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Executive remuneration under scrutiny: The cutting edge of the 'shareholder spring'

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Abstract
As profits and share prices in large corporations fell in recent years, the venerable argument that high pay levels must exist to attract the best people lost credibility. Disgruntled shareholders focussed on excessive levels of executive remuneration. They began to act in concert to discourage excessive remuneration. They voiced other concerns, too. The 'shareholder spring' had arrived.

Keywords
executive remuneration, excessive executive remuneration, say-on-pay, shareholder spring, stock options, bonuses, advisory vote

Disciplines
Law

EXECUTIVE REMUNERATION UNDER SCRUTINY: THE CUTTING EDGE OF THE 'SHAREHOLDER SPRING'

JF Corkery and Sabina Medarevic[1]

As profits and share prices in large corporations fell in recent years, the venerable argument that high pay levels must exist to attract the best people lost credibility. Disgruntled shareholders focussed on excessive levels of executive remuneration. They began to act in concert to discourage excessive remuneration. They voiced other concerns, too. The 'shareholder spring' had arrived.

There has been concern, even anger, over increasing levels of senior executive remuneration. President Obama labelled the 2008 end-of-year bonuses given to directors and top executives of rescued banks in America 'shameful'.[2] By 2012, Reuters was cautioning: 'The days when Wall Street banks could blithely hand out half their revenue in compensation to their staff without a murmur from shareholders have come to an end'.[3] At Morgan Stanley, 'furious' institutional shareholders took executives to task, questioning why compensation could not be lowered to about 30% of revenue from 51%. Morgan Stanley's chief executive felt shareholders' concerns: 'There's way too much capacity and compensation is way too high,' he said in an interview with the *Financial Times*. 'As a shareholder I'm sort of sympathetic to the shareholder view that the industry is still overpaid'.[4]

The 'Shareholder Spring'

Since 2011, Australian public company shareholders had been having their annual 'say-on-pay' and often voting against the pay recommendations of the board of directors by 20%, sometimes by over 50%. 'Say-on-pay' provisions have empowered shareholders and gave voice to the gap between shareholders' expectations and executive performance. The recent period of activism was dubbed the 'shareholder

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[2] Macon Phillips, 'Shameful', *The White House Blog* (online), 29 January 2009, <http://www.whitehouse.gov/blog_post/Shameful>, containing the text of remarks by the President after meeting with the Vice President and the Secretary of the Treasury:

> One point I want to make is that all of us are going to have responsibilities to get this economy moving again. And when I saw an article today indicating that Wall Street bankers had given themselves $20 billion worth of bonuses -- the same amount of bonuses as they gave themselves in 2004 -- at a time when most of these institutions were teetering on collapse and they are asking for taxpayers to help sustain them, and when taxpayers find themselves in the difficult position that if they don't provide help that the entire system could come down on top of our heads -- that is the height of irresponsibility. It is shameful.

[3] http://www.reuters.com/article/2012/10/05/us-financial-compensation-idUSBRE8931PM20121005.

[4] William Alden, 'The I.P.O. Blues', Dealbook, *The New York Times* (online), 5 October 2012, <http://dealbook.nytimes.com/2012/10/05/the-i-p-o-blues/>.

spring',[5] a slightly crass play on the 'Arab spring', that series of Middle East revolutions in pursuit of democratic ideals. Any shareholder activity is made possible by increased communication and information now available to shareholders. The major manifestation of this rise of shareholder power and interest is the enactment of 'say-on-pay' provisions, whereby shareholders have the opportunity to advise yea or nay on remuneration proposals put forward by the board itself. In 2002, the United Kingdom was the first to introduce a non-binding, advisory vote by shareholders on executive remuneration. This innovation was sparked by spectacular corporate collapses like Enron[6] and Worldcom, and the rise and rise in executive remuneration, even as many companies were in decline and under public scrutiny.

The United States and Australia soon followed suit and brought in similar 'say-on-pay' legislation. Newly-informed and communicative shareholders, flexing their power as 'owners', have begun using such provisions to review and comment on executive remuneration. The 'shareholder spring' now appears to be ready to surge forward in 2013 when, for example, European Union lawmakers seek to enact actual limits on financial industry pay bonuses.

Excessive executive remuneration

Shareholder revolts against excessive executive remuneration has been some time in coming. Directors and senior executives, being charged with the management of their companies, one way or another ended up determining their own levels of pay. Deciding on salaries and remuneration is a managerial task, after all, and corporate law statutes invariably say that the directors shall 'manage' the company. But no matter how loyal they are to the company, senior executives and directors are surely tempted to minimise their performance hurdles and maximise their own remuneration. In a competitive corporate environment, this self-managing system is bound to mean excessive pay for directors and senior executives.

It would make more competent for the shareholders, as the principals, to decide the level of their agents' pay. In fact, corporate legislation invariably says this. The company decides directors' remuneration by resolution of the shareholders. Section 202A(1) of Australia's *Corporations Act 2001* (Cth), for example, says that 'directors of a company are to be paid the remuneration that the company decides by resolution'.

