,000) would ordinarily be sufficiently wealthy and/or credit-worthy to mitigate substantially any liquidity problems.⁷⁷

Second, the parties could disguise fixed compensation as performance-based by using easy to reach objective bonus targets. The regulations promulgated under § 162(m) explain that a "performance goal need not . . . be based on an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses."⁷⁸ However, at the time that the bonus arrangement is structured, the outcome must be "substantially uncertain."⁷⁹ Two examples in the regulations apply this substantially uncertain condition. In one example a bonus based on a percentage of *profits* is sufficient, while in the other example a bonus based on a percentage of *sales* is not.⁸⁰ The regulations explain this result by noting that, while a company is "virtually certain" to have some sales during the year,⁸¹ "it is substantially uncertain whether a company will have profits for a specified future period even if the company has a history of profitability."⁸² In another example, a bonus payable on the favorable settlement of litigation fails the "substantially uncertain" factor where the bonus arrangement was established after the other side has already "informally indicated . . . [its] willingness to settle the litigation [favorably]."⁸³ These highly stylized examples are not very helpful in giving taxpayers guidance regarding the application of the substantially uncertain condition.

77. While the corporation's deduction is deferred, this will not increase the corporation's after-tax compensation costs provided that the executive's deferred compensation account grows by an after-tax rate of return. See Yale & Polsky, *supra* note 74, at 625. Accordingly, putting aside the risk of firm insolvency and the burden of executive illiquidity, a properly structured deferral arrangement can avoid the impact of § 162(m), while remaining economically consistent with the original arrangement (i.e., current cash compensation) of the parties.

78. Treas. Reg. § 1.162-27(e)(2)(i) (1996). Note that this rule is conceptually inconsistent with the regulations' treatment of stock options, which must have an exercise price equal to or above the fair market value of the underlying stock at the time of grant in order to qualify as performance-based. Treas. Reg. § 1.162-27(e)(2)(vi)(A). For further discussion of the treatment of stock options under § 162(m), see *infra* notes 89–90 and accompanying text, and Part V.A.

79. Treas. Reg. § 1.162-27(e)(2)(i).

80. Treas. Reg. § 1.162-27(e)(2)(vii), ex. 2 & 3.

81. Treas. Reg. § 1.162-27(e)(2), ex. 2.

82. Treas. Reg. § 1.162-27(e)(2), ex. 3.

83. Treas. Reg. § 1.162-27(e)(2), ex. 4.

Because of the vagueness of this condition, the easy-to-reach bonus circumvention strategy creates the risk that the IRS and the company will disagree as to how it will be construed, which could result in litigation and increased tax liability.⁸⁴ As the likelihood of the bonus payment approaches certainty, this litigation risk increases. On the other hand, as the likelihood of payment becomes less certain, more risk is imposed on the risk-averse executive, undermining the effectiveness of this avoidance strategy. Another significant problem with the strategy is that the material terms of bonus arrangements, including performance goals, must be disclosed to and approved by shareholders in order to qualify under § 162(m).⁸⁵ Even if it makes sense for the firm to set bonus targets extremely low so as to minimize its after-tax compensation costs, as a public relations matter it may be difficult for the firm to justify bonus standards that are obviously easy to reach.⁸⁶

84. These risks are exacerbated by administrative law doctrine regarding the appropriate level of judicial deference afforded an agency's interpretation of its own regulations. Under the so-called *Seminole Rock* doctrine, an agency's interpretation of its own regulations will ordinarily be upheld unless it is "plainly erroneous or inconsistent with the regulation." *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945). See also *Auer v. Robbins*, 519 U.S. 452, 461 (1997) (upholding interpretation and citing *Seminole Rock*). Because of this deference, a taxpayer could expect that any reasonable interpretation of the "substantially uncertain" factor would be upheld.

85. See I.R.C. § 162(m)(4)(C)(ii) (2000). Treasury regulations provide "[t]he material terms include the employees eligible to receive compensation; a description of the business criteria on which the performance goal is based; and either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to the employee . . . if the performance goal is attained" *Treas. Reg. § 1.162-27(e)(4)(i)* (1996). The regulations go on to provide, however, that (i) "[d]isclosure of the business criteria on which the performance goal is based need not include the specific targets that must be satisfied under the performance goal," *Treas. Reg. § 1.162-27(e)(4)(iii)(A)*, and (ii) a material term need not be disclosed if "the compensation committee determines that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the [company]," *Treas. Reg. § 1.162-27(e)(4)(iii)(B)*. It has been argued that the current § 162(m) disclosure standards are ineffective in ensuring that shareholders have the requisite information necessary to evaluate bonus arrangements. See *Effectiveness of § 162(m) in Controlling Executive Pay: Hearing Before the S. Finance Comm.*, 109th Cong. D914 (2006) [hereinafter *Effectiveness*] (testimony of Steven Balsam, Professor of Accounting, Temple University) (testifying that current disclosures "lack specificity with regard to actual plan parameters, targets, thresholds, etc." and suggesting that disclosure of this information would "increase the link between pay and performance as directors and executives would be less likely to set low standards").

86. As discussed above, it is not entirely clear that the current disclosure standards in the Treasury regulations would make extremely easy-to-reach bonus arrangements obvious to shareholders. See *supra* note 85. To the extent that the laxity of an easy-to-reach bonus arrangement can be hidden from shareholders, the only constraint on using this circumvention strategy is audit risk.

The most feasible circumvention strategy, therefore, appears to be the one of mandatory deferral. To the extent that § 162(m) is circumvented in this manner, the provision does nothing except to impose additional transaction costs on the parties because of the insolvency risk and illiquidity burden placed upon the executive. To what extent these burdens are shifted to the company in the form of higher compensation is a function of the relative elasticity of the supply of, and demand for, individuals capable of managing public companies. Research using the arm's length model suggests that at a minimum, a portion of these burdens would be shifted to the company.⁸⁷

2. Substitution Effect

a. Substituting Incentive Compensation for Cash

If avoidance is costly, we might expect to see a substitution effect whereby the parties substitute deductible incentive compensation for nondeductible cash compensation. In general, stock options or formulaic bonus arrangements could be substituted for cash compensation. There are two advantages of using stock options as compared to formulaic bonuses. First, implementation costs are reduced because there is no need to negotiate any complex formulas, to explain these formulas to executives, board members, or investors, or to make calculations to determine payouts. Second, there is likely less of an incentive to manipulate accounting results because options—unlike formulaic bonuses—are not based on specific accounting results (e.g., return on equity) that relate to specific accounting periods (e.g., the current fiscal year).⁸⁸

On the other hand, there may be advantages to using formulaic bonuses instead of stock options. Stock options that qualify under § 162(m) are of the "one size fits all" variety. In order to qualify as performance-based under the

87. Cf. Halperin et al., *supra* note 9, at 63 (predicting that, as a result of the enactment § 162(m), firm profitability would decline in part because compensation expense would increase to offset the additional risk placed upon the executive when incentive compensation is substituted for cash compensation).

88. See Reitenga et al., *supra* note 63, at 1–23 (finding that firms with formulaic § 162(m)-qualified bonus plans engaged in greater income-smoothing behavior than firms without such plans); see also Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 739 (1995) (predicting that § 162(m) "will encourage compensation committees to rely heavily on explicit accounting-based bonuses, which, in turn, will encourage executives to focus on and manipulate short-term earnings at the expense of long-term value creation"). This is not to say that the issuance of stock options does not create incentives to manipulate. The point is that formulaic bonuses, because they are based wholly on specific accounting results, likely create stronger incentives.

§ 162(m) regulations, stock options cannot ever have a strike price below the underlying stock's fair market value on the date of grant.⁸⁹ Indexed options—ones whose strike price fluctuates with a benchmark such as the Dow Jones Industrial Average—are therefore not qualified under § 162(m) because if the benchmark depreciates in value, the original strike price would be reduced.⁹⁰ Accordingly, fixed at-the-money options are universally used.

As a result, while options cannot be structured to account for market-wide or industry-wide impacts, formulaic bonus arrangements can be designed to account for such impacts.⁹¹ Similarly, formulaic bonuses can be structured so as to be based primarily on factors that are under the control of the executive. For example, if an executive has more control over the costs of a business as compared to its revenues, bonuses could be based strictly on bringing down costs. Finally, formulaic bonuses offer greater flexibility with respect to the amount of risk foisted upon the executive. Because executives are risk-averse, this gives the parties the opportunity to reduce the size of the burden created by § 162(m).

If the executive were not risk-averse, substitution into either options or formulaic bonuses could be accomplished without increasing the cost of the executive's compensation. For example, assume that in the absence of § 162(m), the parties would have agreed to a fixed salary of \$1,500,000.⁹² After the enactment of § 162(m), the parties could agree to a fixed salary of \$1,000,000 and a \$1,000,000 performance-based bonus with a 50% likelihood of payment in full and a 50% likelihood of no payment whatsoever. If the executive were risk neutral, this arrangement has the same ex ante value to the executive as the all-cash arrangement, and the company would not lose any

89. See Treas. Reg. § 1.162-27(e)(2)(vi)(A) (1996).

90. See *id.* (providing that, in order for compensation attributable to a stock option or stock appreciation right to qualify under § 162(m), it must be based solely on an increase in the value of the stock after the date of grant or award). See also David M. Schizer, *Reducing the Tax Costs of Indexed Options*, 96 TAX NOTES 1375, 1377–80 (2002) (suggesting that an argument can be made that indexed options qualify under the regulations, but ultimately concluding that tax counsel would not give a favorable opinion on the issue without the IRS issuing a private letter ruling or amending the regulation).

