EXECUTIVE COMPENSATION, CORPORATE GOVERNANCE, AND THE PARTNER-MANAGER

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In the debate over executive compensation, the assumption seems to be that the CEO of a publicly traded corporation is ultimately an employee of the corporation. According to the conventional view, the business belongs to the stockholders. Executive compensation is an expense like any other business expense that must be subtracted from income in reckoning stockholder return. The central problem has been that the CEO has too much power, and the board of directors has not acted as an effective monitor. Thus, the problem of executive compensation appears to be a thinly disguised problem of self-dealing.

Professor Booth argues here that partnership law offers an alternative model that may explain some of the more puzzling aspects of executive compensation. Simply stated, if one sees a publicly traded corporation as a partnership between management and stockholders, the fact that a substantial share of gains goes to management does not seem problematic. For example, it is well-known that using stock options as the primary form of executive compensation serves the purpose of focusing a CEO on stock price rather than second best metrics such as earnings or assets. What is less well-recognized is that options also force managers to assume additional risk. As a result, CEOs naturally insist on the prospect of greater returns. In effect, CEOs have bargained for a substantial piece of the action. They have come to insist on returns more consistent with those of a partner rather than an employee. It should thus come as no surprise that success will be more richly rewarded.

In addition, Professor Booth addresses several misconceptions about executive compensation that may be clarified somewhat by the partnership model. First, he shows that in the aggregate, executive compensation (including option-based compensation) has been remarkably stable over the last twenty years, suggesting that the perception of excess may be the result of redistribution and undue focus on those who have gained from the evolution to options. Second, he ar-

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gues that unlike other forms of compensation, stock options are self-regulating and thus inherently less worrisome than other more fixed forms of compensation. Finally, he contends that the partnership model of the corporation sheds new light on the debate over how to account for stock options. If stock options are seen as a way for CEOs and other high-level managers to participate as equity partners in company returns, it makes little sense to treat the grant of stock options as an expense that reduces reported earnings.

I. INTRODUCTION

Executive compensation has always been a problem for corporation law as it relates to publicly traded companies because CEOs effectively set their own salaries. The traditional view is that executive compensation is akin to a duty of loyalty problem, albeit one based on an unavoidable structural conflict of interest.[1] That view is ultimately based on the idea that a corporation is owned by its shareholders. The shareholders elect the board of directors. The board of directors hires a CEO who assembles a management team. Under this view the shareholders are entitled to the return generated by the corporation except to the extent that they may agree to share it with management. In short, the CEO is a hired gun.[2]

To be sure, the board of directors, which has the ultimate authority to decide how much to pay the CEO, is supposed to act as a check on CEO overreaching. As a matter of good practice, the CEO should not be involved in that decision (although presumably the CEO may negotiate on his own behalf). But most boards of directors are handpicked by the CEO and largely are under the CEO's control. Even if the board of directors has a nominating committee or other procedures designed to ensure independence, the relationship between the board of directors and the CEO is not ultimately an adversarial one.[3]

1. For example, the ALI, Principles of Corporate Governance, treats compensation decisions under the duty of fair dealing. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.03 (1994). On the other hand, Delaware law tends to ignore such structural conflicts and to apply the duty of care and the business judgment rule to situations in which conflict is unavoidable. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720–22 (Del. 1971); *see also* Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY L.J. 183, 199–200 (2004); Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 754 (2002).

2. In this essay, I focus on the CEO rather than the entire management team even though compensation problems may extend beyond the CEO. I do so to some extent out of convenience. In other words, one may usually substitute the phrase "management team" wherever CEO appears. On the other hand, the CEO typically presents the most acute compensation problem. First, the CEO typically gets the biggest pay package. Second, and more important, the CEO may serve as an independent arbiter in connection with compensation decisions for all lower-level executives. Thus, the only truly unavoidable conflict of interest problems relate to CEO compensation.

3. The typical board is more an advisory body that seldom meets more than once a month and whose primary function is to advise and monitor the CEO rather than engage in active management. Although the relationship may be acrimonious at times, it is not intended to be so. Teamwork and

The hired gun model is not the only possible view of the relationship between a CEO and the firm he runs. One could just as well characterize the CEO as being in partnership with the shareholders or the company itself. In other words, as under the traditional view, the shareholders may be seen as owning the company and its assets, but the CEO may be seen as a services partner working for a piece of the action—a share of the profits or an ownership interest.[4] There is nothing in corporation law that would seem to prohibit such an arrangement if the parties want it.[5] In fact, the partnership model is a fairly accurate model of the way things really work at many companies. Among the 200 largest publicly traded companies, as much as ninety percent of CEO compensation has come in some form of equity participation.[6] Until recently, most of that compensation came in the form of options. But because of worries that options may have led some CEOs to cook the books or engage in other unsavory tactics, many compensation packages have been modified to include more stock than options.[7]

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consensus are the goal. To be sure, majority rule is the norm, but few decisions are made by a close vote or indeed other than unanimously. Corporation law reflects this ideal in several fairly explicit ways. For example, one of the rare exceptions to the business judgment rule is the failure to manage. Some courts have quite explicitly suggested that directors have a duty to cooperate, and even compromise, with each other. *See, e.g.*, Smith v. Atlantic Props., Inc., 422 N.E.2d 798, 804 (Mass. App. Ct. 1981). Deadlock is grounds for dissolution. *See, e.g.*, MASS. GEN. LAWS ANN. ch. 156D, § 14.30 (West 2005). Indeed, corporation law even presumes that a director who votes against a resolution nonetheless has assented to it unless a formal objection is lodged. *See, e.g.*, MASS. GEN. LAWS ANN. ch. 156D, § 8.24(d) (West 2005). Thus, it would seem that rules designed to foster independence or corporate democracy are ultimately doomed to fail. *See* Henry G. Manne, *Citizen Donaldson*, WALL ST. J., Aug. 7, 2003, at A10.

4. I am not the first to have considered this possibility. *See* Susan J. Stabile, *Viewing Corporate Executive Compensation Through a Partnership Lens: A Tool to Focus Reform*, 35 WAKE FOREST L. REV. 153 (2000). Stabile starts from the premise that partners are free to share gains and losses however they please, and proceeds to analyze the features of partnership that make us comfortable with that arrangement. She argues that if three features of partnership are present in the context of a corporation—meaningful negotiation, sharing of losses, and checks against manipulation of results—we should be as sanguine about CEO compensation as we are about profit sharing in partnerships. (She also makes the independent—and probably obvious—point that compensation arrangements should be judged ex ante rather than ex post.) Although I agree that each of these requirements must be addressed, I would argue that they are addressed in an informed and efficient market composed primarily of diversified investors. In other words, I disagree that a corporation must actually *be* a partnership in order for CEO compensation to be considered as a system of gain sharing.

5. In the alternative, one might view the typical arrangement in a publicly traded corporation as one in which the shareholders rent the corporation's assets to management in exchange for a reasonable return. The rental model is also consistent with the minimal duty to maximize shareholder wealth that is imposed in practice by corporation law.

6. PEARL MEYER & PARTNERS, EXECUTIVE PAY TRENDS 7 (2000) (reporting that among the 200 largest U.S. companies, CEO pay averaged $11.3 million with $1.0 million in cash (9%), $2.1 million in annual incentives (19%), $1.6 million in long term incentives and restricted stock (14%), and $6.5 million in stock options (58%) (as measured by the modified Black-Scholes Option Pricing Model (BSOPM)). Note that BSOPM necessarily understates the aggregate value of options that end up in the money. Accordingly, for those CEOs who end up exercising their options, the average percentage of compensation coming from options will necessarily be much higher. The opposite mix was typical in the 1950s, with salary comprising 80%–85% of total pay. PEARL MEYER & PARTNERS, EXECUTIVE PAY TRENDS 1 (1998).

7. For example, GE and even Microsoft have refocused their incentive compensation plans on grants of stock rather than options. *See* Joann S. Lublin, *With Options Tainted, Companies Award*

One can push the analogy even further. A CEO who accepts compensation mostly in the form of options, in effect, works primarily for a share of the growth of the company—just as a new partner buys into an existing firm in order to gain a share of the profits going forward. As in a partnership, the optionee must make a significant capital contribution to the company when exercising options. To be sure, the CEO need not pony up any money until it is known whether stock price has increased and the options are in the money.[8] Thus, the CEO bears no risk of loss other than the risk of being paid a minimal salary. But that is not an unusual arrangement even in a true partnership following the advent of the LLP.[9] Moreover, the risk of minimal pay may be equivalent to the risk of loss if the CEO could have negotiated for a higher fixed salary. And the risk of being fired may be even more significant than the risk of financial loss that attends a classic partnership. In a partnership one remains a partner even if the business has losses. It is quite unusual for a partner to be fired.[10]

Which view of the CEO's relationship to the company is the more accurate? Which view best comports with what the shareholders want? And, is that the proper criterion? Do shareholders want managers who view themselves as employees working primarily for a salary, or do they want managers who view themselves as partners working for a share of the company? It is not clear that we must choose between these models. The answer may depend on the company. The traditional model may better fit an established company, while the partnership model may better fit a growth company.[11] Or it may be a matter for negotiation. Some executives may prefer to work for a salary and bonus. Others may prefer to work for an ownership interest.