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5 See, eg, Kate Burgess and Dan McCrum, 'Boards Wake Up to a Shareholder Spring', Financial Services, *Financial Times* (online), 4 May 2012, <http://www.ft.com/cms/s/0/a284e414-95ee-11e1-a163-00144feab49a.html#axzz2H9lMcYor>; Bloomberg View, 'Welcome Shareholder Spring that Holds Bosses to Account', *Bloomberg View* (online), 22 May 2012, <http://www.bloomberg.com/news/2012-05-21/welcome-shareholder-spring-that-holds-bosses-to-account.html>; but c/f Joel Dimmock, 'Well Sprung?', Global Investing, *Reuters* (online), 29 May 2012, <http://blogs.reuters.com/globalinvesting/2012/05/29/well-sprung/>, challenging the validity of this trend.

6 For more on the collapse of Enron, see the University of California accounts of the litigation and the causes of the collapse: <http://www.ucop.edu/news/enron/art408.htm>. The Litigation Complaint of 2003 alleged: 'By 97-98, Enron was a hall of mirrors inside a house of cards – reporting hundreds of millions of dollars of phony profits each year, while concealing billions of dollars of debt that should have been on its balance sheet, thus inflating its shareholder equity by billions of dollars.'

Unfortunately, this provision is a replaceable rule, and replaced it usually is, by provisions in the company's constitution.

For example, the BHP Billiton Ltd constitution says that the Board decides on remuneration for non-executive directors:

> As remuneration for services each non-executive Director … is to be paid out of the funds of the Company a sum determined by the Board payable at the time and in the manner determined by the Board but the aggregate remuneration paid to all the non-executive Directors in any year together with remuneration paid to those non-executive directors by Plc for their services may not exceed an amount fixed by the Company in general meeting.

And for executive directors:

> … a Director appointed to hold employment or executive office with the Company or Plc shall be appointed on such terms as to remuneration (whether by salary, commission or participation in profits or otherwise) as may be determined by the Board or any committee authorised by the Board.

Determining a fair amount for your own and your board colleagues' pay must be an agonising task, steeped as it is in conflicts. One's bounden duty to do one's best for the company conflicts with one's healthy interest in handsome remuneration. Boards often appoint sub-committees, ostensibly to provide objectivity to remuneration decisions, and these sub-committees in turn appoint and pay consultants to advise about suitable levels of pay. The possibility that this advisory chain could be influenced by the board, deliberately or otherwise, is always there.

In happier financial times, the public tended to marginalise and ignore directors' and senior executives' self-largesse. But the rhinoceros in the room was revealed by the global financial crisis ('GFC') in 2007. With the arrival of leaner years, and the age of abundant and swift information, shareholders were equipped to have their say, bringing executive remuneration into the realm and then to the forefront of the 'shareholder spring'. Tom Powdrill, spokesman for investor body PIRC, describes growing shareholder interest:

> Shareholders tended to take their eye off the ball on governance when the tide was rising. Now that we are in a weak economic environment, they have run out of patience when they see companies paying a lot of money when the returns are not there ...[7]

Some of the pay rates were beyond daring, with shareholder returns well out of step with senior executive remuneration. The boldness or blindness of some boards at a time of financial instability was amazing and must be humbling to them in hindsight. WPP (the advertising company) 'awarded Martin Sorrell, its chief executive, a 60 percent increase in total pay to £6.77 million, even as the firm's share price dropped 14.4 percent last year'.[8] Generally, across beleaguered Europe there was talk of

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[7] Richard Crump, 'Boardrooms' Backlash over Executive Pay', *Financial Director* (online), 29 May 2012, <http://www.financialdirector.co.uk/financial-director/feature/2180325/boardrooms-backlash-executive-pay>.

[8] Julia Werdigier, 'Aviva Chief Resigns Over Shareholder Pay Revolt', Dealbook, *The New York Times* (online), 8 May 2012, <http://dealbook.nytimes.com/2012/05/08/aviva-chief-resigns-over-shareholder-pay-revolt/>.

stringency and few executives tried to insist on a pay increase. New French President François Hollande proposed taking the lead in the 'shareholder spring' and capping the pay of senior executives of state-owned French companies at 20 times the lowest wage paid in the company.)

Determining fair levels of remuneration

One mantra of executive remuneration is 'paying for performance'. Executives are paid more because they earn more for the company, says the theory - and directors are entitled to pay hikes because, through technology and globalisation, companies are accessing wider markets and doing more with less.

But there was scant correlation between high rates of pay and the company's performance:

> Of the fourteen highest paid executives between 2006 and 2008, ten companies recorded extraordinarily poor returns, led by Babcock & Brown, which paid former executive, Phil Green, $51.3 million while its share price slipped by 99 percent. Investors in News Corp, Macquarie Bank and Toll lost almost half of their capital, despite their CEOs collecting $86.6 million, $79.5 million and $23.4 million respectively.[9]

Nor is the law generally able to curtail such decisions on the basis of how excessive the pay rates. Boards may make such exorbitant decisions, so long as they do so lawfully. In *Guinness P/L v Saunders*,[10] for example, a director was paid a massive 5.2 million pounds at takeover time. The board had decided the remuneration amount for their colleague. The House of Lords, which held that the director had to repay the money, as it was not authorised under the company's constitution, reflected on the risk of over-empowered boards approving their own pay:

> The shareholders … run the risk that the board may be too generous to an individual director at the expense of the shareholders but the shareholders have ... chosen to run this risk and can protect themselves by the number, quality and impartiality of the members of the board who will consider whether an individual director deserves special reward.[11]

In the US, action by shareholders over the exorbitant remuneration awarded to directors according to the vote of their boardroom colleagues has tended not to proceed to final determination. For example, in *In re Viacom, Inc, Shareholder Derivative Litigation*[12] shareholders commenced a representative action alleging breach of fiduciary duty and unjust enrichment by the board of directors, who had granted over $150 million in compensation to the chairman/CEO and two leading executives. That compensation had been awarded despite the fact that the company's share price declined. The litigation settled, with the original remuneration almost halved.

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9 Adam Schwab, 'Paying Caviar to Get Monkeys: Our Overvalued CEOs', *Crikey* (online), 13 January 2009, <http://www.crikey.com.au/2009/01/13/paying-caviar-to-get-monkeys-our-overvalued-ceos/>.

10 (1990) 8 ACLC 30; [1990] 2 AC 663.

11 Ibid 686.

12 Consolidated Case Index No 602527/05 (New York County, NY 2005).

Types of remuneration

Stock options as incentives

In the 1980s, public company executives did not invest much in the companies they governed (unlike their private counterparts). As a result, executives were showered with stock options as incentives to do well. For example, the director may be granted an option over a number of fully-paid shares. The option is exercisable before a certain date, at a predetermined price (usually the share price at the date of the grant of the option). In theory, these option grants are an incentive for the director to improve the company's performance and consequently improve its share price, thereby making these options more valuable. The options link the interests of the shareholders with those of the executives – the options to buy company shares become more valuable as the share price rises.

The use of stock option incentives did not always work well. Senior executives tweaked the option grant dates to make the value of the options higher, or granted options just ahead of good news that they knew would lift the company's share price and thus the value of the options.

Moreover, the problem with stock options is systemic: those shielded from losses (as a result of having discretion as to when options could be exercised) were the same individuals who controlled companies, chased profits and exposed their companies to excessive risk. Enron and Worldcom are notable examples. Stock option incentives can even reward poor performance. Such is the case for the CEO of Citigroup in 2011, who was compensated with further stock options and awards when, under his leadership, the stock price collapsed 55.3%. The CEO was personally able to recover from these losses, while the ordinary shareholders lost out.

This issue over rate of pay versus company performance is the main gripe of shareholders. They 'have no problem approving generous compensation packages, provided they're getting richer too … [but w]hen a company's stock falls, they are not so agreeable'.[13] For example, satisfied Apple shareholders were happy to approve a $378 million package for their CEO Tim Cook, including stock that vests over 10 years.

Even though shareholders have rejected less than 2% of executive packages in America in 2012, commentators insist that US boards are responding to say-on-pay by adjusting the size and type of packages offered.[14] Share options have been less popular in remuneration packages since 2007; and executives have lost the power to decide when to exercise the options they do receive. As an example, the Singapore Airlines AGM in July 2008 firmly voted down a resolution that directors be given authority to offer and grant options.

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[13] Diane Brady, 'Say on Pay: Boards listen when shareholders speak', *Bloomberg Business Week* (online), 7 June 2012, <http://www.businessweek.com/articles/2012-06-07/say-on-pay-boards-listen-when-shareholders-speak>.

[14] Ibid.

Bonuses

These days, exceptional performance is often rewarded with bonuses, taken from company profits. Bonuses are preferred to share options in the financial industry. Bonuses are usually a large multiple of the banker's fixed pay. The problem exposed by the GFC is that the prospect of bonuses encouraged short-term thinking and risk-taking, there being a limited down side. For example, if the financier loses all the company's money, she does not lose her fixed pay and only misses out on a bonus.

The European Parliament has been particularly critical of this and proposes a legislative reaction – to cut back variable pay such as bonuses and set a maximum size on bonuses (a maximum ratio of bonus to underlying fixed pay). This would take the form of a cap that restricts bankers' pay so it is no greater than the person's fixed pay and limiting 'guaranteed bonuses' to the first year of employment (to prevent banks offering disproportionate compensation to attract rainmakers from other companies).

The 'golden handshake'

Even when shareholders exercise their right to remove a director (in Australia, under s 203C of the *Corporations Act* for proprietary companies and s 203D of the *Corporations Act* for public companies), the cost associated with termination are often exorbitant. Parting ways is often accompanied by a generous payout. For example, the CEO of Viacom received $84M in 2010 and the CEO of Narbor Industries received $100M in 2011 as parting gifts.

Excessive and disproportionate salaries, unsanctioned and tipped incentive schemes and generous parting payments coupled with the financial devastation caused by the GFC have highlighted obvious cracks in the executive remuneration system. Legislative reforms have responded with increased disclosure requirements and rules of best practice.

Responses to the problem of executive remuneration

Increasing disclosure

No doubt, sunlight is a fine disinfectant. A heightened public awareness now exists of elevated and sometimes ridiculously generous[15] executive compensation packages awarded to executives by the board, which is often acting on the chummy advice of consulting firms that develop extravagant compensation plans.