91. For example, bonuses could be based on the performance of the firm relative to other similar firms.

92. Under the arm's length model, it is assumed that this \$1,500,000 fixed salary structure is optimal. Thus, it is assumed either that (i) there is no need for any performance-based component (because, for example, the risk of shirking is extremely low) or (ii) the marginal cost of using this riskier component outweighs its incremental benefit. Though this assumption may be unrealistic in certain circumstances, it keeps the example simple and does not change the ultimate conclusion that substitution under the arm's length model invariably imposes an additional cost on the parties.

deductions under § 162(m).⁹³ However, as previously discussed, corporate executives are risk-averse.⁹⁴ As a result, substitution will result in an extra cost to the parties and the allocation of that cost between the two parties will be a function of their bargain.

For example, assume that the executive, due to her risk-averseness, would be indifferent between choosing \$500,000 of risk-free compensation and \$1,500,000 of potential bonuses which she has a fifty percent chance of earning.⁹⁵ If, because of § 162(m), the parties agree to a \$1,000,000 salary plus \$1,500,000 bonus structure (rather than \$1,500,000 of salary), then the executive is made whole because she is fully grossed up to account for the additional risk, and the corporation bears the entire brunt of the § 162(m) wedge.⁹⁶ If, instead, the parties agree to a \$1,000,000 salary plus \$1,000,000 bonus structure, then the executive bears the entire burden of the § 162(m) wedge because she has received no gross up for the additional risk. If the parties agree to a bonus amount between \$1,000,000 and \$1,500,000, then the parties will have shared the burden of the § 162(m) wedge through a partial gross up.

While the statutory (i.e., nominal) incidence of § 162(m) falls on the firm because the provision denies the deduction for "excess" compensation—increasing the firm's labor costs—the economic incidence depends on the relative elasticities of the supply of and the demand for individuals capable of leading public companies. The literature suggests that, under an arm's length model, at least some of the burden of the § 162(m) wedge will be borne by the firm.⁹⁷ If so, the result is that, under the arm's length model, to the extent § 162(m) results in substitution, the provision decreases firm value and

93. The two arrangements have the same ex ante market value because the expected value of the bonus is \$500,000, the same amount as the excess salary in the all-salary arrangement.

94. See *supra* note 59 and accompanying text.

95. The bonus portion has an expected value of \$750,000. Accordingly, a risk-neutral individual would choose the bonus so long as the cash compensation option was less than \$750,000.

96. Note, however, that the corporation is still better off than had it paid \$1,500,000 of salary because the after-tax cost of the extra nondeductible \$500,000 salary is higher than the after-tax cost of the deductible incentive compensation with an expected cost of \$750,000, assuming that the corporation's marginal tax rate is in excess of 33.3%.

97. See Halperin et al., *supra* note 9, at 52–65 (predicting that, as a result of § 162(m), firm profitability would decline in part because compensation expense would increase to offset the additional risk placed upon the executive when incentive compensation is substituted for cash compensation); Murphy, *supra* note 88, at 739 ("Executives shifting from salaries to performance-based compensation will demand a premium for bearing more risk, resulting in higher pay levels.").

increases executive wealth.⁹⁸ As discussed below, these perverse effects are likely even more pronounced under the managerial power model.⁹⁹

b. Substituting Formulaic Bonuses for Discretionary Bonuses

Because bonuses based on objective formulas are preferred under § 162(m), one would expect that companies would consider transforming discretionary bonus plans into formulaic ones. The cost of this substitution is that the board of directors loses the ability to make qualitative judgments (i.e., judgments not based exclusively on quantitative results, such as accounting results) about the firm's performance in awarding bonuses. In addition, boards lose the flexibility to alter bonus amounts to take into account unusual circumstances, such as war, recession, collapse of a major competitor, etc., that are beyond the control of the executive.

The loss of this discretion and flexibility must be weighed against the costs of forfeiting deductions for the bonuses paid. The most obvious cost is the extra tax owed by the company as a result of the lost deductions for amounts paid pursuant to the bonus plan. The firm may incur political costs as well. SEC rules require firms to disclose in their proxy statements the impact of § 162(m) on their compensation policies.¹⁰⁰ As a result, firms that forfeit deductions must effectively admit to the public that they are more willing to forfeit valuable tax deductions than they are to restructure executive compensation plans.¹⁰¹ The public may not appreciate the subtle possibility that increased board discretion and flexibility might be more valuable than the cost of the lost deductions.

98. Under the arm's length model, assuming at least part of the § 162(m) burden is placed on the company through increased executive compensation, firm value is decreased because of the extra compensation costs. Further, executive wealth is increased because of the risk premium they receive.

99. See *infra* Part IV.B (discussing the likely effects under the managerial power model).

100. Executive Compensation Disclosure; Securityholder Lists and Mailing Requests, Exchange Act Release No. 7032, 55 SEC Docket 1352 (Nov. 22, 1993) (requiring that a proxy statement "should in its discussion of executive compensation policies address the registrant's policy with respect to qualifying compensation paid to its executive officers for deductibility under § 162(m)").

101. Despite the SEC's rule requiring disclosure of the company's § 162(m) policy, Steven Balsam has noted that disclosures are sometimes "exceedingly vague" and has suggested that firms be required to disclose the amount of actual deductions forfeited and the additional taxes paid by virtue of § 162(m) as a result of the company's compensation practices. See *Effectiveness*, *supra* note 85, at 3. To the extent that disclosures are ineffective in conveying the true additional cost of excess nonqualified compensation, the political costs of forfeiting deductions would be reduced.

If the costs of forfeiting deductions are high, there are two ways that a board might attempt to ameliorate the loss of flexibility and discretion while still qualifying bonus arrangements under § 162(m). First, the board could use objective formulas that err on the high side and then preserve negative discretion to scale the bonuses back down. One problem with this approach is that the objective formulas could be perceived by the public as overly generous despite the fact that the board has the power to reduce the amounts derived from them.¹⁰² Second, the board could narrow the range of payouts generated under an objective plan. This would reduce the impact of unexpected positive factors (e.g., sudden supply shortage for the goods sold by the company) that are beyond the control of the executive. Consider, for example, a bonus based on revenues. If the range of revenue growth that is considered in computing the bonus is smaller (e.g., 80% to 120% of the target), the effect of unexpected positive factors will be muted compared to arrangements that use a larger range (e.g., 80% to 200% of target).¹⁰³ In fact, empirical data suggest that companies that qualify their bonus arrangements use a narrower range of payouts as compared to companies that do not qualify their bonus plans.¹⁰⁴

3. Deduction Forfeiture

Because circumvention and substitution may be costly, corporations in certain circumstances may simply choose to not comply with § 162(m) and thereby forfeit deductions for compensation in excess of \$1,000,000. For example, consider the example described above where parties are considering whether to restructure a \$1,500,000 all cash arrangement into a \$1,000,000 cash plus \$1,500,000 bonus (50% likelihood of payment) arrangement. The executive demands the extra \$250,000 of expected bonus value so as to offset

102. Recall that, to qualify compensation arrangements under § 162(m), the material terms of arrangements must be disclosed to (and approved by) shareholders. *Supra* notes 37–39 and accompanying text. The Treasury regulations interpreting the disclosure requirement have been criticized for not requiring the disclosure of sufficiently detailed information. See *supra* note 85. To the extent this criticism is valid, the risk of public outrage may not be a significant constraint on using this approach.

103. The lower end of the range usually will not fall below 80% because that is the lowest performance level that boards feel can justify a bonus from a public relations perspective. See Reitenga et al., *supra* note 63, at 2 n.2 (discussing the 80/120 convention).

104. Reitenga et al. found that the rate of earnings smoothing is higher with respect to companies that qualify their plans under § 162(m). *Id.* at 2. They argue that this is consistent with narrower ranges of bonuses, which "result in a greater penalty for extreme negative performance and a smaller reward for extreme positive performance." *Id.* This increases the incentive to smooth earnings, which is consistent with their empirical findings.

the additional risk to her under the restructured arrangement. In such a scenario, if the firm's marginal tax rate is 30%, the firm should choose to forfeit the deduction by paying \$1,500,000 cash.¹⁰⁵ If so, the after-tax cost to the firm of the extra \$500,000 cash payment is equal to the pre-tax cost of \$500,000 because the compensation deduction is denied.¹⁰⁶ If, alternatively, the firm pays \$1,000,000 in cash and a \$1,500,000 bonus (with a 50% likelihood of payment),¹⁰⁷ the expected after-tax cost of the bonus is \$525,000 (expected value of \$750,000 reduced by the 30% tax deduction). Under these circumstances, forfeiting the deduction makes sense because the tax benefit of the deduction is more than offset by the additional payment that the executive requires because of her risk-aversion.