Restricted Stock, WALL ST. J., Mar. 3, 2003, at B1 (documenting the trend away from granting options among twenty-nine major U.S. corporations).

8. If the company does not increase in value, neither will its stock. If the company simply chugs along meeting expectations, stock price should not rise. In effect, the shareholders maintain their capital contribution, and the services partner gets nothing. Of course, stock price may rise because dividends are withheld or because the market as a whole rises. Indeed, for this reason, options may discourage dividends. But it is easy to control for such manipulation, as well as for supposed windfall gains from a rising market (though it is not clear that one should control for the latter).

9. *See generally* Stephen M. Bainbridge, *Contractarianism in the Business Associations Classroom:* Kovacik v. Reed *and the Allocation of Capital Losses in Service Partnerships*, 34 GA. L. REV. 631, 667 (2000).

10. The partnership model is also consistent with increased mobility of the labor force in which know-how and information may be more important than hard assets. The analogy of a law firm partner who is more or less free to move around with her clients comes to mind. A law firm partner is nonetheless somewhat bound to the firm by capital contribution and works in progress. *See, e.g.*, Meehan v. Shaughnessy, 535 N.E.2d 1255, 1261 (Mass. 1989).

11. *See* RIBSTEIN, *supra* note 1, at 196; *cf.* Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 824–32 (1987) (suggesting that takeover defenses such as dual class stock may be a legitimate defense for a growing company that has natural incentives to meet investor demands, whereas such defenses may not be appropriate for a mature company that has little need for new capital and thus need not please the market).

Models matter. Although a model may be developed in an effort to explain a puzzle of academic interest, a model may come to be so accepted that its implications affect the evolution of law. The idea, for example, that a corporation is owned by its shareholders is ultimately a model, but it has real world implications. How we view the relationship between a CEO and a corporation, and the proper function of options within that relationship, may also have real world implications. For example, if options are viewed as a way of working for a share of the business rather than as a substitute for cash compensation, the argument that an option grant should be treated as an expense for accounting purposes makes little sense.

Recent history suggests that the partnership model of executive compensation has been gaining ground on the traditional model.[12] The cynical view of this trend is that it is the result of management opportunism enabled by a variety of accounting and tax gimmicks. But there is another much more compelling view. Indeed, one can argue that the trend toward equity compensation was and is necessitated by the invigoration of the market for corporate control that began in the late 1960s.

II. THE RISE OF OPTIONS AS COMPENSATION

To make a long story short, the rise of hostile takeovers forced CEOs to focus on stock price and ultimately induced a shift to compensation packages heavy on the stock options to encourage CEOs to maximize share value. But the long version of the story is much more interesting.

The story begins with the rise of hostile takeovers, which began in the late 1960s and peaked in the 1980s, though the roots of the takeover movement can be traced to the 1950s. There were three primary factors that fueled takeovers.

The first factor was the growth of highly diversified risk-neutral institutional investors such as mutual funds and pension plans. As is well-known, institutional investors came to dominate the market.[13] What is less well-known is that the rise of diversified institutional investors effectively forced all investors to diversify. Diversified investors avoid com-

12. *See* Stabile, *supra* note 4, at 153–58.

13. Domestically, institutional investors own sixty percent of equities. UNITED STATES CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES 2003, Table 1198 (2002 data). In that calculation, the holdings of nonprofit organizations (which includes the substantial holdings of university foundations, and the like) are grouped with individual investors. Thus, the sixty percent figure is presumably on the low side. To be sure, not all institutional investors are well-diversified. Many company-sponsored pension plans are heavily invested in the stock of the employer company. *See* John Leland, *All the Nest Eggs in One Company Basket: Corning Shows Risk of Betting Fortune on Employer*, N.Y. TIMES, Apr. 11, 2004, at 29 (reporting that nationally about twenty-five percent of 401(k) assets are in employer stock, and 11.5% of 401(k) accounts consist almost solely of the stock of the employer); Gretchen Morgenson, *Lopsided 401(k)'s All Too Common*, N.Y. TIMES, Oct. 5, 2003, at C3.

pany-specific risk and are therefore willing to pay more for a given share of stock as part of a portfolio than is an undiversified stock-picker.[14] Accordingly, diversified investors bid up the price of stocks to reflect the lesser risk assumed, and an undiversified investor must meet that price even though the undiversified investor assumes more risk for the same return. Thus, diversification is not merely a question of style. A rational investor *must* diversify.

The second factor was the development of the junk bond market, which allowed bidders to raise vast sums of cash.[15] The rise of junk bonds was itself fueled in part by the reluctance of corporations to pay dividends (and the concomitant misuse of available cash), as well as the recognition by investors that junk bonds were roughly equivalent to stock with an enforceable promise to pay dividends. If the obligor defaulted, there was always the alternative of a prepackaged bankruptcy in which the holders of junk bonds would get back stock—which was roughly what they had in the first place. The result of this confluence of factors was that corporations came under pressure to become more leveraged or face takeover. Risk-neutral shareholders are indifferent to the increased risk generated by leverage, but they have a strong preference for the increased returns. Thus, a corporation that failed to leverage itself would likely become a takeover target.

A third factor was the formation of conglomerate corporations during the 1950s and 1960s.[16] There were several reasons for the boom in conglomerate mergers including the rise of finance capitalism, the goal of company-level diversification, stock market inefficiencies (or the perception thereof), favorable accounting rules, antitrust policy, and tax laws that strongly favored retention of earnings.[17] But conglomerate corpora-

14. If an investor can command a given level of return while taking less risk, the investor will be willing to pay more for the less risky investment. Thus, a diversified investor will be willing to pay more for a given share of stock than will an undiversified investor.

15. *See* ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS FOR LAW STUDENTS, 401 (3d ed. 2002).

16. *See* ANTITRUST DIV. SUBMISSION FOR OECD ROUNDTABLE ON PORTFOLIO EFFECTS IN CONGLOMERATE MERGERS, U.S. DEP'T. OF JUSTICE, RANGE EFFECTS: THE U.S. PERSPECTIVE, 4–12 (2001), *available at* http://www.usdoj.gov/atr/public/international/9550.htm.

17. *See* Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605 (1981). Aside from the direct benefits of risk reduction, a less risky company can presumably raise capital more cheaply in the market and by using its own stock as currency pass the benefits of risk reduction to each new portfolio company. Thus, there would be a mutual gain from a diversifying acquisition. *See* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 61–74 (1973); David Horowitz & Reese Erlich, *Litton Industries: Big Brother as a Holding Company*, *in* DAVID MERMELSTEIN, ECONOMICS: MAINSTREAM READINGS AND RADICAL CRITIQUES 91 (1970); *cf.* Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974) (rejecting the argument that some companies may be seen as engaged in the business of acquiring others and therefore entitled to keep a disproportionate share of gains attributable to minority shares in freeze-out mergers). Yet another motivation for conglomerate mergers may have been the fact that it was relatively expensive to invest through a mutual fund up to the mid 1970s. Sales loads were as high as 8.5% and brokerage commissions were fixed until 1974 (although some funds had discovered ways to achieve negotiated commissions). RICHARD W. JENNINGS ET AL., SECURITIES REGULATION 647–52 (8th ed. 1998). Thus, it may have been

tions did not serve shareholder interests well, and diversified investors developed a distinct distaste for them.[18] It is much cheaper for shareholders to diversify than it is for companies to diversify. Shareholders can easily adjust the mix of companies in which they invest. Why would they want prepackaged diversification when they could form their own custom portfolio or choose from thousands of mutual funds? Perhaps even worse, management of a diversified company tends to be less focused than that of a company in a single line of business. In other words, the CEO of a conglomerate company tends to be a jack of all trades but a master of none. Finally, market analysts have a tough time setting a value on a collection of companies in a wide variety of businesses.

For all these reasons, the market did not like diversified conglomerate companies and drove down their price relative to more focused companies. Hostile bidders discovered that they were able to sell the pieces of such companies for more than the price of the whole. And with the advent of the junk bond market, they could borrow the money to do it.[19] As a result, most such companies are gone as a result of bust-up takeovers.[20]

One early reaction to the threat of hostile takeovers was the golden parachute, an attractive severance package designed to compensate an ousted CEO for losing his job. Many commentators saw golden parachutes as just another managerial abuse, but some noted that a properly tailored golden parachute would allow management to consider dispassionately the merits of a takeover bid from the point of view of the shareholders.[21] It is a small step from the golden parachute to the stock

cheaper for investors to achieve diversification by investing in a conglomerate company. Tax law also precluded shareholders from forming their own investment companies. I.R.C. § 351(e)(1) (2005). All of this suggests that stock options should have been popular at the time, because they were a relatively safe bet. But it does not appear that they were. Rather, managers seem to have been paid primarily on the basis of aggregate earnings or assets, which effectively rewarded empire building.

18. *See, e.g.*, David J. Ravenscraft & F. M. Sherer, *The Profitability of Mergers*, INT'L J. INDUS. ORG. 7 (1989).