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15 $10 million pay packages for CEOs are not uncommon; but that is small beer compared to the staggering sums the US hedge funds managers and private equity executives can take home. These astronomical rates of pay are usually justified on the traditional grounds that such executives bring in substantial returns for their company. See, eg, Tim Paradis, 'Some Hedge Fund Managers Soar into Salary Stratosphere', *The Post and Courier* (online), 7 May 2007, <http://v1.charleston.net/stories/default_pf.aspx?newsID=142496>:

Take James Simons, a one-time math professor turned hedge fund manager, who last year earned an estimated $1.5 billion to $2 billion, according to Trader Monthly. Simons' firm, Renaissance Technologies, controls the Medallion fund, which showed a return of 40% last year, the publication said. By comparison, the Standard & Poor's 500 Index returned 15.8%.

There are polarized views. The critics say top executives wield too much authority and are using it to shamelessly ransack the shareholders' funds. The apologists assert that top executives face ever larger challenges in a global environment and deserve the pay they get. But cynicism is wide-spread:

> Many experts argue that chief executives have a particular ability to drive their own pay upward, in part by manipulating directors they work closely with and encouraging the use of consulting firms that have a built-in incentive to increase pay packages for those who hire them. 'There's a sense that the C.E.O.'s pay is not determined by supply and demand', said Robert J. Gordon, a professor of economics at Northwestern University.[16]

Empirical studies generally conclude that heady remuneration packages in listed public companies rarely achieve their purpose of greater profitability for the company.[17] There is little relationship between remuneration levels and shareholder returns. In Australia, the average fee of a non-executive director of an S&P/ASX top 100 company rose from $90,343 in 2001 to $163,548 in 2006. Chairmen were getting $401,660. CEOs receive the handsomest pay, of course. In the US in 2006, the average pay for the S&P 500 CEOs was US$14.7 million. These are not faint-hearted numbers. The deepening concern over excessive executive pay has lead to an overhaul of rules on disclosure of compensation.

Previously in Australia, reluctant boardrooms were forced into only limited disclosure of remuneration levels. Under s 202B of the *Corporations Act*, a company had to disclose the remuneration paid to each director, if 5% of the votes that may be cast at a general meeting or 100 members so requested. In relation to stock options, under s 300(1)(d) of the Australian *Corporations Act*, the company's annual report had to include details of any share options that are 'granted to any of the directors or any of the 5 most highly remunerated officers of the company (other than the directors)'.[18]

CLERP 9 (2004) set out to investigate remuneration excesses in public listed companies and the limited disclosure in annual reports. There were also rumours that ever-stronger Chairs limited discussion on remuneration at annual general meetings. CLERP 9 deemed that the shareholders and public exposure would control excessive pay. Australia introduced more-stringent disclosure.

The current rules also require companies to present specific information on remuneration at the Annual General Meeting, including information on the value of any options granted to any key management personnel.[19] It must also include discussion of the relationship between the board's remuneration policy and the

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16 Eduardo Porter, 'More Than Ever, It pays to be the Chief Executive', *The New York Times* (online), 25 May 2007, <http://www.nytimes.com/2007/05/25/business/25execs.html?th&emc=th>.

17 See, eg, Krishnan Sharma, *Financial Sector Compensation and Excessive Risk-Taking – A Consideration of the Issues and Policy Lessons*, DESA Working Paper No. 115, April 2012, <http://www.un.org/esa/desa/papers/2012/wp115_2012.pdf>, 3; John C Bogle, 'Reflections on CEO Compensation'(May 2008) *Academy of Management Perspectives* 21; Lawrence Mishel and Natalie Sabadish, 'CEO Pay and the Top 1%', *Economic Policy Institute* (online), 2 May 2012, <http://www.epi.org/publication/ib331-ceo-pay-top-1-percent/>.

18 Corporations *Act 2001* (Cth), s 300(1)(d)(ii).

19 Section 300A (for listed companies).

company's performance.[20] This disclosure in the annual directors' reports must be headed up 'Remuneration Report'.[21]

The CLERP 9 reforms therefore require that there be time allocated for discussing remuneration at the Annual General Meeting,[22] and provide for the shareholders to make non-binding resolutions – the 'advisory vote' – on whether they (the shareholders) adopt the remuneration report.[23] Section 249L(2) of the *Corporations Act* states the general meeting notice must tell the shareholders that a resolution on remuneration will be put.

The Australian Accounting Standards Board (a federal government agency that deals with accounting standard setting in the private and public sectors in Australia) also requires disclosure of remuneration to directors.[24] Pursuant to AASB 1017, directors' pay must be disclosed in financial statements of all companies except small proprietary companies.[25] Pursuant to AASB 1046, remuneration of all directors and at least 5 non-director executives with the greatest authority must be disclosed.[26]

ASX Listing Rule 4.10.3 also requires disclosure. The annual report of a listed company must include a statement of the extent to which the company has followed the best practice recommendations of the ASX Corporate Governance Council and to give reasons for not following them.

Australian legislators and policy-makers, then, have emphasised disclosure and advisory votes. The shareholders have regained significant power over calibration of company performance and executive remuneration.