Nevertheless, there may be political reasons why a firm might choose not to forfeit deductions even in instances when it would make financial sense to do so. As noted above, the impact of § 162(m) on executive compensation policies must be disclosed.¹⁰⁸ As a result, the public might perceive deduction forfeiture as suggesting that boards are captured by management. By allowing the firm to forfeit deductions, the board implies that it is more interested in appeasing management (by not forcing them to accept pay that is more sensitive to performance) than in preserving valuable tax deductions. The public likely will not appreciate that deduction forfeiture might in fact be the best way for the company to minimize its after-tax compensation costs.

A recent empirical study suggests that firms are behaving as expected under the arm's length model.¹⁰⁹ Firms with a riskier business environment

105. This analysis assumes that the entire economic incidence falls on the firm (i.e., that the executive receives a full gross up for risk). It also assumes that there are no political costs associated with forfeiting deductions. See *infra* note 108 and accompanying text (discussing the possibility of political costs).

106. The after-tax cost of the first \$1,000,000 is \$700,000 because it reduces corporate taxable income by \$1,000,000; accordingly, the payment reduces corporate tax liability by \$300,000 (\$1,000,000 x 30%).

107. Recall that the executive would require this arrangement in order to offset the addition risk to which she is subject as a result of the restructuring.

108. Executive Compensation Disclosure; Securityholder Lists and Mailing Requests, Exchange Act Release No. 7032, 55 SEC Docket 1352 (Nov. 22, 1993) (requiring that a proxy statement "should in its discussion of executive compensation policies address the registrant's policy with respect to qualifying compensation paid to its executive officers for deductibility under § 162(m)"). As noted above, however, it has been argued that these disclosures are sometimes vague and of little help in determining the amount of deductions lost and the resulting increased tax liability. See *supra* note 101. To the extent disclosures are not completely effective, the political cost of forfeiting deductions would be reduced.

109. Steven Balsam & Qin J. Yin, *Explaining Firm Willingness to Forfeit Tax Deductions Under Internal Revenue Code § 162(m): The Million Dollar Cap*, 24 J. ACCT. & PUB. POL'Y 300, 322-23 (2005).

were more likely to forfeit deductions, presumably because substitution was more costly.¹¹⁰ When the tax benefit of deductions is higher and when the firm's compensation practices are subject to greater public scrutiny, firms are more likely to preserve their deductions.¹¹¹

4. *Director Independence and Shareholder Approval Requirements*

Section 162(m) appears to create incentives for strengthening corporate governance procedures because, in order to qualify as performance-based under § 162(m), compensation must be approved both by an independent compensation committee and by a shareholder vote.¹¹² Under an arm's length model, however, there would be no need for enhanced corporate governance procedures because the market would balance the benefits and burdens of these procedures, ultimately resulting in the procedure that maximizes firm value. States would compete for corporate charters by creating default governance rules that are optimal. If the default rules happened to be suboptimal in a particular context, then firms would opt out and voluntarily require enhanced procedures in order to best attract capital.

In fact, states have taken a hands-off posture when it comes to procedures relating to the setting and structuring of executive compensation.¹¹³ Furthermore, companies themselves generally have not opted out of these *laissez-faire* default rules.¹¹⁴ Under the arm's length model, therefore, the director independence and shareholder vote requirement is unnecessary, serving only to impose additional costs on companies who choose to qualify their plans.

5. *Effect on Nonaffected Firms*

Under the arm's length model, firms whose base compensation arrangements for covered executives are set well below \$1,000,000 should be

110. *Id.*

111. *Id.*

112. See I.R.C. § 162(m)(4)(C) (2000) (setting forth approval requirements).

113. See Bainbridge, *supra* note 50, at 1650–52 (discussing the "rational apathy" by the states).

114. The exceptions are the recently enacted New York Stock Exchange and NASDAQ rules regulating the corporate procedures for setting executive compensation, which companies on the respective exchanges are required to adopt. NYSE, LISTED COMPANY MANUAL § 303A.05(a) (2004); Self-Regulatory Organizations, Exchange Act Release No. 48,745, 81 SEC Docket 1586 (Nov. 4, 2003).

unaffected by § 162(m). Because § 162(m) does not apply to them, these firms do not have to use circumvention or substitution techniques to preserve deductions. However, empirical data generated by Harris and Livingstone suggests that § 162(m) has in fact caused these firms' compensation costs to increase,¹¹⁵ which seems to be consistent with the result that would be expected under the managerial power model. Because Congress has arguably set a benchmark of \$1,000,000 for base compensation, § 162(m) may be used by complicit directors to deflect public outrage over salary arrangements at or below that amount.

Interestingly, Harris and Livingstone view their results from the opposite perspective. Harris and Livingstone view negative publicity regarding executive compensation as an "implicit contracting cost," defined as a "non-contractual cost that third parties [here, the public,] impose on firms by reacting adversely to firms' behaviors."¹¹⁶ The critical assumption made by Harris and Livingstone is that paying additional compensation always generates firm revenues in excess of the cost of the additional compensation, an assumption that would be inconsistent with either a pure arm's length view or the managerial power view.¹¹⁷ Harris and Livingstone thus assume that publicity is an obstacle that undermines the ability of firms to structure executive compensation arrangements that maximize firm value. Harris and Livingstone's results (i.e., that unaffected firms increased their executive compensation as a result of § 162(m)) would be consistent with results that would be expected under the arm's length view in a world where publicity is an obstacle to shareholder wealth maximization.¹¹⁸

6. Conclusion Under the Arm's Length Model

Under the arm's length model, § 162(m) simply imposes an additional cost on the parties in compensating executives because, in the absence of § 162(m),

115. David G. Harris & Jane R. Livingstone, *Federal Tax Legislation as an Implicit Contracting Cost Benchmark: The Definition of Excessive Executive Compensation*, 77 ACCT. REV. 997, 1014 (2002).

116. *Id.* at 998.

117. Under a pure arm's length view, the firm would pay additional compensation to the point where the additional revenues equaled the amount of additional compensation. Under the managerial power model, the firm would pay additional compensation until the risk of negative publicity was too great, even if the cost of additional compensation was greater than the revenues generated by it.

118. In contrast, Bebchuk and Fried's managerial power model predicts that publicity of compensation practices increases shareholder wealth. See generally BEBCHUCK & FRIED, *supra* note 6.

the parties would have negotiated the optimal compensation arrangement. With respect to this deadweight loss, two issues arise. First, what is the size of the loss? Second, how is its burden shared between the firm and the executive?

The size of the deadweight loss depends on how the parties respond to § 162(m). The parties could avoid the provision by providing for mandatory deferral or easy-to-reach bonus structures. Alternatively, the parties could substitute qualified compensation components (e.g., options, formulaic bonuses) for nonqualified compensation components (e.g., salaries, discretionary bonuses). Finally, the parties could simply continue their existing compensation arrangements, thereby causing the company to lose deductions for compensation in excess of \$1,000,000.

Each of these strategies comes with associated costs, resulting in the deadweight loss. For example, mandatory deferral imposes firm insolvency risk and illiquidity costs on the executive, while substitution inefficiently imposes greater risk on the executive, the more risk-averse party. The extent of these costs is dependent on a variety of factors.¹¹⁹ Under the arm's length view, the parties would choose the strategy that imposes the smallest cost, after taking into account the particular circumstances.

Though the nominal burden of § 162(m)'s deadweight loss might be placed on one party, part or all of the economic incidence may in fact be borne by the other. For example, if the strategy of mandatory deferral is utilized, the nominal burden is on the executive because she bears additional firm insolvency risk and the burden of illiquidity. However, the parties could shift that burden to the company by simply paying the executive a greater amount to offset these costs. Likewise, though the burden of deduction forfeiture is nominally on the company because its tax burden is higher, the company could shift the burden (in whole or in part) to the executive by paying her a lower amount than it would have paid in the absence of § 162(m). The economic incidence of § 162(m), therefore, depends on the relative bargaining power of the company and the executive.

In summary, under the arm's length view, § 162(m) imposes a cost that is borne by the parties. Unless all of the cost is shifted to the executive (either in the form of lower compensation or increased risk-bearing by the executive without any compensation), which the literature suggests is an unlikely scenario,¹²⁰ § 162(m) reduces shareholder wealth. Furthermore, to the extent incentive compensation is substituted for cash compensation, the wealth of

119. The factors include the executive's liquidity and level of risk-aversion and the firm's solvency, level of business risk, marginal tax rate, and level of public scrutiny.

120. See *supra* note 97–99 and accompanying text.

executives is increased because of the risk premium they receive. Both results under the arm's length view are inconsistent with the intent of Congress to increase shareholder value.¹²¹

B. Managerial Power Model

Adherents of the managerial power model argue that directors and management collude to reduce the political costs of overpaying management. Under this view, would § 162(m) improve expected outcomes?

It is important to note at the outset that the statutory incidence of the § 162(m) penalty is placed on the company because, without any restructuring of compensation arrangements, the company's tax liability would be increased.¹²² Therefore, to shift any part of the economic incidence to the executive, collective action must be taken by parties. For example, cash compensation must be deferred or substituted into incentive compensation, bonus arrangements must be restructured, or compensation levels must simply be reduced; otherwise, the company loses deductions and pays more tax. As an initial matter, adherents of the managerial power model would be skeptical that actions taken to preserve deductions would effectively shift the incidence of the burden created by § 162(m). They would likely be even more skeptical that any actions taken would actually make the shareholders better off than they would have been in the absence of § 162(m).