19. There is a potential contradiction here in that I argue that shareholders prefer firm-level leverage but dislike firm-level diversification. There is a good reason for the distinction. Diversification is costless for shareholders, but expensive for companies. Leverage is just the opposite. First, companies can often borrow at lower rates of interest than individuals (though admittedly margin rates are very low). Second, margin borrowing is limited by law. Investors may prefer more leverage than they can legally create on their own. Finally, margin borrowing creates the risk of a disruptive margin call. If a company defaults, the damage is isolated to that one company and does not jeopardize the entire portfolio. Company-level leverage affords a variety of limited liability that is similar to that enjoyed by a parent company that does business through several subsidiaries. Thus, investors presumably prefer company-level leverage.

20. Prominent examples include ATO, ITT, LTV, and Gulf + Western. *See* Geoffrey Colvin, *A Concise History of Management Hooey*, FORTUNE, June 28, 2004, at 166; *Confused Conglomerates*, THE ECONOMIST, Jan. 10, 1987, at 68. *But see* Peter G. Klein, *Were the Acquisitive Conglomerates Inefficient?*, 32 RAND J. ECON. 745 (2001) (arguing that conglomerate diversification may have added value during the 1960s—but not thereafter—by creating internal capital markets); Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413 (1986) (arguing that conglomerate companies may gain by coinsuring debt of diverse acquired firms).

21. Richard A. Booth, *Is There Any Valid Reason Why Target Managers Oppose Tender Offers?*, 14 SEC. REG. L.J. 43 (1986).

option as compensation. If golden parachutes are such a good idea, why not further align management and shareholder interests by using stock options as the primary form of compensation? Incidentally, stock options minimize the need for cash and even raise capital for the corporation upon execution. In any event, managers learned the lessons of the 1980s well, and stock options became the primary form of compensation.

Hostile takeovers may be less common now than they were in the 1980s. The evidence is somewhat equivocal, but the market for corporate control was even more active in the 1990s than it was in the 1980s.[22] The reasons for mergers and acquisitions changed somewhat. Consolidation and competing in global markets became major motivations.[23] Nevertheless, the process of deconglomeration that began with the bust up takeover of the 1980s continued during the 1990s through spin-offs and the issuance of tracking stock.[24] In short, the takeover is not dead. It has just gone in-house. To be sure, one reason may be that potential target managers hope to preempt a hostile takeover. But takeover defenses have become virtually impenetrable. So why does management so often choose to sell? The simple answer may be stock options and the increased equity stake that so many executives have in their companies.

III. PROBLEMS WITH OPTIONS AS COMPENSATION

There is a dark side to the foregoing story. Stock options are not perfect. Even if management could be compensated exclusively with stock, perfect alignment of interests is impossible. Management interest will always diverge from shareholder interest because shareholders are free to diversify. With diversification, an investor can eliminate the risk that some companies in a portfolio will underperform the market. For every company that underperforms, there will be another that exceeds expectations. You win some and you lose some. Only the average really matters.[25]

Thus, a diversified shareholder cares little about risk at the company level. A diversified shareholder prefers that management maximize return even if it entails extraordinary risk. For example, if ten companies each bet the farm on ventures that offer a 50% chance at a 100% return, half will succeed and half will fail. The diversified shareholder will get the expected 50% return. But half of the managers will get nothing (except possibly fired).

22. *See generally* John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837 (1999); John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271 (2000).

23. *See generally* HAMILTON & BOOTH, *supra* note 15, at 317–54.

24. Susan Pulliam, *More Parent Firms Are Setting Units Free,* WALL ST. J., Feb. 3, 2000, at C1.

25. *See* Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (Or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429 (1998).

Management cannot diversify—at least not until options can be exercised. Even then, a manager's human capital is invested in a single venture. Management cannot fully hedge against the risk of failure. Thus, although a diversified shareholder may prefer that management be aggressive about taking on risky new ventures when the potential return is high, management may prefer a merely adequate return (and survival of the business) to a chance at a jackpot. The upshot is that management cares more about how its company performs than shareholders do. Thus, shareholders will have a difficult time inducing management to be sufficiently aggressive unless the rewards are substantial.

Moreover, stock itself has become riskier as companies have become more focused. In the age of conglomerates, a share of stock in a diversified company was rather like a share in a mutual fund. Diversification at the company level tended to stabilize stock price. But with deconglomeration, individual stocks have become more volatile.[26] Thus, the CEO who takes most of his pay in some form of equity suffers the double whammy of having many eggs in one basket and a less sturdy basket to boot.[27]

The bottom line is that the cost of more focused companies is that managers must be compensated for higher risk. And if options are part of the compensation package, a CEO must take more risk for the same return as a diversified shareholder.[28] It stands to reason that a CEO will

26. In addition to the increase in volatility that comes directly from deconglomeration, stocks have become more volatile because of derivative instruments and trading strategies used primarily by diversified investors in connection with portfolio management. Companies have no control over whether their stock will be the subject of options trading or will be stripped and sold in pieces as part of some exotic derivative. And to add insult to injury, many of these investments (and the strategies they allow) are off limits to insiders. *See, e.g.*, Securities Exchange Act of 1934 § 16(a), 15 U.S.C.S. § 78p(a)–(b) (1998) (prohibiting short sales by officers, directors, and ten percent or greater shareholders). Moreover, the addition or subtraction of a stock to an index causes an increase or decrease in price having nothing to do with the fundamental value of the company. These wag-the-dog phenomena do not necessarily justify all of the efforts of management to manage the flow of information and stock price itself, but they do explain such behaviors to some extent. For a notable example of a case in which the court considered and rejected arguments by shareholders based on their peculiarly hedged position in a stock, see H.B. Korenvaes Invs., L.P. v. Marriott Corp., CIV.A. 12922, 1993 WL 257422 (Del. Ch. 1993). *But see* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1386 (Del. 1995) ("This Court has stated that distinctions among types of shareholders are neither inappropriate nor irrelevant for a board of directors to make, e.g., distinctions between long-term shareholders and short-term profit-takers, such as arbitrageurs and their stockholding objectives.").

27. In theory, CEOs could diversify by forming a private investment company and pooling their undiversified equity. But this strategy effectively is prohibited by the I.R.C. as a result of an amendment in 1967. *See* I.R.C. § 351(e)(1) (2005). This change in tax law may have been the result of an effort by the promoters of conglomerate mergers to protect their franchise. If so, it has outlived its usefulness if it ever truly had any. *See* Appendix, Table 2: Mergers, Divestitures & Leveraged Buyouts—1980 to 2003 and accompanying graph.

28. One way to measure this risk might be to compare the number of companies reporting income and loses in any given year. The ratio is something like the odds of winning a bet. There appears to be at least a rough correlation between years in which compensation as a percent of total income is relatively high and years in which the percent of companies with losses and losses as a percent of income is high. *See* Appendix, Table I: Compensation of Officers—1980 to 2000 (see columns Compensation as Percent of Net Income (All), Percent of Companies with Loss, and Losses as Percent of Income). On the other hand, one would naturally expect some correlation. Perhaps more telling is

negotiate for more options as compensation for added risk, and that public companies will come to be owned increasingly by management. Therefore, it should not come as a surprise that pay packages have grown significantly.[29]

IV. THE COMPENSATION CONTROVERSY

It seems clear from the foregoing that shareholders today are seldom satisfied with bureaucratic management. A diversified shareholder has a strong preference for a CEO who acts like he owns the company—or at least like an equity partner. Thus, shareholders should be willing to pay the CEO accordingly. Indeed, if you want a CEO to act like an owner, the CEO should have a meaningful equity stake in the company. To paraphrase Michael Jensen and Kevin Murphy, "If you pay a CEO like a bureaucrat, he will act like a bureaucrat."[30]

Shareholders should recognize the need to pay CEOs more. But it is legitimate to worry about how much more. Substantive regulation of the amount of pay—for example by the courts—is unlikely to work. Thus, the controversy has focused on process, disclosure, methods, and measurement. Some of these efforts have been more controversial than others. Undoubtedly the most controversial proposed reform has been

that the yearly coefficient of variation (standard deviation / mean) for officer compensation in companies with income is 0.122% while it is 0.330% in companies with a loss. In other words, compensation varies year to year in companies with losses by nearly three times as much as it varies in companies with income, which clearly demonstrates that the risk born by officers is significant. Moreover, officer compensation in companies with losses varies more than the number of companies with losses varies, though less than the amount of loss as a percent of income varies. This is precisely the pattern that would seem desirable in that it indicates that officers would suffer lower pay a bit more from poor performance relative to the market as a whole, but would not suffer quite as much from marketwide conditions that cause large aggregate losses. On the other hand, management has a variety of ways that it can reduce the risks of options and indeed stock ownership. Insiders are privileged to use inside information in deciding *not* to buy or sell. *See* Jesse M. Fried, *Insider Abstention*, 113 YALE L.J. 455, 455 (2003). And indeed the rules against insider trading have been somewhat softened for management shareholders. *See* SEC Rules, 17 C.F.R. § 240.1065-1, 240.1065-2 (2004); *cf.* SEC v. Adler, 137 F.3d 1325, 1337–38 (11th Cir. 1998). It has also been suggested that one reason for the boom in options is that management is largely free to coordinate the grant and exercise of options with lows and highs in market price which themselves are somewhat controllable by management. *See* Charles M. Yablon & Jennifer Hill, *Timing Corporate Disclosures to Maximize Performance-Based Remuneration: A Case of Misaligned Incentives?*, 35 WAKE FOREST L. REV. 83, 86–87 (2000). Both of these practices are akin to insider trading. Then again, some commentators have argued that insider trading may be seen as a legitimate form of compensation under many circumstances. *See* Richard A. Booth, *Insider Trading, Better Markets*, WALL ST. J., June 28, 1991, at A12; Henry G. Manne, *Options? Nah, Try Insider Trading*, WALL ST. J., Aug. 2, 2002, at A8.