Shareholder angst

It came as little surprise when 66% of shareholders voted against the remuneration report at the Telstra Corp Ltd annual general meeting in November 2007, 62% against at AGL Energy Ltd, and 40% at Suncorp Ltd. Often larger funds with substantial shareholdings decided to vote against remuneration reports. Institutional shareholders were becoming active. Electronic attendance and voting (instead of posting in proxy votes) enabled shareholders to further exercise their power. Aggravating issues with executive remuneration included that the hurdles for executives' incentive payments (granting of options, for example) are too low and that CEOs' pay packages exceeded industry counterparts.

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20 Section 300(1)(b), (ba).

21 Section 300(1A).

22 Section 250SA.

23 Section 250R(2).

24 The Australian Accounting Standards Board develops and issues AASB Accounting Standards ('AASBs') and maintains the body of Standards. The Board's functions and powers are set out in the *Australian Securities and Investments Commission Act 2001* (Cth). There are also International Accounting Standards Board Standards, which the Australian Board considers and adopts. The *Corporations Act 2001* (Cth) requires most entities falling under the Act to apply Accounting Standards when preparing their financial reports.

25 AASB 1017 (Related Party Disclosures), available online at: <http://www.aasb.gov.au/admin/file/content102/c3/AASB1017_02-97.pdf>.

26 AASB 1046 (Director and Executive Disclosures by Disclosing Entities), available online at: <http://www.aasb.gov.au/admin/file/content102/c3/AASB1046_01-04.pdf>.

Advisory or binding votes on remuneration reports

Despite all these developments, there is currently no single uniform approach for implementing 'say-on-pay' across differing jurisdictions, particularly on whether the vote is binding (or has a legislated effect) or merely advisory.[27] In Australia in July 2011, the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011* (Cth) introduced a 'two strike and re-election' process – that is, shareholders are given a right to vote on a resolution requiring directors to stand for re-election if the shareholders' concerns about director remuneration were not remedied over two consecutive years.[28] The 'first strike' is if the remuneration report receives 25% or more 'no' votes. The onus is then on the company to explain what actions were taken or why no action has been taken in response to that 'no' vote in the following year's remuneration report. The 'second strike' occurs if the subsequent remuneration report also receives 25% or more 'no' votes. This method does not quite create a binding 'say-on-pay', but it is coercive.

Europe has gone a further step. Since 2004, the European Commission has been issuing recommendations to strengthen shareholder power in relation to directors' remuneration.[29] The European Commissions' *Green Paper on Corporate Governance*, released in 2011, raised the question of whether remuneration policies should be subject to a binding or advisory shareholder vote.[30] Several European countries including The Netherlands, Sweden, Norway and Denmark[31] have implemented a binding 'say-on-pay' rule.

In management talk, 'binding say-on-pay can ameliorate the classical agency problem between shareholders and managers'.[32] It is by no means uncontroversial. Swiss legislators are considering a binding 'say-on-pay' vote. The announcement of this approach led 70% of Swiss public corporations to respond 'with abnormal negative stock returns', signifying that many shareholders 'dislike the additional power they would obtain'.[33] Wagner and Wenk conclude that shareholders may prefer an advisory vote only, 'because this is likely to enhance incentives for executives to make extra-contractual, firm-specific investments that ultimately also benefit shareholders'.[34]

In the UK, executive pay has been a hot-button issue, with the outrage over high pay and low performance in a contracting economy leading to a reconsideration of the

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27 See Appendix 1.

28 Corporations *Act 2001* (Cth), s 250V (introduced by the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011* (Cth)).

29 Alexander Wagner and Christoph Wenk, *Agency versus Hold-Up: On the Impact of Binding Say-on-Pay on Shareholder Value*, Swiss Finance Institute Research Paper Series No 11-12 (6 August 2012), <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1793089&http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1793089>, 1.

30 European Commission, *Green Paper on the Feasibility of Introducing Stability Bonds*, EUROPA (23 November 2011), <http://ec.europa.eu/economy_finance/consultation/stability_bonds/pdf/green-pepr-stability-bonds_en.pdf>.

31 See Appendix 1.

32 Wagner and Wenk, above n 29, 31.

33 Ibid 1.

34 Ibid 32.

balance of power between shareholders and the boardroom. The UK Labour opposition has called for employee representatives to be placed on compensation sub-committees. It was the banking sector excesses that caused the furore, where excessive risk-taking was richly-rewarded when it succeeded while failure was not punished.

In 2013 the UK will bring in a binding shareholder vote every three years on the proposed executive compensation and on executives' exit payments. The annual shareholder advisory say-on-pay vote will continue, and there will be enhanced disclosure of amounts of remuneration paid in the prior year.

In the US, a nonbinding 'say-on-pay' vote came in with the *Dodd-Frank Wall Street Reform and Consumer Protection Act 2010*. An advisory shareholder vote on executive compensation must take place at least once every three years. In 2012, the US say-on-pay votes saw compensation schemes getting an average of 91% shareholder support at meetings. In 2011, it was 92%. Only 10% of companies received less than a 70% affirmative vote. Further, 25 of the 29 companies that had failed say-on-pay votes in 2011 had pass votes in 2012. Boards appear to have been more communicative about pay practices and less inclined to choose racy pay options. 'The reasons for these improved outcomes seem to be more active engagement with shareholders, responsiveness to shareholder concerns in the 2012 compensation discussion and analysis (CD&A) and changes to compensation policies designed to result in stronger correlation between pay and performance'.[35]

Nevertheless, the 2012 proxy season saw an increase in the number of companies with failed shareholder votes.