This skepticism results from two intuitions. First, recall that under the managerial power model, the only meaningful constraint on executive compensation levels is the risk of public outrage. In the absence of any changed circumstances, therefore, one would expect executive pay levels and structures to remain somewhat sticky.¹²³ Drastic changes, without any

121. Put differently, under the arm's length view, there is no market failure and, accordingly, firms and executives make the optimum trade-off between incentive generation and risk preferences. Introducing § 162(m) into the mix upsets this tradeoff to the detriment of the parties. Unless the entirety of the detriment is borne by executives, the firm is worse off after the enactment of § 162(m) under the arm's length model.

122. See I.R.C. § 162(m)(1) (2000) (denying public companies a deduction for nonqualified compensation in excess of \$1,000,000 paid to a covered employee).

123. See BEBCHUK & FRIED, *supra* note 6, at 75 (noting this stickiness); Iman Anabtawi, Overlooked Alternatives in the Pay Without Performance Debate 39–43 (Jan. 2005) (UCLA School of Law unpublished manuscript, on file with author) (suggesting that path dependence limits the flexibility in designing alternative compensation structures).

apparent rationale, would be more likely to trigger public scrutiny and criticism. The enactment of § 162(m) provides an excuse for the colluding parties to engage in significant restructuring of compensation arrangements all in the name of preserving corporate deductions. Section 162(m), thus, may create the opportunity for management to extract even more rents.

Second, § 162(m) provides an excuse for the parties to substitute incentive compensation for cash. As explained in detail below, for a variety of reasons, the values of incentive compensation components are likely less salient to outsiders than commensurate levels of cash compensation.¹²⁴ Accordingly, the managerial power model would predict that § 162(m) increases executive compensation levels beyond the amount necessary simply to offset the executive's additional exposure to risk, resulting in a windfall for the executive.

Anecdotal evidence supports these intuitions. It is widely believed that § 162(m) contributed significantly to the explosion of compensatory stock options that began in the late 1990s.¹²⁵ Section 162(m) provided an excuse to drastically change compensation structures to shift heavily towards stock options, the value of which is harder to appreciate than cash compensation.¹²⁶

124. See *infra* Part IV.B.2.

125. See, e.g., Christopher Cox, Chairman, Sec. & Exch. Comm'n, Options Backdating: Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs 2 (Sept. 6, 2006), http://banking.senate.gov/_files/ACFB067.pdf (on file with the Washington and Lee Law Review) ("[O]ne of the most significant reasons that non-salary forms of compensation have ballooned since the early 1990s is the \$1 million legislative cap on salaries for certain top public company executives . . ."); James R. Repetti, *The Misuse of Tax Incentives to Align Management-Shareholder Interests*, 19 CARDOZO L. REV. 697, 709 (1997) ("[A]necdotal evidence suggests, however, that management is now happily complying [with § 162(m)] by awarding itself excessive amounts of stock options."); Schizer, *supra* note 52, at 468 (suggesting that "the explosion of option grants is evidence that [§ 162(m)] backfired (or was never intended to work)"); Press Release, Fin. Economists Roundtable, Statement of the Financial Economists Roundtable on "The Controversy Over Executive Compensation" (Nov. 24, 2003), available at www.luc.edu/orgs/finroundtable/statement03.pdf (suggesting that the increased use of stock options during the 1990s was attributable in part to § 162(m)); Press Release, Senator Chuck Grassley (Sept. 6, 2006) (on file with author) (stating that § 162(m) "seems to have encouraged the options culture"). Whether the attribution of the growth in options to § 162(m) is supported by empirical evidence is not entirely clear. See Lora Cicconi, *Blaming the Tax Code for the Backdating Scandal*, 114 TAX NOTES 1129, 1140 (March 19, 2007) (analyzing the empirical evidence and concluding that while there is no question that options growth has been exponential, "it is not nearly as clear that the explosion of options compensation is the result of § 162(m)").

126. See *infra* notes 135–40 and accompanying text (discussing the difficulty in valuing compensatory stock options and the possibility that the public does not fully appreciate the time value component of the option).

1. Avoidance

As discussed above, one relatively easy avoidance strategy would be to require executives to defer receipt of excess cash compensation until they retire. The amount ultimately paid would include an investment yield to account for the fact that the compensation will be paid in the future. If the investment return that the company gives to executives is a reasonable after-tax rate of return, this strategy would put the parties in the same general economic position that they would have occupied in the absence of § 162(m), assuming that executive illiquidity costs and firm insolvency risk are not significant.¹²⁷ However, Bebchuk and Fried argue that deferred compensation arrangements typically provide for a market rate of return that is derived on a pre-tax basis, making the equivalent after-tax rate significantly higher.¹²⁸ If so, deferring the compensation is more expensive than paying current compensation and, Bebchuk and Fried argue, this fact is not adequately disclosed to shareholders.¹²⁹ Accordingly, deferring cash compensation in excess of \$1,000,000, while preserving deductibility under § 162(m), may exacerbate an existing transparency problem. Section 162(m) also may provide an excuse (i.e., to preserve the company's tax deductions) for companies to continue to offer overly generous rates of return in order to encourage executives to defer compensation.

Another circumvention strategy would be to use bonuses with easy-to-reach targets in lieu of cash compensation. However, because the material terms of the bonus arrangement must be disclosed to shareholders, the possibility exists that bonus terms will result in public outrage.¹³⁰ If so, this

127. *See supra* note 77.

128. BEBCHUK & FRIED, *supra* note 6, at 104–05.

129. *See id.* at 105–06 (stating that outsiders cannot easily observe the economic impact of deferred compensation packages). The new SEC regulations requiring enhanced disclosure address this lack of transparency to some extent. While all earnings on deferred compensation must now be disclosed in a Nonqualified Deferred Compensation table, only "above-market" or "preferential" earnings must be disclosed in the Summary Compensation Table, which is the principal disclosure vehicle for executive compensation. SEC Press Release No. 2006-123, Sec. & Exch. Comm'n, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), *available at* www.sec.gov/press/2006/2006-123.htm. In determining whether a yield on deferred compensation is above-market or preferential, the yield is compared to a benchmark that is determined on a pre-tax basis. *See id.* As a result, the Summary Compensation Table will not reflect the tax cost to the firm (nor the tax benefit to the executive) associated with nonqualified deferred compensation arrangements. *See id.*

130. *See supra* notes 37–39 and accompanying text (describing the disclosure and shareholder approval requirements for compensation to qualify under § 162(m)). Whether in practice these disclosures adequately inform shareholders of their material terms is unclear. *See supra* note 86.

would shine a spotlight on the executive pay practices of the firm, which would be counterproductive for managers and board members under the managerial power model.

2. *Substitution Effect*

If cash compensation is substituted with more risky incentive compensation, the first question is whether the manager will be fully grossed up for the additional risk that she is taking on.¹³¹ If so, the entire burden of § 162(m) is borne by the company, while the manager is indifferent to the effect of § 162(m).¹³² A second question is whether the manager will actually be better off (on a risk-adjusted basis) than she would have been in the absence of § 162(m) because the value of the gross up exceeds the burden of the extra risk. In that case, the company is even worse off because of § 162(m), while the manager receives a § 162(m) windfall.¹³³

There are two reasons to suspect that § 162(m) would result in an executive windfall under the managerial power model. Recall that under the managerial power model, the only meaningful constraint on executive compensation is the risk of public outrage. The enactment of § 162(m) might reduce the risk of public outrage over unduly generous compensation arrangements for two primary reasons. First, the enactment might negate the stickiness inherent in executive pay norms, providing an excuse for drastic restructuring that would, in the absence of any external stimulus, generate public scrutiny.¹³⁴ Companies could now justify their decisions to revamp executive compensation arrangements as actions taken to preserve their valuable tax deductions.

Second, § 162(m) likewise provides an excuse for companies to alter the mix of compensation towards components whose value is less conspicuous to outsiders. As previously discussed, qualified compensation includes primarily

131. Recall that, because of various constraints on the ability of executives to effectively hedge against the additional risk, this Article ignores the possibility of executive hedging strategies. *Supra* note 52.

132. This is the full gross up for risk scenario explained above. *See supra* notes 95–96 and accompanying text. In such a case, § 162(m) reduces shareholder wealth and increases management wealth, an effect opposite to that intended by Congress. Nevertheless, due to management's risk aversion, management would be no better off under § 162(m).

133. In such a case, management would prefer the increased amount of incentive compensation over the value of fixed compensation that would have been payable in the absence of § 162(m).

134. *See supra* note 123 and accompanying text.

stock options and formulaic-based bonuses. The transparency of the value of each of these types of incentive pay will be considered in turn.