29. Incentive compensation is more important in a publicly traded company than it is in a closely held company. Obviously, those who manage a closely held company usually also own a large stake and keep the returns from it. But both managers and passive investors in a closely held company are usually undiversified and therefore risk averse. They do not necessarily favor high-risk profit maximization over pursuit of a merely adequate return at lesser risk.

30. *See* Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay but How*, HARV. BUS. REV., May–June 1990, at 138; *see also* Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653 (1998) (discussing increase in option compensation in the 1990s which—notably—followed the Jensen and Murphy article).

to require that the grant of stock options be treated as an expense for income statement purposes.[31] It is remarkable that debate over an accounting rule can be so passionate, but the stakes in this case are high. Although many critics appear to believe in good faith that options should be expensed as a matter of good accounting practice, there is little doubt that many think that expensing will serve to limit the use of options by forcing companies to report lower earnings. To be sure, options have been less in the news in the last few years because of the bear market.[32] But as the market recovers, they have emerged from hibernation. And on March 31, 2004, the FASB once again proposed a rule requiring the expensing of options.[33]

The remainder of this section addresses three discrete misconceptions swirling around option-based compensation. First, despite perceptions to the contrary, executive pay has not increased significantly as a percentage of corporate income in the last twenty-five years.[34] Indeed, it has arguably declined. Second, executive pay is not out of control. Although it is difficult say how much is too much when it comes to a traditional salary and bonus, there are natural limits on stock options that make them effectively self-regulating. Third, option grants do not need to be treated as an expense for accounting purposes. To do so complicates rather than simplifies financial reporting and its interpretation.

A. The Amount of Executive Compensation

As in the classic case *Rogers v. Hill*, the complaint seems to be that executive compensation has *become* excessive because the mechanisms by which pay is calculated (primarily stock options) are somehow defective.[35] Management appears to have lost the knack for self-control and independent boards of directors appear to have been captured by ever more powerful CEOs. Although executive compensation should be regulated by the market, takeover defenses are formidable. Moreover, there may have developed a self-reinforcing pay race to the top in which each subsequent CEO cites the salary of the last CEO as the number to beat. Thus, even a truly independent compensation committee advised by a high-priced compensation consultant will find it difficult to discern an objective standard by which to set CEO compensation. There appears to be no natural upper limit. The situation smacks of market failure and suggests that CEO compensation must ultimately be limited by

31. *See* Iman Anabtawi, *Secret Compensation*, 82 N.C. L. Rev. 835 (2004).

32. *See* Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating the Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. 971, 973–75 (2004).

33. EXPOSURE DRAFT, Proposed Statement of Financial Accounting Standards, Share-Based Payment No. 1102-100, § 15 (Financial Accounting Standards Bd. 2004).

34. *See* Appendix, Table 1: Compensation of Officers—1980 to 2000.

35. Rogers v. Hill, 289 U.S. 582 (1933).

some externally imposed rule of reason. But the courts have effectively washed their hands of the matter.[36] In short, the situation appears to be desperate.

There can be no dispute that some CEO pay packages appear to be astronomical. The fact is, however, that executive pay has been remarkably stable when measured as a percentage of corporate income. Table 1 is based on corporate tax returns for the period 1980 to 2000 and sets forth aggregate reported corporate income for U.S. corporations with assets of $250 million or more and aggregate reported officer compensation (both in billions of dollars).[37] The table also shows income and officer compensation separately for companies with and without income. Finally, the table shows officer compensation as a percentage of corporate income and loss. Note that under the Internal Revenue Code (I.R.C.), officer compensation includes gains from the exercise of stock options (which are deductible by the corporation). Thus, corporate tax returns provide a ready source of data on total officer compensation which is difficult to assemble from SEC filings that report compensation in a variety of categories and may or may not include information about the exercise of options. It is also worth noting that the number of corporations with assets of $250 million or more closely tracks the number of publicly traded companies, rising from 2877 in 1980 to 10,883 in 2000.

As Table 1 shows, total officer compensation among companies with income has been remarkably stable during the period between 1980 and 2000, averaging 5.8% of income, with a high of 7.5% in 1992 and a low of 4.6% in 1980 and 1981. Clearly, management compensation has not increased as a percentage of shareholder return. Indeed, the table also shows that total officer compensation has been on a downward trend since 1982. The implication is that compensation going to officers at companies that lost money has in fact declined as a percentage of the total. What accounts for perceptions to the contrary? There are several possibilities.

First, the critics of executive compensation have focused on absolute numbers rather than management share. Aggregate income of the subject companies increased by 621% between 1982 and 2000. During the same period, aggregate officer compensation increased by 423%. To be sure, the figures are closer if one compares the change from 1980 to 2000, but it is arguable that numbers from before 1982 are skewed by abnormally high interest rates and a moribund stock market. As I argue below, it may be that corporate income has grown *because* incentives have grown.

36. *See* Glazer v. Zapata Corp., 658 A.2d 176, 183 (Del. Ch. 1993).

37. *See* Appendix, Table 1: Compensation of Officers—1980 to 2000. Data in the table is taken from I.R.S., *Corporation Source Book of Statistics of Income 1980 Through 2000*. This publication is available online for tax years 1994 through 2001 *at* http://www.irs.ustreas.gov/taxstats/article/0,,id=96249,00.html.

Second, it may be that the distribution of compensation has changed. If options are the primary form of compensation, then winners get more and losers get less (as a percentage of the pot). In other words, pay may have been redistributed from companies that underperform the market to companies that outperform the market. Minimal pay at a company whose stock is flat does not make the news. But a doubling or tripling of pay at a company whose stock has beaten the market makes headlines. Moreover, the greater the proportion of pay that is taken in options, the more risk the recipient assumes. Again, as of 2001, CEOs of the 200 largest U.S. companies took about ninety percent of their pay in some form of equity and most of that in options.[38] It thus stands to reason that one who accepts options as compensation will insist on a lot of them. By the same token, it is unfair to view gain from options as the dollar-for-dollar equivalent of cash pay. Part of the gain is compensation for risk. And although one hears plenty about those who win, there are plenty of losers too. The last two columns of the chart show the percentage of companies with a loss and the aggregate loss as a percent of income. The ratio of income to loss is a rough surrogate for the odds of management success in any given year. For example, in the year 2000, the last year for which data is available, 24.7% of companies reported no income compared to 21.0% the prior year. In other words, the odds that a given company would have a profitable year dropped from about four in five in 1999 to about three in four in 2000. But aggregate pay increased during the same period from 7.7% of income to 8.3% of income. Thus, pay tends to be higher as a percentage of net aggregate income in years in which the odds of success are lower, which is precisely the relationship one would want to see if pay is designed to encourage managers to assume risk.[39] Finally, it may be that CEOs have come to command a larger portion of the pay within individual companies. Perhaps the number of officers has been reduced or CEO pay has risen while the pay of lesser officers has remained flat.

Third, many critics have focused on the discrepancy between CEO pay and the pay of lower-level employees. But it may not be entirely fair to compare the pay of a CEO even to that of a lower-level officer. To some extent, a CEO is paid for perseverance—for making it to the top. The prospect of a significant bonus creates competition. Lower-level officers work harder than they otherwise might. So some portion—perhaps most—of a CEO's pay should be viewed as winnings from an office pool. It is not necessarily clear that this system of jackpot compensa-

38. *See* Appendix, Table 1: Compensation of Officers—1980 to 2000; *see also* I.R.S., *supra* note 37, *at* http://www.irs.ustreas.gov/taxstats/article/0,,id=112834,00.html.

39. Yet another way to see this relationship is to compare the standard deviation of pay as a percentage of income (0.7% on a median of 5.8%) with the standard deviation of the percentage of companies with losses in a given year (8.3% on a median of 26.3%).

tion is optimal, although it seems to be the norm in many other settings.[40] CEOs undoubtedly want some security, and lower-level officers and employees presumably want incentives. It is unclear what the mix should be. But it is quite clear that we should give companies wide berth in devising incentive compensation.[41]

Although it is not at all obvious that executive compensation is excessive, many critics cite two specific problems with the way option plans work, asserting that option plans tend to inflate the amount of compensation.