> Some commentators attribute these failures to an increasing disconnect between pay and performance, often fueled by negative recommendations from proxy advisory firms like ISS. Other commentators note that the failures correlate more closely to shareholder dissatisfaction with corporate performance (wholly aside from whether pay levels were appropriate for the performance actually achieved), or are attributable to high absolute or relative pay levels, above-median benchmarking or use of disfavored types of compensation.[36]

In Canada, although there is no express legal requirement, there is voluntary adoption of advisory say-on-pay.[37] Adoption is gathering momentum, with 97 Canadian companies currently agreeing to hold 'say-on-pay' votes affecting executive remuneration.[38] In 2012, QLT Inc's annual meeting produced a vote of 57.9% in the advisory 'say-on-pay' resolution. Other Canadian Corporations that

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[35] Harvard Law School Forum on Corporate Governance, 'Binding Shareholder say-on-pay Vote in UK' by Edward F Greene http://blogs.law.harvard.edu/corpgov/2012/07/31/binding-shareholder-say-on-pay-vote-in-uk/.

[36] Ibid.

[37] Stanford Graduate School of Business, 'Ten Myths of Say-on-Pay', *Stanford Graduate School of Business* (online), 28 June 2012, <http://www.gsb.stanford.edu/sites/default/files/research/documents/CGRP26-Myths.Say_.on_.Pay_.pdf>.

[38] Shareholder Association for Research and Education, 'Proxy voting', *SHARE* (2012), <http://www.share.ca/>.

received less than 70% of shareholder support for approval of 'say-on-pay' entitlements include Agnico-Eagle Mines Limited at 64.06%, Canadian Pacific Railway Limited at 61.67% and MDC Partners Inc at 66.75%.[39]

Some commentators warn that advisory votes on pay are enough, as votes that empower shareholders to dictate pay usurp the proper role of directors and could interfere with contractual obligations. Others argue otherwise – that shareholders would be reluctant to exercise a mandatory vote for fear of driving out skilled managers, destabilizing the company and pushing down the share price.[40]

Controls on pay in Australia and elsewhere

The path followed by Australia and others thus far is to toughen pay-disclosure rules, giving shareholders a greater say in the remuneration of corporate leaders, and linking executive pay to the performance of the company. Companies now tie share-based remuneration of senior executives to company performance and disclose the criteria used to calculate the pay. Directors who rort the compensation system can expect challenges to their re-election and an increased risk of lawsuits from disgruntled shareholders.

In Australia, if directors' fees are excessive, then this may amount to statutory oppression, especially in smaller companies. An oppression action could be brought pursuant to s 232 of Australia's *Corporations Act*.[41]

Shareholder concern at grandiose termination payments made to executives who quit their poorly-performing companies with a too-handsome handshake led to requirements that the shareholders approve retirement or termination payments to directors.

In Australia, such payments cannot be made unless the shareholders give prior approval, and only on the basis of full disclosure.[42] However, there were significant exceptions. So, in 2009, the *Corporations Amendment (Improving Accountability on Termination Payments) Act 2009* (Cth) tackled three tasks: first, lowering the threshold at which termination benefits must be approved by shareholders; second, expanding the range of personnel whose termination benefits could require shareholder approval; and third, clarifying the types of benefits that are subject to shareholder approval.

The demise of the business judgment rule

A traditional protection for directors from litigation has always been the business judgment rule. In the aftermath of the collapses of the US Enron Corp and the

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[39] Andrew MacDouggal and Vanessa Cotric, 'The State of Play on Say-on-pay in Canada in 2012', *OSLER* (online), 12 June 2012, <http://www.osler.com/NewsResources/The-State-of-Play-on-Say-on-Pay-in-Canada-in-2012/>.

[40] Bloomberg View, above n 5.

[41] See *Sanford v Sanford Courier Service Pty Ltd* (1987) 5 ACLC 394; also *Shamsullah Holdings Pty Ltd v CBD Refrigeration & Airconditioning Services Pty Ltd* [2001] WASC 8.

[42] *Corporations Act 2001* (Cth), s 200E.

Australia's HIH Ltd,[43] and the vocal criticism of governance standards, the courts have been reluctant to allow the business judgment rule to shield directors. The higher the standards expected of business judgments, the less the protection offered by the rule. Section 180(2) can now give little extra comfort to risk-taking Australian company directors in light of the entirety of the legislation and the judicial mood.[44]

The business judgment rule offers slightly more comfort internationally, though even in the US it may be on its last legs. In *Brehm v Eisner*[45] concerned a board decision to make a massive payout to get rid of a top executive:

> One can understand why stockholders would be upset with such an extraordinarily lucrative compensation agreement and termination payout [over $140 million] awarded a company president who served for only a little over a year and who underperformed to the extent alleged.