Compensatory stock options are notoriously difficult to value even by financial experts in light of their vesting restrictions, their relatively long terms, and the risk-averseness of executives.¹³⁵ Furthermore, until very recently, the value of executive stock options was generally not recorded as a compensation expense on the company's income statement, but instead was required to be reported for information purposes only in the statement's footnotes.¹³⁶ In addition, the value of at-the-money stock options (the type of options that qualify under § 162(m))¹³⁷ is likely not nearly as salient to the public as an equivalent value of cash. These options have no so-called "intrinsic value" at grant because there is no spread between exercise price and existing fair market value. Thus, if the options were exercised immediately, the holder would receive nothing. Nevertheless, these options still often have significant value at grant because they allow the holder to participate in share price gains without the necessity of putting any capital at risk.¹³⁸ This benefit, referred to as the option privilege, increases as the volatility of the underlying stock increases and as the term of the option increases.¹³⁹ It is likely that the public simply focuses on the lack of intrinsic value in executive options and neglects to consider fully the value of the option privilege.¹⁴⁰

This notion is supported anecdotally by the fact that public uproar over options inevitably occurs upon exercise rather than upon grant. In other words, the public focuses on the intrinsic value of options at the time of exercise (the ex post value of the option) instead of the value of the option privilege at the time of grant (the ex ante value of the option). This focus is misplaced, however, in assessing the propriety of executive compensation amounts because the ex post value of the option includes not only the original compensatory element (i.e., the ex ante value) but also the investment yield thereon. In assessing executive pay structures, only the compensatory element ought to be considered.

135. See Kevin J. Murphy, Executive Compensation 18–20 (April 1998) (unpublished manuscript, on file with author).

136. See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123, at 1 (2004).

137. See *supra* notes 89–90 and accompanying text (discussing the qualification requirements for stock options under § 162(m)).

138. See Treas. Reg. § 1.83-7(b)(3) (1996) (describing the option privilege).

139. See STEPHEN A. ROSS ET AL., CORPORATE FINANCE 555–57 (5th ed. 1999).

140. Cf. BEBCHUK & FRIED, *supra* note 6, at 162 (arguing that granting in-the-money options would likely increase public outrage costs for directors and executives).

Another difficulty in understanding the value of option grants relates to the prospect that the board will reprice or refresh the options in the event of a significant reduction in stock valuation. Repricing involves the resetting of an exercise price down to current fair market value.¹⁴¹ Refreshing is the granting of additional at-the-money options after a stock price drop, in lieu of repricing.¹⁴² If an informal agreement or understanding exists that, in the event of significant stock value depreciation, the board will reprice or refresh options, then the option values reported by companies will be understated.¹⁴³

One final problem in valuing options involves the issue of spring-loading, the term used to refer to the practice of granting options just ahead of the release of favorable nonpublic information. While these options are technically issued with at-the-money strike prices, because of the spring-loaded feature, the options are in substance in-the-money at the time of grant. Accordingly, the real value of spring-loaded options reported to shareholders in the company's financial statements will be understated because it will be based on the trading value of the stock, which will not have fully incorporated the impact of the yet-to-be-released favorable news.¹⁴⁴

Turning now to formula-based bonuses, if they are substituted for cash compensation, a similar reduction in transparency may occur. At the time the bonus arrangements are implemented, relevant outsiders may not be able to appreciate the expected cost of complicated bonus formulas. And when bonus

141. Formal repricing, once quite popular, is much less common since adverse accounting rules were promulgated in late 1998. See N.K. Chidambaran & Nagpurnanand R. Prabhala, *The Fall of ESO Repricing: Governance Reform or Reform Gone Awry?* 1 (2005) (unpublished working paper, on file with the Washington and Lee Law Review), available at http://www.rhsmith.umd.edu/faculty/prabhala/wpapers/repricing_2.pdf (noting the decline in formal repricing).

142. See *id.* at 2 (concluding that, as a result of the adverse accounting rule promulgated in 1998 with regard to repricing, many companies chose to refresh options in lieu of repricing, to the detriment of the firm); *id.* at 30 ("Stopping repricing did not stop the flow of compensation when options go underwater, but merely shifted the vehicle for conveying compensation [A] popular choice used in lieu of repricing, viz., refresher grants, is inferior and imposes deadweight costs that benefit neither the firms' shareholders nor its employees [T]hese costs . . . can be quite significant for heavy users of options.").

143. See Repetti, *supra* note 125, at 709 (noting the problem of repricing under § 162(m)).

144. A similar transparency problem occurs when options are backdated, a phenomenon that has received a great deal of recent attention. See Ciconni, *supra* note 125, at 1130–32 (describing the backdating scandal). When options are backdated, their true value is understated. See generally David I. Walker, *Some Observations on the Stock Option Backdating Scandal of 2006* (Boston Univ. Sch. of Law, Working Paper No. 06-31, 2006), available at <http://ssrn.com/abstract=929702> (noting that the common thread among springloading, backdating, repricing, and refreshing is that option design can somewhat easily be manipulated to surreptitiously transfer value to executives).

payouts are actually made, while outsiders will certainly be able to appreciate the cost at that time, boards can justify the large payments by noting that the amounts were derived from objective performance-based arrangements previously approved by shareholders.

Furthermore, if at the time the bonus arrangements are structured, an implied understanding exists that bonus targets will be re-set in the event of poor firm performance. Even though bonuses paid pursuant to the re-set plan would be nondeductible under § 162(m), the apparent cost of the formulaic bonus structures at inception will be understated relative to actual value.¹⁴⁵ This is analogous to the transparency problems associated with repricing or refreshing of options.

In addition, like stock options, formulaic bonuses can be spring loaded. At the time the bonuses are structured, the board and management could be aware of nonpublic information that would significantly increase the chances of achieving the relevant bonus targets. As a result, the real value of the bonus arrangements would be hidden from outsiders.

Finally, consider the impact of bonus structures that involve negative discretion. Recall that the parties could structure generous objective bonus formulas, with the board retaining the discretion to reduce the amounts derived from the formulas. At the outset, boards might justify these arrangements by emphasizing their ability to use negative discretion. Boards could argue that such arrangements allow the board to preserve deductions under § 162(m) while retaining the ability to take into account relevant qualitative facts and circumstances in deciding how best to compensate management. However, when the time comes to use the negative discretion to scale down the award, the board, because of its cozy relationship with management, decides against it. The board can then justify its decision by noting that the bonus payment formula was performance-based and previously approved by shareholders.¹⁴⁶

145. See Jesse Drucker, *As CEOs Miss Bonus Goals, Goalposts Move—Companies Adjust Target Levels, Keeping Their Executives Happy; IRS Pay-Curb Incentives Ignored*, WALL ST. J., July 7, 2004, at C1 (describing the prevalence of bonus re-setting).

146. One prominent practitioner suggests that this scenario is not atypical:

Because boards had to formulate and give shareholders a range of awards based on future results, they typically included at the high end amounts far in excess of anything previously paid, against the possibility that the CEO or other top executives reached extreme stretch goals or otherwise "shot the lights out." This is what happened: when, at the end of the measuring period, the board has to decide how much to award, it invariably moved toward, or in some cases, to the top, of the range approved by shareholders.

Bevis Longstreth, *A Real World Critique of Pay Without Performance*, 30 J. CORP. L. 767, 769 (2005); see also Murphy, *supra* note 88, at 739 (suggesting that, in the case of negative discretion bonus arrangements, "compensation committees will avoid imposing meaningful

In other words, negative discretion bonus arrangements can implicitly shift the burden of proof with regard to large bonus grants. For example, assume a bonus award of \$10,000,000. If the bonus were purely discretionary, the board would likely be required to justify in some detail, at the time it is awarded, how it arrived at such a large number. On the other hand, if the \$10,000,000 was initially derived objectively, the amount could be viewed as having some presumption of validity. If so, the board will not be required to justify the \$10,000,000 amount as vigorously as in the discretionary bonus context.

In summary, the enactment of § 162(m) negated the stickiness inherent in executive compensation norms and provided an excuse for companies to use compensation structures whose true values are harder to appreciate for a variety of reasons.¹⁴⁷ Under the managerial power model, this combination would result in an increase in executive pay beyond that necessary merely to offset the additional risk placed upon executives. Executives would receive a § 162(m) windfall.

3. Deduction Forfeiture

As previously noted, SEC rules require that companies disclose the impact of § 162(m) on their compensation policies. Accordingly, a company's decision to forfeit substantial deductions may draw public scrutiny.¹⁴⁸ Relevant outsiders may perceive that decision as one that elevates the manager's interest over the shareholders. By forfeiting deductions, it appears that the board is more willing to increase the company's tax liability than to force executives to accept pay structures that are sensitive to firm performance. In fact, as discussed above, in certain circumstances it may be rational for firms to forfeit deductions rather than incur the additional costs of restructuring compensation arrangements or circumventing § 162(m).¹⁴⁹

[negative] discretionary . . . and [accordingly] total bonuses will drift up to the 'upper bound' specified by the formula").

147. In addition to the opacity of the substituted compensation components, these components may be more plausibly justified to outsiders because they have the appearance of enhancing firm value by aligning incentives. David Walker has argued that, under the managerial power theory, the extent to which compensation components can be plausibly justified is significant. See David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587, 635 (2005) ("The more opaque and/or plausibly justifiable the transfer [wealth from firm to executive], the less the outrage, and the greater the value appropriation via that channel.").

148. *But see supra* note 101 (noting that whether the required disclosures are fully effective is unclear).

149. *See supra* Part IV.A.3 (discussing deduction forfeiture).