First, many critics argue that because stocks tend to rise and fall with the market, options tend to overcompensate management when the market is rising. Thus, they argue that options should be indexed—that the exercise price should be adjusted upward (or maybe even downward) by whatever percentage the market has moved. At least a few companies have modified their option plans accordingly.[42]

Commentators have also argued that conventional nonindexed options are exceedingly expensive for the granting company because a successful company ends up issuing very valuable shares at a fraction of the price for which they could be sold to investors. Saul Levmore notes that indexed options should be cheaper for the paying company because employees would avoid the risk of a falling market and would therefore be willing to accept fewer options.[43] As he also notes, many commentators have cited accounting rules and tax law as explaining this seemingly counterproductive compensation strategy, though he doubts, as do I, that either of these explanations is adequate.[44] Ultimately, Levmore concludes that the relative unpopularity of indexed options is attributable to the fact that they would lead employees to pursue excessively risky strategies in an effort to beat the market and would often result in rewarding employees (or some of them) even though shareholders (and possibly other employees who accept conventional options) lose.[45]

40. One of the dangers of jackpot compensation is that observers—including shareholders and fellow employees—will confuse ex post results with an ex ante bargain. We can all be envious of the guy that wins, but it is important to recognize the emotion for what it is.

41. Many high technology companies spread the wealth of options quite broadly and thus use many more options. To require that a grant of option be treated as an expense may therefore skew the competition between various forms of compensation. Indeed, the relatively high level of employee ownership in high technology companies may constitute the emergence of a new form of organization akin to partnership in which stock ownership (or option holding) serves as a surrogate for fiduciary duty or intellectual property law. Moreover, options are cheap and tax efficient, and may serve in part to minimize the capital needs of a new business. Thus, the greater danger may be that compensation models will be standardized and that companies that want to follow a different drum beat will be forced into a traditional compensation scheme. If so, we should not use accounting rules to stack the deck in favor of one model or the other.

42. *See* Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. PA. L. REV. 1901, 1906–07 (2001).

43. *Id.* at 1916, 1920.

44. *Id.* at 1908–15.

45. *Id.* at 1922.

I think Levmore is correct, but that the explanation can be simplified. The problem with indexing is that only the half of managers whose stock beats the market average in any given year would be rewarded. Indexing would dramatically increase the risk of accepting options—especially if not indexed on the downside—and would mean that a CEO would insist on more options. Shareholders would not likely be any better off.[46] Moreover, there is no reason to think that only those CEOs who do better than the market average are doing their job well. No one claims that corporate executives, like the children of Lake Wobegone, are all above average.[47] If corporate profits were a zero sum game, then it might make sense only to reward those who beat the average. But even below average performance adds to shareholder wealth. There is nothing magical about the median. Finally, as Levmore also points out, indexing exacerbates the CEO's problem in fully diversifying.[48] In other words, indexing would further disconnect the fortunes of CEOs and shareholders. It would in effect force the diversified shareholders' *weltanschauung* on CEOs rather than respecting the bargain they would more likely make with each other as partners. Thus, conventional non-indexed options are more consistent with a partnership-like relationship between CEOs and shareholders.[49]

Second, many who generally favor option-based compensation question the practice of repricing. For example, if stock price falls some time after a grant of options, the company may reset the exercise price of existing options to the new lower market price. As one might expect, the critics argue that repricing rewards managers even if share price falls.[50] The argument is somewhat disingenuous. Repricing does not in itself constitute a reward. Rather, it is a second chance. Moreover, repricing usually comes at a price. Typically, a manager must accept fewer shares, an extended vesting period, or both. Thus, a repriced option is really a new grant.[51] Finally, repricing is not necessarily inconsistent with the

46. In addition, there is a serious practical problem with indexing. Different companies follow the market to different degrees. If one compares established companies to the entire market, such companies almost always underperform the broader market when stock prices are generally rising. If one compares companies industry-by-industry, then high-risk ventures must not only beat the market, they must beat the higher average rate of return in high-risk industries even though the chances of total failure and bankruptcy are very real and mere solvency may be seen as success.

47. GARRISON KEILLOR, LAKE WOBEGONE DAYS (1985).

48. Levmore, *supra* note 42, at 1919.

49. Levmore also discusses the effects of options as a bonding mechanism within the firm, which is quite consistent with my argument that companies often go public not so much to raise capital as to gain access to the market as an independent pricing mechanism to which all employees may refer. *Id.* at 1907.

50. A critic might argue further that an executive whose stock has fallen should be punished rather than given a second chance. But the fact that a disappointed executive has had to work for only a fraction of expected pay is probably penalty enough even if there is some chance to make it up in the future. Moreover, the reward from options is variable. A stock that beats the exercise price by a few cents will not generate much of a gain.

51. Nevertheless, repriced options must be expensed under existing FASB rules. *See* ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Financial Accounting Standards No.

idea of options. It is important that options and other incentives be reset periodically. It is those that are not that turn out to be abusive (as is illustrated in *Rogers v. Hill*).[52] Again, it is common in a partnership for partners to renegotiate periodically the way they share the gains. Thus, repricing may be easier to understand if one thinks of a CEO and the shareholders as partners.

Admittedly, the arguments against indexing on the upside would also seem to argue against repricing on the downside. But it does not necessarily follow that repricing is abusive just because indexing is a bad idea. The truth is more complicated. If the market as a whole falls (as we have seen that it can), it takes most stocks with it. Thus, options may fall far out of the money for reasons having nothing to do with bad management. Moreover, even if the market price has fallen while the rest of the market has risen, who is to say that a stock's price might not have fallen even further but for the efforts of the management team? Indeed, it is arguable that a well-crafted option plan should be indexed downward but not upward.

Finally, options entail more risk for managers who cannot diversify than for shareholders who can. Repricing may thus be seen as a way of managing the risk faced by managers and, in fact, making their position more consistent with that of shareholders. Diversified shareholders do not really assume the risk of business failure. It is not clear that an optimal compensation system requires that managers must do so. For example, a CEO might agree to accept a smaller number of options in exchange for some protection on the downside. Even if management is responsible for the decline in the stock price, it is not obviously abusive for the board to grant additional options as an incentive to reverse the decline. Indeed, it may be important to offer a bigger stake if the company is playing catch up. Indexing could in theory avoid the need for repricing but at the cost of eliminating any reward on the upside for good performance that falls short of beating the market average.

There are no easy answers here. In the end, the wisdom of repricing is a decision that must be trusted to the sound business judgment of the board. After all, the board can always sack the CEO, and does so from time to time. But incentives usually work better than penalties. Again, although repricing seems inconsistent with the hired-gun management model, it is much more palatable if one views the relationship between the CEO and the shareholders as a partnership.

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123 (Financial Accounting Standards Bd. 1995). The need for repricing often stems from some limitation on the number of shares authorized in the articles of incorporation or the stock option plan. *See, e.g.*, Lewis v. Anderson, 692 F.2d 1267, 1269 (9th Cir. 1982). Repricing may also be a way of avoiding the appearance of making an unusually large grant following a decline in market price.

52. Rogers v. Hill, 289 U.S. 582, 591 (1933) ("[T]he payments under the by-law have by reason of increase of profits become so large as to warrant investigation in equity in the interest of the company . . . . [The by-law] . . . cannot . . . be used to justify payments of sums as salaries so large as in substance and effect to amount to spoliation or waste of corporate property.").

B. Self-Regulation and Optimal Incentives

Even if management effectively sets its own pay, it does not follow that executive compensation is out of control. One of the distinct advantages of options as compensation is that they are self-regulating. No rational CEO would ever seek so much in options that the grant would depress the price of the company's stock. Aside from the fact that it would reduce the value of the options themselves, the company would be that much more exposed to takeover because of a lower stock price. Rather, an utterly self-interested CEO would seek options that would maximize gain by balancing the forces of dilution against anticipated increases in stock price.[53] This is not to deny that sometimes companies may propose plans that are too rich, but the market will likely veto any such plan.[54]

53. One might think that any grant of options would have the effect of depressing stock price simply because of potential dilution. But an option will be exercised only if the price of the stock rises. Thus, there is no danger of dilution unless the price rises and no reason for the mere grant of options at market to ever cause the price of a stock to fall. (On the other hand, one might argue that a stock's price inherently includes anticipated future price increases, and that a grant of options could thus depress stock price. This is a classic example of "double think." To the extent that the price of a stock reflects anticipated future growth, it is already impounded in the stock price. Furthermore, growth will result in further increases in the future.) As time passes, however, dilution becomes a concern because in-the-money options are likely to be exercised and to dilute per share returns (irrespective of how they are reported). On the other hand, exercise entails payment of the option price to the corporation and increases firm value accordingly, but never by quite enough to counter fully the effects of dilution.