The Delaware Chancery Court refused to dismiss the shareholders' complaint – a derivative suit – against the Disney directors for approving this massive payout. The trial ensued. Although the Delaware Supreme Court took a dim view of the directors' behaviour in approving the payout,[46] it ruled that the board approval was not so deficient as to constitute a lack of due care.[47] In other words, there was no breach of duty. By deciding to make the payout, the board had removed the risk of protracted litigation over the dismissal of the company president. Nor, ruled the Court, was there 'waste'.[48]

The rise of business ethics and corporate social responsibility

As the business judgment rule has lost favour, there was an increased clamour for more 'ethics' in the boardroom:, 'the management of these companies [such as Enron] had been misleading investors … with the result that … investors lost millions of dollars'. This also illustrated self-regulation's weaknesses in the promotion of an ethical culture.[49] The broad movement called corporate social responsibility (CSR) now clamours for an ethical approach in the boardroom.

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43 For more on the collapse of HIH, see the April 2003 Royal Commission Report of Justice Neville Owen: <http://www.hihroyalcom.gov.au/finalreport/>.

44 If the words 'would hold' were replaced by 'could hold' in s 180(2), this might introduce the administrative law test for judicial review of a seemingly irrational decision by, for example, an arbitrator. On the unsatisfactory wording of the business judgment rule in s 180(2) see Matthew Hooper, 'The Business Judgment Rule: *ASIC v Rich* and the Reasonable-Rational Divide' (2011) *Corporate Governance eJournal* http://epublications.bond.edu.au/cgej/22.

45 Delaware S Ct No 489 of 1998; 746 A 2d 244 (Del 2000).

46 Many aspects of the defendants' conduct … fell significantly short of the best practices of ideal corporate governance … [Chair and CEO Eisner's] lapses were many. He failed to keep the board as informed as he should have. He stretched the outer boundaries of his authority as CEO by acting without specific board direction or involvement … these actions fall far short of what shareholders expect and demand from those entrusted with a fiduciary position: *Brehm v Eisner* 2006 Del Lexis 307 (Del 8 June 2006).

47 Ibid.

48 A claim for waste is that there is a deal that is so lop-sided that no business person of ordinary, sound judgment could conclude that the company has received adequate consideration.

49 See the neat summary of the corporate governance crisis surrounding Enron and other corporate scandals in John Lessing, 'Law in Society: The Corporate Governance Debate', *The National Legal*

However, much of the monitoring and oversight of corporations is still left to shareholders.

Increasing shareholder power

Telstra, Qantas and Suncorp Metway shareholders have disciplined their directors with significant votes against the remuneration reports. These expressions of disapproval are becoming bolder; and the number of shareholders voting at meetings one way or the other (electronically) is up over 50%, from about 30%.[50] The sort of transparency that Australia sought for many years has arrived and directors are now forced to listen to and communicate with the investors. The AGM is a place of dialogue, where it is dangerous, and not just foolish, to fend off shareholder inquiries and stakeholder concerns.

Internationally, shareholder activism is on the rise. The number of shareholder proposals has grown. Even a modest rise is significant, as new regulations have made certain votes mandatory. Shareholders no longer have to put them on the ballot.[51]

Large, institutional shareholders are voicing their concerns more often, holding the executives accountable. At *Yahoo*, the CEO was asked to step down after misstating information on his resume. Following shareholders' pressure, Barclay's announced its executives would forfeit their bonuses if it failed to meet certain profit goals. Citigroup was forced to take into consideration its shareholders' rejection of the CEO's pay package, despite the vote being non-binding.[52]

The use of share options to 'reward' directors in the grand old style has dropped away, and options are granted generally only if the company's performance warrants such largesse. Retirement benefits do not flow so sweetly, especially for non-executive directors, and termination payments equivalent to several years' salary for non-performing executives are no longer common.

What now?

Company chiefs had become used to maverick investors disrupting annual general meetings. But they were not prepared for the tsunami of concern from institutional investors and other normally supportive shareholders over executive pay. It is a worldwide pattern. As in the US, proxy advisory firms in India – many of them founded by former CEOs and other insiders – have been advising votes against the reappointment of auditors, as well as questioning the lack of dividends and the

Eagle, April 2003, pp. 10-11, <http://epublications.bond.edu.au/cgi/viewcontent.cgi?article=1087&context=law_pubs>.

50 Kate Askew, 'Power to the Owners', *The Sydney Morning Herald* (online), 21 May 2008, <http://www.smh.com.au/news/portfolio/power-to-the-owners/2008/05/19/1211182700625.html?page=6>.

51 Ben Protess and Katherine Reynolds Lewis, 'Once Reticent Investors Join Shareholder Revolts', Dealbook, *The New York Times* (online), 7 June 2012, <http://dealbook.nytimes.com/2012/06/07/once-reticent-investors-join-shareholder-revolts/?nl=business&emc=edit_dlbkam_20120608>.

52 Ibid.

retention of high reserves of cash.[53] Other factors, including anti-carbon corporate social responsibility initiatives, are activating the shareholders and contributing to their 'spring'. But it is overgenerous executive remuneration that has given rise to the most militant shareholder action.