Under the managerial power model, it would seem that boards would be loath to forfeit deductions—even though doing so might be efficient—because of the potential negative public response. By appearing to favor executive interests over the company's, deduction forfeiture would have the potential to increase public scrutiny of compensation practices. Furthermore, as described above, § 162(m) provides an excuse to restructure compensation arrangements in ways that could allow for even more abusive compensation practices. It would seem that, under the managerial power model, boards and managers would use § 162(m) as cover to do so (i.e., "we, as diligent directors and managers, are restructuring compensation arrangements to preserve deductions and help the company"). If they simply forfeited deductions, they might miss the opportunity to negate the stickiness inherent in executive compensation norms.¹⁵⁰ For these reasons, the managerial power model would predict that it would be rare for firms (particularly high-profile ones) to forfeit significant amounts of deductions.

4. *Director Independence and Shareholder Approval Requirements*

In order to qualify incentive compensation under § 162(m), the arrangements must be approved both by independent directors and by shareholders after adequate disclosure.¹⁵¹ These conditions, at first glance, might appear quite beneficial under the managerial power view. Independent directors would presumably be much less susceptible to management influence. And the shareholder approval requirement should result in increased transparency of executive compensation arrangements and greater director accountability to shareholders.

Nevertheless, managerial power adherents are skeptical about the magnitude of the benefit of § 162(m)'s approval requirements. While Bebchuk and Fried note that independent director measures may be somewhat beneficial, they also emphasize a number of factors that undermine their effectiveness.¹⁵² Chief among them is the fact that even though "[t]he CEO and his or her director allies may not fully control board nominations in the future . . . [.] remaining on good terms with them is likely to continue to increase a director's

150. See *supra* note 123 and accompanying text (discussing the stickiness of executive pay structures).

151. See I.R.C. § 162(m)(4)(B) (2000).

152. See BEBCHUK & FRIED, *supra* note 6, at 202–04 (discussing the limits of independent director requirements).

chances of being renominated."¹⁵³ Furthermore, Bebchuk and Fried note that "[a]s long as directors are supposed to act collegially and feel like part of a team of which the CEO is for many purposes the leader, they will feel more comfortable accommodating his or her wishes than opposing them."¹⁵⁴

With respect to the shareholder disclosure and approval condition, Bebchuk and Fried are even less sanguine.¹⁵⁵ They point to the fact that disclosures are generally broadly worded, leaving directors with substantial discretion.¹⁵⁶ More importantly, according to Bebchuk and Fried, "even though shareholders can collectively veto the [proffered compensation structure], they will have little control over how executives are compensated if they turn down the plan proposed by the board."¹⁵⁷ As a result, the board could simply replace the rejected plan with one that is even worse for shareholders. For example, if the shareholders fail to approve an otherwise qualified § 162(m) arrangement, the board could unilaterally approve a different plan that is not qualified under § 162(m), thereby costing the firm valuable tax deductions.

Furthermore, as described above, the shareholder approval requirements might actually result in increased management compensation.¹⁵⁸ When incentive arrangements are proposed, shareholders may not fully appreciate their value for a variety of reasons. And, as Bebchuk and Fried suggest, shareholders may feel that they have little choice but to approve the arrangements to preserve the company's tax deductions.¹⁵⁹ Then, when amounts are paid out under the incentive arrangement, large payments can be justified by noting that the amounts paid are "performance-based" under plans previously disclosed to and approved by shareholders.

5. *Effect on Nonaffected Firms*

Section 162(m) could also adversely affect shareholders of nonaffected firms (i.e., those public companies whose cash compensation to covered

153. *Id.* at 203.

154. *Id.* at 203–04.

155. *See generally id.* at 196–97. Though Bebchuk and Fried focus their discussion here on the shareholder approval of equity-based plans, their concerns should apply equally to formula-based bonus arrangements.

156. *See id.* at 196.

157. *See id.* at 197.

158. *See supra* Part IV.B.2.

159. *See BEBCHUK & FRIED, supra* note 6, at 197 (noting that if shareholders vote down a proposed compensation arrangement, "they have little assurance that the board will not instead adopt arrangements that may be even worse for shareholders").

executives is well below \$1,000,000). The \$1,000,000 threshold could be viewed as a congressionally sanctioned norm for cash compensation. If so, it would provide political cover for nonaffected firms to increase their cash compensation levels to approach \$1,000,000. The managerial power model would predict that the enactment of § 162(m) would result in increased compensation for managers of nonaffected firms to the detriment of their shareholders. There is both anecdotal¹⁶⁰ and empirical¹⁶¹ support for this hypothesis.

6. Symbolic Value of § 162(m)

Under the managerial power model, one possible salutary effect of § 162(m) is that it shined a bright light on executive compensation practices. By enacting § 162(m), Congress has warned the public that boards and executives must be carefully watched. By favoring compensation structures negotiated by independent compensation committees, Congress identified board capture by management as a significant problem. And, simply by legislating in this area, Congress indicates a willingness to intervene in the company/executive relationship if boards and managers fail to clean up their act. These symbolic effects could be beneficial even if, considering its subtleties and nuance, the statute suffers from technical design flaws.¹⁶² Under the managerial power model, where perception is more important than reality, the symbolic impact of § 162(m) could be more significant than these flaws.

7. Conclusion Under the Managerial Power Model

Under the managerial power model, the enactment of § 162(m) may result in increased overall management compensation for two interrelated reasons. First, the enactment would negate the stickiness or path dependence of executive compensation norms. In the absence of changed circumstances, it

160. See, e.g., John A. Byrne, *That's Some Pay Cap, Bill*, BUS. WK., Apr. 25, 1994, at 57 (suggesting that the cap has effectively established the standard for executive pay).

161. See Harris & Livingstone, *supra* note 115, at 1.

162. Cf. Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 507–43 (2005) (analyzing Congress's responses to the perceived problem of corporate expatriations and concluding that, while the technical design of the responses were flawed, there may have been salutary symbolic effects stemming from congressional attention to the issue).

would be difficult for the board and management to defend drastic deviations from their existing pay arrangements. Second, the enactment of § 162(m) provides the excuse to implement such deviations in favor of pay structures that are preferred under the provision. The values of these pay preferred structures are less salient to outsiders and more manipulable by insiders, resulting in probable gains for executives.

Under this model, therefore, shareholders would likely be worse off and executives better off after the enactment of § 162(m). The substitution of qualified components for nonqualified ones would result in an increase in executive pay beyond the amount necessary to offset the additional risk placed upon the executive as a result of the substitution. If so, the harm to shareholders under the managerial power model would be greater than that under the arm's length model. Furthermore, executives receive a windfall under the managerial power model, unlike in the arm's length model where executives would generally be indifferent to the effect of § 162(m).

On the other hand, it is possible that § 162(m) could act as a constraint on executive compensation levels and structures under the managerial power model. By preferring compensation negotiated by independent compensation committees, the provision could result in better bargaining by directors on behalf of shareholders, although managerial power proponents are generally not optimistic about the benefits of independent director requirements. Perhaps more significantly, § 162(m) might have substantial symbolic value under this model, where public perception of compensation practices is critical.

V. Empirical Studies

Under the arm's length model, § 162(m) simply creates a burden that is borne by the company and the executive. The incidence of this burden is a function of the parties' bargain and could be shared in a variety of ways. For example, the executive could be subject to additional unwanted risk without adequate compensation¹⁶³ or the company could forfeit some deductions.¹⁶⁴ Regardless of how the burden is divvied up, it is clear that, under this model, § 162(m) would fail to meet its objectives.

163. As discussed above, the executive could bear part or all of the burden of § 162(m) in other ways. The executive could be forced to defer compensation or, more simply, to accept a lower value of compensation.

164. There are other ways in which the company could bear part or all of the § 162(m) burden. The company could compensate the executive for the additional risk imposed upon him by virtue of the substitution of qualified compensation for cash compensation or for the burden resulting from the executive's deferral of compensation.

The analysis is significantly more complex under the managerial power view. On the one hand, the introduction of § 162(m) gives the parties an excuse to drastically depart from existing executive compensation norms and to utilize executive compensation components whose true values are harder for relevant outsiders to appreciate. On the other hand, by enacting the provision, Congress highlighted the agency problems inherent in executive compensation. These two effects push in opposite directions under the managerial power model, and it is impossible to predict which is stronger. This section considers the existing empirical research regarding the effect of § 162(m) on executive pay packages following its enactment in 1993.

A. Levels of Executive Compensation

1. Affected Firms

Several studies have found that the compensation of executives of "affected firms" (i.e., those whose executives earned at or near the \$1,000,000 threshold) increased after § 162(m)'s enactment.¹⁶⁵ These studies also found that, while all components of executive pay packages increased, the increase in stock options was the largest.

The overall increase in executive pay is theoretically consistent with both models under certain assumptions. Under the arm's length model, risk-averse executives would receive larger amounts of compensation to offset the additional unwanted risk foisted upon them.¹⁶⁶ Under the managerial power view, the increase in overall pay could result from § 162(m)'s stickiness negation and its preference in favor of less transparent pay structures.¹⁶⁷ In order to draw any additional conclusions, we would need to know whether the increase in pay is merely sufficient to offset the executive's additional risk (consistent with the arm's length model) or whether it results in a windfall gross up (consistent with the managerial power model). This analysis would

165. See generally STEVEN BALSAM, AN INTRODUCTION TO EXECUTIVE COMPENSATION (2002); Balsam & Yin, *supra* note 109; Todd Perry & Marc Zenner, *Pay for Performance? Government Regulation and the Structure of Compensation Contracts*, 62 J. FIN. ECON. 453 (2001); Marilyn F. Johnson et al., *Stakeholder Pressure and the Structure of Executive Compensation* (1997) (unpublished working paper, on file with the Washington and Lee Law Review), available at <http://papers.ssrn.com/abstract=41780>.