There are two ways to deal with this problem. One solution is to do nothing. As long as earnings per share meet expectations, there should be no adverse effect on stock price. In other words, sometimes a company will be able to absorb the effects of dilution. Another, more common, way to deal with dilution is to repurchase stock (either directly or by using various derivative strategies). By reducing public float, a company may eliminate the effects of dilution. It is even possible by such means to report higher earnings per share and thus (presumably) to cause the stock price to rise, making options that much more valuable. While such practices are common—at least to the extent of countering dilution—they have been criticized strongly as the next thing to insider trading when used to prop up or enhance market price (even though the practice is perfectly legal). *See* Jesse M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421 (2000) (discussing repurchase tender offers); *see also* Bebchuk et al., *supra* note 1, at 796–824. Such practices may also be viewed in a much more positive light as part of a complex self-regulating system of executive compensation. There is a limit to the amount of cash available to management for use in countering the forces of dilution. For example, it was reported in one recent year that Microsoft had used cash in an amount roughly equal to two-thirds of the year's earnings to repurchase stock and equivalents in connection with managing dilution. Roger Lowenstein, *Intrinsic Value: Microsoft and Its Two Constituencies*, WALL ST. J., Dec. 4, 1997, at C1.

Presumably, management has every incentive to modulate option grants in accordance with the cash available to counteract dilution as well as the other cash needs of the business. It also bears noting that management must fight dilution whether or not options are exercised. Thus, a fair amount of planning is required. Accordingly, one could argue that investors should view a generous grant of options as a positive signal of the prospects of the company rather than a sign of reprehensible management opportunism. Options effectively force companies to distribute available cash through repurchase, thus achieving one of the ultimate goals that motivated many hostile takeovers in the 1980s. (Most commentators favor repurchases over dividends as a more efficient mode of distribution, although the arguments for repurchases are somewhat less powerful now that the tax rates applicable to dividends and capital gains have been equalized). The use of options as compensation thus tends to foster a liberal distribution policy in addition to beneficial company-level strategies such as spin-offs. To be sure, options may discourage the payment of dividends, because dividends have the effect of decreasing stock price. Thus, a well-crafted option plan should provide for adjustment of exercise

The traditional salary and bonus system of compensation is difficult to calibrate. Salary comes off the top and is payable whether or not the company makes money. A bonus also comes off the top, but it may or may not be commensurate with the recipient's estimate of her worth. Thus, salary carries the chance of overcompensation, whereas a bonus carries the chance of undercompensation. In contrast, an option has no value in the end unless the price of the stock rises. Furthermore, it comes out of the pot of gains to be shared with shareholders precisely in proportion to the gains enjoyed by shareholders. An optionee knows the bargain up front. Accordingly, options encourage goal setting. And an optionee can calculate the interim value of an option with great precision. People like to see the fruits of their labor and a connection between pay and performance.[55] Options avoid the danger of disappointment (other than as may be caused by uncontrollable circumstances or the market at large) and the natural tendency to discount the value of the reward for the chances that it might not be paid.[56] In short, compensatory stock options may be seen as a bonding mechanism that substitutes to some extent for the ability of partners in a true partnership both to bargain with each other over gain sharing and to monitor partner performance.

There are additional serious problems with the way bonuses are often calculated. To pay management on the basis of some artificial and manipulable number like earnings or sales invites invidious gaming.[57] For example, in one notable case, American Express held stock in Donaldson Lufkin Jennrette (DLJ) which had declined in value. American Express could have sold the stock and taken a nice loss for tax purposes, but to do so would have resulted in a reduction in earnings. Instead, American Express distributed the DLJ stock to its own

price for any dividends paid. Otherwise, the plan may skew management incentives to pay dividends. To be sure, one might argue that the system of self-regulation described here could conceivably allow for option grants that are so generous as to permit all of a company's return on equity to be distributed as compensation or antidilution repurchases. But is that necessarily a problem? Again, the partnership model—or something similar to an open-end fund comes to mind—where the firm may be seen as in a continuous process of settling up with investors who are free to come and go. That is possible only because of the continuous cash infusion from the exercise of options and antidilution measures.

54. Despite the recently imposed requirement of a shareholder vote in connection with the adoption or modification of any equity compensation plan, it seems unlikely that shareholders will often get the chance to vote down a plan that is too rich. Disclosure of plan terms in proxy materials will likely cause the market to react negatively to any plan that is too rich before the proxy cards are even in the mail. The fact that detailed disclosure of plan terms has been required anyway since 1992, may explain why there was little objection to the idea of a required shareholder vote for stock option plans. Self-Regulatory Organizations, Exchange Act Release No. 34-48108, 68 Fed. Reg. 39,995 (July 3, 2003).

55. Indeed, one of the major motivations for tracking stock has been to facilitate option plans that are more specific to discrete operations.

56. One of the fundamental problems with the traditional law firm reward structure is the fact that partnership may not be bestowed even on an associate who makes the requisite contribution to firm value unless the partners are willing after the fact to share the wealth.

57. To calculate a bonus on the basis of stock appreciation is simply an ersatz stock option that freights in all the problems of true stock options without many of the benefits.

shareholders as a dividend and sacrificed a significant tax benefit.[58] Management argued that the market would react adversely if the loss were taken (as if the market did not already know what the DLJ stock was worth). As it turned out, the American Express bonus plan paid management based on earnings.

Stock options focus management attention where it belongs—on maximizing the value of the company rather than on second-best indicators like sales or earnings. It is difficult to believe that so many companies in the 1990s would have been so quick to spin off underperforming divisions, or to split themselves into pieces, if management had not been induced to maximize share price by taking most of its compensation in the form of options. Again, a partnership analogy comes to mind. It is relatively easy to dissolve a partnership and divvy up the assets. Thus, a partnership tends to be a much more fluid collection of assets.

In any event, it would seem counterproductive to discourage the use of options in favor of basing compensation on some highly manipulable number like earnings, particularly at a time when earnings manipulation seems to be the real problem. Indeed, because stock options ultimately depend on the stock market, which is exceedingly difficult to manipulate, they are essentially self-regulating. That is not to say that managers do not try to fool the market. But it is unclear that they often succeed. To be sure, this may sound like a strange claim in the wake of Enron, World Com, and other corporate scandals. But it is not necessarily the case that the market was wrong about those companies given the false information they disseminated. Lying is one thing. Manipulation is another.

Some critics have asserted that the problem with options as compensation is the options themselves. The argument—which is not without irony—is that because options are risky, too many must be granted to substitute for cash compensation. The better argument is that focused management assumes more risk and therefore requires more return. Nevertheless, it has been suggested that payment in stock (which is reported as an expense) would make more sense because it would give management the same kind of stake as an investor.

The argument misses a key feature of stock options. It is not enough that management merely maximizes stock price. Rather, investors expect ever increasing stock prices. After all, to hold is to buy. Thus, the question every investor asks of management—no matter how

58. *See* Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 809–11 (Sup. Ct. 1976). Similarly, a CEO whose compensation is based on sales may be inclined at the extreme to sell goods at a loss. (Such tactics led to the downfall of Sunbeam. *See, e.g.*, Martha Brannigan, *Sunbeam Audit to Repudiate '97 Turnaround*, WALL ST. J., Oct. 20, 1998, at A3.) Or the CEO of a bank whose compensation is based on the dollar amount of loans outstanding may be tempted to make loans at below market rates. *Cf.* Joy v. North, 692 F.2d 880, 883 (2d Cir. 1982). It recently has been reported that officers at Shell Oil Company may have been motivated to overstate oil reserves in part because of the bonus system there. *See* Chip Cummins et al., *SEC Examines Shell's Bonus Awards*, WALL ST. J., Mar. 11, 2004, at A3.

successful it has been in the past—is "What have you done for me lately?" The best way to induce management to increase stock price is stock options. In contrast, with a grant of stock, management assumes the risk that stock price will fall—and not simply fail to increase. The incentive created by a grant of stock is thus somewhat ambiguous. At the very least, management will have some interest—and perhaps an overriding interest—in undertaking conservative strategies designed to maintain stock price. In the context of a bear market, creating incentives to maintain stock price may sound like a pretty good idea. Then again, if one is interested primarily in safety of principal, or even a reliable return, there is always the bond market. It makes no sense to invest in stock unless one seeks a higher return. So it makes no sense to create incentives for management to pursue a conservative strategy. Here again, investor diversification is key. A diversified investor prefers that each portfolio company maximizes return even if it means that a few may go belly up. If one is adequately diversified, the winners will usually outperform the losers by more than enough to generate a superior return. Most CEOs would not be disinclined enough to bet the farm as often as investors like if it were not for stock options.

A proposal that is closely related to the idea that stock grants should be favored over stock options is that CEOs (and presumably other high-ranking officers) be prohibited from selling option shares until they leave office.[59] Those who favor such lock-ups agree that diversification is dandy for employees and other investors. But they seem to suspect that diversification is an excuse for CEOs to take the money and run. There is some merit in this argument. Although rational investors diversify, they also prefer managers who are focused on the business and not on some market index. On the other hand, a CEO who sells his shares still has much of his wealth—not to mention virtually all of his human capital—invested in his company: There are always more options waiting to mature or be granted. Requiring a CEO to retain option stock increases the risk inherent in accepting options as compensation. Other things being equal, if one must assume more risk, one will insist on more return, or the prospect of it. The bottom line is that requiring a CEO to retain option stock will cause the CEO to demand more options.[60]

Moreover, CEOs (and anyone else to whom the rule applies) will be forced to resign in order to cash out. Or companies will turn to contrac-

59. Senator John McCain of Arizona has been a particular advocate of this reform. *See The McCain Solution* (July 12, 2002), *available at* http://www.salon.com/politics/feature/2002/07/12/mccain/index.html?cp=rdf&dw=310.