Some are still not happy with their enhanced powers of scrutiny:

> Investors seemingly made their voices heard when they voted down the pay packages of 51 companies this spring, known as proxy season. But since then, many of the companies targeted by activist shareholders have been eerily silent. This shows that new powers given to investors thanks to the Dodd-Frank Wall Street reform law only go so far. Shareholders now have the right to have a 'say-on-pay' – the ability to vote yes or no to an executive compensation package at a company's annual meeting. But a company's board isn't obligated to do anything further than take note of investor dissatisfaction.[54]

The shareholder revolts are 'a sign that there clearly needs to be a much greater alignment between what directors do and shareholder interests'.[55] An empirical study by Clarkson, Walker and Nicholls, analysing 240 Australian ASX-listed firms' annual reports 2001-2009, concludes:

> Enhanced oversight over the executive remuneration process brought about by regulatory change appears to have positively impacted the executive remuneration process in such as fashion as to strengthen the pay-performance relation, and thereby make the process appear more accountable.[56]

The 'shareholders spring', call it what we will, has led to a more sincere alignment of shareholders' expectations and executive performance. Increasing shareholder impatience in a time of economic strain found its sharpest expression in these say-on-pay measures and the adverse votes. They are not just expressions of anger over excessive pay, although the financial industry's executive pay levels, based inexplicably on a percentage of the amount of funds under control, were provocation enough. And there has been a reduction in pay across the board, with longer term incentives increasing, and a closer alignment of corporate success with levels of pay.

Shareholders were tiring of excessive confidence and self-belief in the boardroom. Hubris creeps into boardrooms, especially in benign years. Once the directors start to think they are in fact the wealth creators in their companies and that they therefore had ownership of the profits, shareholders will be provoked. For now, boardroom hubris may have been dispelled. No longer does a sensible director regard escalating pay as her bounden right. There may be a bounce back as the economy improves

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53 Bhuma Shrivastava, 'Proxy Advisory Firms Give a Boost to Shareholder Activism', *LiveMint.com & The Wall Street Journal* (online), 29 June 2012, <http://www.livemint.com/2012/06/28225443/Proxy-advisory-firms-give-a-bo.html>.

54 *Bloomberg* View, above n 5.

55 Werdigier, above n 8.

56 Peter Clarkson, Julie Walker and Shannon Nicholls, 'Disclosure, Shareholder Oversight and the Pay-Performance Link', *Social Science Research Network* (online), 7 February 2010, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1549429&http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1549429>.

and the boardroom tries to reassert itself on pay, but the rules have changed and things may never be as they were.[57]

Excessive time now may be taken in calculating fair pay and following complex rules of reporting, leaving too little time for the company's core business, for strategizing. The main task is to create value, shareholder value. The agents should not be worrying so much about their own pay – they should leave much of that to the principals, their shareholders. As the statute says, directors of a company are to be paid the remuneration that the company decides by resolution. That decision should remain with the shareholders.

Having say-on-pay signals a shift in the balance of power. Shareholders are and will be taking an increasingly part or role in the company, necessarily at the expense of the board. A decade ago it was de rigueur to assert that shareholder control was a myth in public companies, especially as they had no real power to remove directors.[58] And anyway, since board governance benefits shareholders, why would the shareholders want any more say? Times have changed.

[57] *Dealbook* 18 January 2013: 'Goldman Awards Blankfein $13.3 Million in Stock. Days after announcing a jump in quarterly profit, Goldman Sachs disclosed that the board had granted the bank's chief executive and chairman restricted stock valued at $13.3 million for 2012, which is expected to bring his total compensation to $21 million … In 2007, Mr. Blankfein made about $69 million, in an apparent record for executives at big Wall Street banks.' <http://dealbook.nytimes.com/2013/01/18/goldman-awards-blankfein-13-3-million-in-stock/?nl=business&emc=edit_dlbkpm_20130118.

[58] Bebchuk, Lucian A, 'The Myth of the Shareholder Franchise' 93 *Virginia Law Review* 675; cf Martin Lipton and William Savitt, 'The Many Myths of Lucian Bebchuk' (2007) 93 *Virginia Law Review* 733; Lynn A Stout, 'The Mythical Benefits of Shareholder Control' (2007) 30 *Regulation* 42.

Appendix 1: Comparative Table of Models of 'Say-on-Pay' in Differing Jurisdictions

Country	Year adopted	Binding or Advisory	Frequency	Required or voluntary
United Kingdom	2003	Advisory	Annually	Required
The Netherlands	2004	Binding	Upon Changes	Required
Australia	2005	Advisory	Annually	Required
Sweden	2006	Binding	Annually	Required
Norway	2007	Binding	Annually	Required
Denmark	2007	Binding	Upon Changes	Required
United States	2011	Advisory	Annually/ Biennially/ Triennially	Required
Switzerland	2013 (Pending decision)	Advisory	Annually	Currently Voluntary
Germany	None	Advisory	Annually	Voluntarily
Canada	None	Advisory	Annually	Voluntarily

Source: Jeremy Ryan Delman, 'Survey: Structuring Say-on-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation' (2010) 2 *Columbia Business Law Review* 583.