166. This assumes that, due to the relative bargaining power of the parties, the company is required to offset some or all of this additional risk through increased compensation.

167. This assumes that these effects of § 162(m) outweigh its symbolic effects.

require an evaluation of each executive's level of wealth and risk preferences, which the studies were not able to do.

2. *Unaffected Firms*

Harris and Livingstone found that unaffected firms also increased executive compensation, a result that is generally inconsistent with the arm's length model.¹⁶⁸ The result is, however, consistent with the managerial power model, suggesting that the enactment of § 162(m) provided political cover for these firms to increase their nonqualified compensation components to approach the \$1,000,000 "target" set by the provision.

B. *Substitution Effect*

The arm's length model would predict that, unless restructuring costs are high,¹⁶⁹ incentive compensation would be substituted for cash compensation.¹⁷⁰ As a result, one would expect to find an increase in the sensitivity of executive pay to firm performance after the enactment of § 162(m) in 1993.¹⁷¹

On the other hand, under the managerial power model, the impact of § 162(m) on pay sensitivity is not as clear. Assuming that the symbolic impact of § 162(m) is not significant, the provision would be expected to increase overall executive compensation beyond that necessary to offset the executives' additional exposure to risk. These windfall gross ups could lead to enhanced performance sensitivity because the windfall amounts could grow as firm performance increases. In other words, while most (or all) executives would receive windfalls, executives at high-performing firms might receive the largest windfalls, in which case pay sensitivity would increase. Alternatively, the windfall amounts could be unrelated to firm performance, in which case pay sensitivity would not increase.

168. As discussed above, the result is consistent with the arm's length model only if one assumes that before the enactment of § 162(m), unaffected firms were unable to pay their executives optimally high amounts of compensation because of the possibility of negative publicity.

169. If restructuring costs are high, then the company may choose to simply forfeit deductions.

170. This assumes that § 162(m) is not easily avoided through mandatory deferral or easy-to-reach bonus structures.

171. Because managers would likely receive a gross up to some extent to offset the additional risk of the performance-sensitive pay, managers in the aggregate would receive an overall increase in pay.

The empirical evidence with regard to changes in pay sensitivity is mixed. Some researchers have found that pay sensitivity has increased after 1993,¹⁷² which is consistent with both the arm's length model and the managerial power model under certain conditions.¹⁷³ However, the latest study concluded that "[t]here is little evidence that [§ 162(m)] significantly increased the performance sensitivity of chief executive officer (CEO) pay at affected firms."¹⁷⁴ This conclusion is consistent with the arm's length model if (i) restructuring costs are high causing many firms to choose to forfeit deductions or (ii) many firms are avoiding § 162(m) through mandatory deferral and/or easy-to-reach bonus structures. The conclusion is also consistent with the managerial power model if windfall gross up amounts are not related to firm performance.

C. Deduction Forfeiture

Under the arm's length model, firms would be willing to forfeit deductions in cases where the costs of substituting performance-based compensation are higher than the cost of the lost deduction.¹⁷⁵ Under the managerial power model, firms should be less willing to forfeit deductions for two reasons. First, boards that forfeit deductions would publicly appear to be favoring executives at the expense of shareholders. Second, by forfeiting deductions, managers and boards miss out on the restructuring opportunity handed to them by Congress.

Balsam and Yin examined deduction forfeiture in a recent study.¹⁷⁶ They found that firms forfeit at least some amount of deductions in 40% of firm-year observations in their sample.¹⁷⁷ They also found that firms were more likely to forfeit deductions in cases where recontracting costs were higher and where the firm's business environment was riskier.¹⁷⁸ These findings are consistent with

172. See Balsam & Yin, *supra* note 109, at 320–21; Perry & Zenner, *supra* note 165, at 454.

173. The conditions for this conclusion under the arm's length model are: (i) § 162(m) is not easily avoided and (ii) restructuring costs are not high enough such that deduction forfeiture is more efficient. The condition for this conclusion under the managerial power model is that windfall gross up amounts are related to firm performance.

174. Rose & Wolfram, *supra* note 45, at 138.

175. This assumes that the cost of avoiding § 162(m) is higher than the cost of the lost deduction and that the political costs of forfeiting deductions is not high.

176. Balsam & Yin, *supra* note 109.

177. *Id.* at 300.

178. This factor would increase the cost of substituting performance-based compensation for cash compensation because the executive would demand a higher gross up for the additional risk she would be facing.

the arm's length model, where firms would perform a cost-benefit analysis in deciding whether to qualify compensation under § 162(m).

The large number of forfeitures would appear to be inconsistent with the managerial power model for the two reasons described above.¹⁷⁹ However, the result could be consistent with this view if the disclosure rules regarding the impact of § 162(m)¹⁸⁰ are not fully effective. In recent testimony before the Senate Finance Committee, Balsam criticized the required disclosures as "exceedingly vague."¹⁸¹ If so, the large number of forfeitures would not be inconsistent with the managerial power model.

D. Conclusion

The empirical evidence regarding § 162(m) is somewhat ambiguous. Most of the evidence cuts both ways in that it is consistent with both models under certain conditions. However, the increase in overall executive compensation amounts paid by unaffected firms is more consistent with the managerial power model. On the other hand, the prevalence of deduction forfeiture would appear more consistent with the arm's length view, although the possibility of inadequate disclosure undermines this conclusion.

Nevertheless, the empirical evidence confirms the intuition that § 162(m) is not helpful to shareholders. A number of studies have found that executive compensation has increased since its enactment in 1993. And the most recent study showed that a significant number of firms are forfeiting deductions.

VI. Incidental Consequences

Thus far, this Article has suggested that the probable effect of § 162(m) under each of the two prevailing models is to increase executive wealth at the expense of shareholders, a result directly contrary to that intended by Congress. This section considers some other unintended incidental consequences resulting from the enactment of § 162(m).

179. See *supra* note 175 and accompanying text.

180. See *supra* notes 101, 108.

181. See *Effectiveness*, *supra* note 85, at 3 (arguing that the current disclosure rules are ineffective).

A. Option Design

Critics of current executive compensation practices, such as Bebchuk and Fried, often point to existing stock option design as proof that boards are captured by management.¹⁸² Firms universally issue stock options with at-the-money exercise prices ("conventional options").¹⁸³ Critics contend that, absent board capture, firms would use indexed stock options (i.e., those whose exercise prices float with a relevant market index) because they are both fairer and more effective in aligning incentives.¹⁸⁴ Using indexed options (in lieu of conventional ones) would prevent windfalls for executives of lagging firms in rising markets and would continue to provide incentives even in a down market.¹⁸⁵

Section 162(m), however, provides an incentive for firms to use conventional options in lieu of indexed options because the latter fail to qualify as performance-based compensation under existing Treasury regulations.¹⁸⁶ The failure stems from the fact that the exercise price of an indexed option has the potential to float below the fair market value of the underlying stock at the time of grant, a disqualifying feature under the regulations.¹⁸⁷

Section 162(m)'s preference for conventional options is problematic in two ways. First, it can distort behavior, causing firms to use these arguably less efficient options.¹⁸⁸ In addition, it provides a tax "excuse" to use these options, thus making it harder to prove the claim that their universal use is a symptom of poor corporate governance.

182. See BEBCHUK & FRIED *supra* note 6, at 137–64 (discussing conventional option plan design and managerial power).

183. See *id.* at 143.

184. See *id.* at 144.

185. See *id.* at 143.

186. See Treas. Reg. § 1.162-27(e)(2)(vi)(A) (1996) (setting forth stock option qualification requirements under § 162(m)).

187. David Schizer argues that, while an argument can be made that indexed options could qualify under the regulations, a well-advised taxpayer would not take that position without first obtaining a favorable private letter ruling. See Schizer, *supra* note 90, at 1377–80 (noting that, to date, no such private letter rulings have been issued).

188. Arguments have been made that conventional options are actually efficient notwithstanding tax considerations. See BEBCHUK & FRIED, *supra* note 6, at 152–57 (identifying, analyzing, and ultimately rejecting these efficiency arguments).

B. Restricted Stock

It has been suggested that firms could obtain better results by compensating management with restricted stock in lieu of stock options.¹⁸⁹ Restricted stock plans typically grant executives a number of shares in the firm that vest ratably over a three-to-five-year period. If the executive's employment with the firm is terminated during the vesting period, then the executive forfeits the unvested shares.

Restricted stock may provide better incentives than stock options for three reasons. First, holders of options have a greater preference for risk than stockholders because they do not suffer from reductions in stock price below the exercise price. This could cause managers to prefer projects that are unduly risky from the perspective of the stockholders.¹⁹⁰ Second, options provide little or no performance incentive effects when the stock price falls significantly below the price at the time of grant.¹⁹¹ Finally, because compensatory stock options are generally not dividend protected,¹⁹² executives holding options have incentives to cause the firm to avoid paying dividends. Instead, the option holder has the incentive to cause the firm to use available cash to invest in new

189. See Murphy, *supra* note 88, at 738 (noting that restricted stock "continues to be one of the most effective vehicles for providing both incentives and compensation to managers").