60. Aside from the foregoing, the difference between market price and the price paid for option shares is taxable income. How is one to pay the taxes without selling some shares? Ask anyone who exercised options in early 2000 and did not immediately sell enough stock to pay the tax on the gain. When NASDAQ collapsed many found that there was not enough value left in the stock they owned even to pay the tax they owed. Many ended up in bankruptcy court. Gretchen Morgenson, *Some Suffer Tax Hangovers from Microsoft Option Spree*, N.Y. TIMES, Apr. 18, 2001, at A1.

tual devices like stock appreciation rights or will begin to grant shares outright, neither of which gives the company an infusion of cash. Again, the cure may be worse than the disease. The critics seem to think of the typical CEO as an opportunist with a congenital end-period mentality. But there is no reason to think that options somehow create an incentive to cash out and abandon the company to bankruptcy. Does anyone really believe that Ken Lay and Bernie Ebbers actually intended to destroy their companies?

Others have argued that stock options lead to a focus on short-term performance. This is a peculiar argument when it comes from a shareholder activist, because options are designed to make management more responsive to shareholders. There is, however, some historical consistency to this argument when it comes from those who doubted the benefits of takeovers, which they saw as preventing management from focusing on long-term prospects. So to the extent that stock options make managers more responsive to the demands of the market, there may be some truth in this argument. But there are also reasons to think that options encourage management to take a long view as well. Most options may only be exercised after a period of a year or two or three. Thus, a rational manager would prefer steady growth over time rather than opting for accounting treatment that maximizes immediate quarterly performance at the risk of volatile future earnings. Of course, the market itself may be focused on short-term performance, which may in turn require managers to do so. But that is not a problem with options as compensation. Rather it is responding to what investors want. In any event, options seem more likely to be a cure for the short term view rather than an exacerbation. And indeed studies seem to indicate that CEOs who are heavily paid in options are more likely to retain underperforming operations.[61] To be sure, this seems to contradict somewhat the notion that

61. *See generally* John C. Coates IV & Reinier Kraakman, *Valuing Stock-Based Compensation: Executive Pay and Merger Activity in the 1990s* (forthcoming) (addressing the effect of compensating options and golden parachutes on the tendency of target management to sell); *see also* Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002) (arguing that manager and stockholder interests still diverge in takeover context and that executive compensation schemes cannot be relied on to eliminate such agency problems). *But see* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 908 (2002) ("Most stock option packages vest immediately in the event of takeover, which may provide substantial gains to executives in the event of a premium acquisition; golden parachutes, too, can provide extremely large side-payments to managers in the event of takeover. If stock options and parachutes are sufficiently large, managers would use defenses to gain bargaining power but in the end would prefer to sell rather than remain independent."); Marcel Kahan & Edward Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002) (arguing that stock options reduce incumbent tendency to resist takeover).

The tendency of target CEOs to resist takeover may be somewhat off the point, because takeover may mean retirement. Thus, it is not clear that studies focusing on mergers or takeover resistance truly speak to the point of whether a CEO who is heavily compensated with options is or is not more inclined to divest underperforming operations, although one might argue that the tendency to hold on

options encourage divestitures. But that is not necessarily so. Divestitures were relatively rare prior to 1983 and rose steadily to a peak in 1988. The rate of divestiture has more or less stabilized since that time but at a higher average rate. That pattern is perfectly consistent with the idea that a CEO today is willing to consider divestiture but may also retain an operation that carries the prospect of improvement and sale at a still higher price in the future. There is no reason to think that stock options should disincline a CEO to shed operations whose performance cannot be improved at a profit.

Finally, some critics have gone so far as to suggest that management will find ways to manipulate stock price downward prior to grant and upward prior to exercise. Of course, manipulation and insider trading are illegal under existing law. Still, there may be some timing issues around the edges. Management may seek to have options granted when it thinks that the company's stock is trading at a low. Indeed, there is evidence that options are granted disproportionately at market lows. Then again, that may be the most appropriate time for a grant. Moreover, it sends a signal to the market that management has enough confidence in the company to accept a portion of its pay in options, and one would think that the market should be pretty good at analyzing such signals. Discouraging the use of options would thus seem to chill an important source of soft forwarding-looking information.

C. Accounting Treatment

The most persistent complaint about options is that there is no requirement that their grant be recognized as an expense for accounting purposes. The seemingly simple argument is that options are a substitute for cash compensation and should therefore be reflected as an expense that will reduce earnings. This argument assumes that the CEO is a hired gun paid with other peoples' money. The argument sounds like nonsense if one thinks of a CEO as a partner. Indeed the argument is nonsense. The hidden agenda of the advocates of expensing is that option grants are too rich and that if the company was required to recognize an expense (which would reduce earnings and presumably cause stock price to fall), boards of directors would be far less generous.[62] The argument is misguided on many levels.

First, and most generally, aside from the difficulties inherent in expensing options (more below), it is not clear that options do have a cost. An option will be exercised only if the value of the underlying stock increases. Who is to say that the rising stock price is not the result of the

to such operations is somehow enhanced by the prospect of receiving options when such operations drag down stock price and exercising them after they have been rehabilitated or spun off.

62. Holman W. Jenkins, Jr., *Sound, Fury and Stock Options*, WALL ST. J. Apr. 21, 2004, at A19; Lublin, *supra* note 7, at B1.

added incentive created by stock options? Do options have a cost if shareholders also enjoy a gain as a result? On the other hand, an option that expires unexercised presumably costs the company nothing even though it may be required to recognize an expense under the new world accounting order. Will the company recognize income if its stock price remains flat and options are never exercised? It will indeed have received services for free—ask any engineer or programmer whose options are currently deep under water. Clearly, options have a cost but they do not necessarily constitute an expense. Options carry a cost in the sense that a big piece of the pie goes to management. But how big would the pie be without the options? Would the gains be there if management did not have the incentive to generate them?

What the reformers may really want is a hard number (however soft it may be) that represents the slice of the pie taken by management. In other words, the ultimate goal may be to expose what they view as excessive compensation that might have been added to shareholder return. One could make many of the same arguments about a traditional salary and bonus. If the CEO were not well-paid, the company might not have fared so well. The difference is that a salary gets paid no matter what, while options get exercised only if stock price rises. Thus, one might argue that salary should be expensed up front when the company assumes the obligation to pay it. Ironically, recent changes to the I.R.C. require that salary payments in excess of $1,000,000 per year be tied to performance in order to be deductible.[63]

Second, no one ever seems to note the (equally) simple point that a company does not record income when it issues stock and receives cash, nor does it record an expense when it uses cash to buy back stock. Transactions in stock are simply not treated as part of operations. The treatment of stock options is thus hardly a loophole. It is merely a consistent extension of sensible principles.[64] Rather than being seen as a substitute for cash compensation, an option may just as easily be viewed as a bargain under which the CEO or other employees work in part for a share of the profits or a partnership in the business. Such a deal does not give rise to an expense at the time it is struck. Options are almost always granted with an exercise price equal to the market price at the time of grant and afford no gain to the recipient if exercised immediately. Typically the recipient must wait a year or two or three before options may be exercised. This is not to say that the option has no value at the time of grant. But the value lies in the possibility that the price of the underlying stock will rise. A company does not recognize income when it enters into

63. 26 U.S.C. § 162(m) (2004).

64. Indeed, it is arguable that much of the mess at Enron stemmed from deals in which income was booked in connection with the sales of stock. Matt Kranz, *Trouble Grew in Enron's Interlinking Partnerships*, USA TODAY, Jan. 22, 2002, *available at* http://www.usatoday.com/money/energy/2002-01-22-enron-sidebar.htm.

a contingent contract or a bargain purchase or because it can reliably predict some portion of future revenue. Why should it recognize an expense when it enters into an equally iffy deal with its employees? Even the almighty I.R.C. agrees that the recipient of options has income only when the option is exercised.[65] And no income means no expense.[66]

Third, options are difficult to value when used as compensation. One standard argument for expensing the grant of options is that we now know how to value options. Estimating the value of an option was once highly speculative business. But thanks to Fisher Black and Myron Scholes (the latter of whom also brought you Long Term Capital Management), the value of an option can now be calculated with relative precision.[67] The rub is that one of the variables that must be considered is the riskiness of the underlying stock. Curiously, options on riskier stocks are more valuable than options on safer stocks, because riskier stocks are more volatile and therefore more likely to jump to the exercise price at some point. Thus, other things being equal, it costs more for a growth company to use options as compensation than it does for an established company to do so.