190. See *id.* at 738 n.66 (stating that, unlike restricted stock, "options provide incentives to . . . adopt excessively risky projects"); Murphy, *supra* note 135, at 17–18 (noting that executives with options instead of restricted stock have incentives to engage in riskier projects). Note, however, that this risk-preference may balance out to some extent the executive's inherent risk-aversion with respect to firm-specific risk. See David Hirshleifer & Yoon Suh, *Risk, Managerial Effort, and Project Choice*, 2 J. FIN. INTERMEDIATION, 308, 308–45 (1992).

191. See Murphy, *supra* note 88, at 738 n.66 ("Restricted stock granted at \$30 still provides incentives when the price falls to \$15, while stock options granted at \$30 provide very few incentives when the stock price falls significantly under the exercise price."); Murphy, *supra* note 135, at 18 ("[O]ptions lose incentive value once the stock price falls sufficiently below the exercise price that the executive perceives little chance of exercising . . ."). When options are significantly "underwater," there has been pressure for the companies to reprice the exercise price or to issue new options; this problem is avoided if restricted stock were used. Hall & Murphy, *supra* note 52, at 59.

192. Dividend protected options are ones that would allow option holders to effectively participate in dividend distributions made during the option period. The typical option holder is hurt by dividend distributions because the value of her interest in the company is diminished by the withdrawal of cash from the company without any corresponding receipt of cash by the option holder. In 2003, Hall and Murphy noted that a "small number of companies offer 'dividend protection' for employee stock options, usually accomplished by paying the employee accumulated dividends (plus interest) upon exercise of the underlying options." Hall & Murphy, *supra* note 52, at 60.

projects or institute share repurchase programs, which will result in higher share prices (and option values) than if dividends were paid out.¹⁹³

Nevertheless, the § 162(m) regulations treat conventional stock options more favorably than restricted stock, which is treated as qualified performance-based compensation only if the vesting conditions themselves are performance-based. Strictly time-vested restricted shares (i.e., those that vest after a period of time provided that the employee remains employed with the company) are thus not treated as qualified compensation.¹⁹⁴ As a result, the value of restricted stock is generally subject to the \$1,000,000 cap.¹⁹⁵ On the other hand, conventional stock options, whether vested or not and regardless of the type of any vesting conditions, are always treated as qualified compensation exempt from the cap. Therefore, as in the case of option design, § 162(m) impedes the ability of the firms to design arguably more efficient executive compensation structures.

C. Accounting Manipulation

Section 162(m) created incentives for firms to substitute formulaic bonus arrangements for discretionary ones because while the former qualifies as performance-based compensation exempt from the \$1,000,000 cap, the latter does not. This preference for formulaic bonuses could result in greater accounting manipulation by executives.

Most obviously, formulaic bonuses "encourage executives to focus on and manipulate short-term earnings at the expense of long-term value creation."¹⁹⁶ More subtly, the technical design of formulaic bonuses could encourage income-smoothing—the artificial redistribution of profits and losses from one year to another—in order to achieve less variable net income. When discretionary bonus plans give way to formulaic ones, the board loses discretion and flexibility in awarding ultimate payouts. To reduce the impact of this loss, boards will typically narrow the range of payouts generated under the formulaic

193. See Murphy, *supra* note 88, at 738 n.66 (noting that "options provide incentives to lower dividend yields"); Murphy, *supra* note 135, at 18 (stating that "executives holding options have incentives to avoid dividends and to favor share repurchases").

194. An example of performance-vested restricted stock is stock that vests only if the company earnings increase by more than 5%.

195. The firm generally deducts the value of restricted stock at the time it vests. But if the employee makes an election to include the value at the time of grant, then the firm deducts the value of the restricted stock at the same time. See I.R.C. § 83(h) (2000).

196. Murphy, *supra* note 88, at 739.

plan, as previously described.¹⁹⁷ This narrower range of payouts creates an incentive for executives to move earnings from very good years to other years because the marginal benefit of going from a good year to a very good year is often quite small. In fact, researchers have found that the rate of income-smoothing is higher for firms that qualify their bonus arrangements under § 162(m) as compared to firms that do not.¹⁹⁸

D. Inflation Effects

Section 162(m)'s \$1,000,000 threshold has not been adjusted for inflation. When § 162(m) was enacted in 1993, 1,000,000 of today's dollars were worth only roughly \$700,000.¹⁹⁹ Put differently, if the \$1,000,000 threshold were properly adjusted for inflation, it would equal roughly \$1,400,000.²⁰⁰ The effect is that more companies will creep into the purview of § 162(m) simply by adjusting executive pay for inflation even though their executives receive no increased purchasing power. In addition, with respect to companies that are already subject to § 162(m) because their nonqualified executive pay is in excess of \$1,000,000, more of their pay will be nondeductible even though they are not increasing their executives' purchasing power. As a technical matter, this problem can be alleviated quite simply by requiring automatic inflation adjustments as a number of other Code provisions do, or by periodically amending the threshold to account for past inflation.²⁰¹ However, such a fix may be quite difficult to accomplish as a political matter. Legislators who propose it will likely be subject to criticism for trying to make it easier for firms to pay fat-cat executives more than \$1,000,000 in salary. In the current political climate, this soundbite could be extremely dangerous.²⁰²

197. See *supra* notes 102–03 and accompanying text.

198. See Reitenga et al., *supra* note 63, at 22.

199. Computed using inflation calculator found at <http://data.bls.gov/cgi-bin/cpicalc.pl> (last visited June 26, 2007). The precise value in 1993 dollars is \$699,128.15.

200. Precise value is \$1,430,352.94.

201. See, e.g., I.R.C. § 1(f)(2) (2000) (adjusting tax brackets for inflation); I.R.C. § 63(b)(4) (adjusting standard deduction amounts for inflation). One problem with requiring inflation adjustments in the § 162(m) context is that executive compensation agreements typically cover a number of years. Annual inflation adjustments would make it difficult for firms to know how much salary they could pay in the future without triggering the provision. One solution to this problem would be to require inflation adjustments on fixed schedules (e.g., every three or five years). Thus, to ameliorate the inflation problem, Congress could immediately increase the cap to \$1,400,000 (to reflect inflation since 1993) and then require the cap to be increased for inflation at five-year intervals (i.e., in 2012, 2017, etc.).

202. Nevertheless, there has been some public criticism of § 162(m) by legislators in the

This suggests that the \$1,000,000 cap—without inflation adjustments—may be around for awhile. If so, this means that, assuming a future annual average inflation rate of 3%, the \$1,000,000 cap will in reality be a \$600,000 cap (in 1993 dollars) in five years and a \$520,000 cap (in 1993 dollars) in ten years.

E. Conclusion

The enactment of § 162(m) may have resulted in unintended adverse consequences. The provision discourages the use of indexed options and restricted stock to compensate executives even though their use may enhance firm value. It also encourages nondiscretionary formulaic bonuses, which encourage accounting gamesmanship. Finally, because of inflation, the \$1,000,000 threshold is effectively reduced over time even though no affirmative legislative action has been taken.

VII. Conclusion

Under either the arm's length model or the managerial power model, the likely effect of § 162(m) is to increase executive wealth and decrease firm value. Under the arm's length view, where the board is assumed to act faithfully in the shareholders' best interests, the provision is simply unnecessary, imposing a deadweight loss that is borne by the parties. Unless the entire economic burden is borne by the executive, her pay will increase and firm value will decrease.

Under the managerial power view, where there is little faith in the board, the effect is less clear. Leaving aside for a moment the symbolic value of the provision, the enactment of § 162(m) would tend to increase executive wealth. By introducing the provision into the mix, Congress provided an excuse for boards to deviate substantially from existing executive compensation norms. And by preferring certain types of compensation whose values are less salient and more manipulable, § 162(m) arguably created an opportunity for even greater mischief by boards and executives. On the other hand, the enactment of § 162(m) could have had positive symbolic impacts. Whether these impacts outweigh its technical flaws is unclear.

wake of the recent back-dating scandal, though the relationship between the provision may be tenuous. See Cicconi, *supra* note 125, at 1140–52 (describing the criticism by legislators that § 162(m) contributed to the backdating scandal, but arguing that the empirical data suggests that the criticism has been misplaced).

The empirical evidence suggests that § 162(m) has had unintended consequences. Executive compensation has increased, while a large number of firms are apparently forfeiting valuable tax deductions. Both of these results are contrary to the intent of Congress.

In addition, § 162(m) creates some perverse incentives. It discourages the use of indexed options and restricted stock, even though these structures may have better incentive effects than conventional options, which are preferred under the provision. It encourages nondiscretionary formulaic bonus arrangements, which themselves encourage accounting manipulation.

Perhaps the worst aspect of § 162(m) is its likely permanence. It would be politically difficult, if not impossible, to repeal the provision. Proponents of repeal would be criticized for trying to make it easier for firms to pay executives more than \$1,000,000 in performance-insensitive pay.

Congress has recently considered tax legislation that would penalize employees who defer large amounts of compensation.²⁰³ This legislation is clearly aimed at executive compensation, the levels of which have been the subject of intense public scrutiny. The perverse effects of § 162(m) should give Congress pause before it chooses to enact this or similar tax legislation designed to control executive compensation.

203. See *supra* note 4 and accompanying text (describing the Small Business and Work Opportunity Act of 2007).