For example, as of July 15, 2002 (the date Coke announced it would begin to expense options), both Coke and Microsoft were trading for about $52 per share.[68] Yet a January 2004 option to buy Coke at $50 was selling for $7.90 per share while the same option on Microsoft was selling for $13.70 per share (according to the Chicago Board Options Exchange).[69] In other words, it would cost Microsoft nearly twice as much to grant an option as it would cost Coke to grant an option with identical terms. Most would agree that options are most useful for growth companies that need to conserve cash. Yet a rule requiring the grant of stock options to be treated as an expense would affect growth companies dis-

65. I.R.C. § 83 (2004). Admittedly, I.R.C. § 83 was enacted well before the BSOPM was discovered. *See supra* note 6.

66. Some advocates of expensing have argued that a company could pay its suppliers with stock options and thus avoid reporting any expense in connection with such purchases. The argument is supposed to be rhetorical—that clearly such a result would be wrong and therefore it is wrong in connection with using stock options as compensation. But quite to the contrary, there is no apparent reason why a supplier could not agree to accept a contingent ownership interest in the company rather than cash. Indeed, it became a common practice among Silicon Valley law firms in the late 1990s. *See, e.g.*, Jean Eaglesham, *Shearman to Take Equity in Lieu of Fees*, FIN. TIMES, July 28, 2000, at 12. Moreover, the use of the pooling method to account for mergers was roughly equivalent. To be sure, the pooling method was recently abandoned in favor of requiring that all mergers be accounted for as purchases, but under the new regime there is no requirement that the purchase price be amortized. Thus, the purchase method does not entail any expense for accounting purposes.

67. Lingling Wei, *What's the Cost of a Stock Option?*, WALL ST. J., Mar. 4, 2004, at C3.

68. Betsy McKay, *Coke to Expense Employee Options*, WALL ST. J., July 15, 2002, at A3. Share prices for Coke and Microsoft on July 15, 2002, *available at* http://bigcharts.marketwatch.com/historical/default.asp?detect=1&symbol=ko&close_date=7%2F15%F02&x=38&y=19 and http://bigcharts.marketwatch.com/historical/default.asp?detect=1&symbol=msft&close_date=7%2F15%2F02&x=24&y=21, respectively (last visited Feb. 22, 2005).

69. Option prices are according to the Chicago Board Options Exchange website on July 13, 2002, *available at* http://www.cboe.com/ (on file with author).

proportionately, not only because each option would represent a larger expense, but also because growth companies tend to grant more options.

Moreover, if the point of expensing options is to get a better handle on exactly how much the CEO is getting paid, it is not clear that extant option pricing theories provide a good measure. Again, under existing models, the market value of an option increases as the underlying stock becomes more volatile. But options increase in value as the underlying stock becomes more volatile, because their value is set in a market that views an option as an instrument for hedging. No CEO sees his options so. So why should we place a value on options for accounting purposes that has nothing to do with their value to the recipient? Does anyone think that a CEO who holds a bundle of options is better off in a turbulent market? Of course not. Option pricing theories invariably assume a market composed of diversified investors who are free to invest in a wide variety of contracts and whose trading activity sets the price.[70] A diversified investor knows that you win some and you lose some but only the average matters. In contrast, for the company that grants options or the employee who accepts them, options are an all or nothing proposition. If your stock goes up you win. If it goes down you get bupkas. It follows that options are worth a whole lot less as compensation than they are as market instruments.[71] And it is not at all clear that there is a reliable method of valuing options as compensation.[72]

Fourth, aside from the fact that it makes little sense to treat the grant of options as an expense, such treatment will lead to a string of bizarre adjustments that are likely to confuse most investors. Currently, earnings per share are reported on a fully diluted basis—as if all outstanding matured options have already been exercised.[73] In a sense, then, options are effectively treated as an expense because they reduce per share earnings by increasing the denominator shares. If options are treated as an expense at the time of grant, presumably per share earnings will need to be reported on the basis of actual shares outstanding: To do otherwise would be double counting. And that, in turn, will mean that

70. *See* Hal R. Varian, *Stock Options Are Still a Gamble, But the Size of the Pot May Soon Be Clearer*, N.Y. TIMES, Apr. 8, 2004, at C2.

71. For example, if the odds are fifty-fifty that the option will pay off for the employee (and there is good reason to think they are so, net of market movements), then should a grant be treated as an expense? Can the company book $10 in income if it buys a fifty-fifty chance at a $200 payoff for $90? Clearly not. In the end, the fact that we can place a value on options is no more a reason for expensing their grant than is a parking lot full of tanks a reason for going to war. In other words, the ability to place a value on something does not imply that one must recognize income or expense.

72. Even the advocates of expensing recognize that there are serious problems with the BSOPM. *See supra* note 6. Thus, a modified binomial model has been proposed that seeks to control for the likelihood of exercise by factoring in the vesting period. Although this model generally results in lower expense, it does not address either of the fundamental problems of volatility or diversification. The latest FASB proposal does not specify any particular method of calculating option value. *See* Lowenstein, *supra* note 53; Wei, *supra* note 69.

73. Pricewaterhouse Cooper, *Earnings Per Share* (2002), *available at* http://www.pwcglobal.com/extweb/service/nsf.

analysts and investors must fend for themselves to figure out the potential dilution if outstanding options are exercised. Still, that is what analysts are paid to do (at least in theory). Moreover, companies that use options heavily also use large amounts of cash to repurchase shares (or the equivalent) in order to control dilution. For example, in one recent year, Microsoft used cash equal to two-thirds of its earnings to purchase its own stock and options thereon.[74] Should such repurchases also be viewed as an expense? And none of this is even to mention the compound effect expensing would have on the venerable price/earnings ratio. Again, the cure is worse than the disease.[75]

Fifth, treating the grant of options as an expense will reduce the comparability of numbers among companies. In theory, it should not matter whether a company expenses options. Numerous studies have shown that a company's choice of one accounting convention over another makes no difference to stock price.[76] (Who cares really whether a merger is treated as a purchase or a pooling? As Hamlet might have said, "The deal's the thing.") As long as the market knows the options are out there, it should adjust stock price accordingly. But there is a real worry that higher-risk companies may need to assign more value to their options and therefore will see their earnings reduced by more than a lower-risk company. One of the ultimate goals of accounting is to foster comparability across companies. Treating the grant of options as an expense will do just the opposite. In order to compare the performance of Microsoft and Coke, an analyst must adjust for the fact that Microsoft's earnings are reduced disproportionately by the recognition of more expense per option granted. As it is, those who read financial statements for a living spend much of their time trying to translate earnings into cash flow, while CFOs spend their time trying to explain away the aberrant effects of accounting rules by calculating pro forma earnings. Does it really make sense to invent yet another way by which the numbers di-

74. Lowenstein, *supra* note 53, at C1.

75. One could recognize option expense at the time of exercise and in an amount equal to the simple difference between market price and exercise price (as does I.R.C. § 83 (2005) for purposes of figuring the company's tax deduction). That would avoid the disproportionate impact of the BSOPM and would reflect actual dilution as it happens. But that does not appear to be the proposal. The problem is that recognition of the expense at the time of exercise would give option holders a new way to manage earnings. (Imagine the flurry of memos around quarter's end about whether now is a good time to exercise.) Coca-Cola has chosen yet another alternative and plans to recognize option expense over the vesting period. McKay, *supra* note 70. Although that avoids the temptation to manage earnings, it hardly reflects the true value of an option in real time. Still, it gives the analysts another number to unwind—and another way to earn their keep—and adds a new layer of mystery and intrigue for investors.

76. *See* Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141 (1997) (collecting studies).

verge? If options are expensed, companies will be further motivated to emphasize pro forma accounting numbers.[77]

The answer to the problem (if it is a problem) is not accounting rules but rather timely disclosure (of which there is plenty already).[78] There is no reason to think that the market cannot understand and adjust for the (potential) dilution that comes with the grant of options. Indeed, there is no reason to believe that the market does not already do so. (This assumes, of course, that investors understand how earnings are calculated, but it is presumably enough that analysts understand, because they effectively set market prices.) By the same token, however, there is no reason to think that expensing the grant of stock options will cause the market to react in a different way. One might thus argue that there is no reason to think that expensing will have any effect on the decision to grant options. The market will see right through it as a mere change in conventions.

Other things being equal, the market may not react to expensing. But other things may not be equal. Expensing may change the way granting companies operate in ways that really matter. Obviously, it may deter some companies from using options. But expensing may also eliminate the incentive to manage dilution and thus the widespread practice of buying back stock (and traded options) to control for the price decline that would presumably follow from floating additional shares onto the market upon exercise. As things stand, options effectively force companies to distribute large amounts of available cash in the form of repurchases. The critics cite such maneuvers as part of the problem with options. The irony is that one of the factors that led to the takeovers of the 1980s was the inclination of managers to withhold dividends and to reinvest free cash flow in inferior expansion opportunities. The advent of junk bonds effectively discouraged such managerialist tendencies. Op-

77. Many commentators have argued that expensing options will help investors and analysts understand cash flow better by focusing more attention on the amounts of cash used to repurchase stock. It does not appear that the proposed rule will require any new disclosures in that connection, and there is no reason to believe that this information is not easy to find as it is.

78. It may make sense to require the disclosure of a proposed option grant either before or at the time it is made. Prior to 2003, the terms of option plans were not required to be disclosed in advance of adoption. The new requirement of a shareholder vote on equity compensation plans has the effect of advance disclosure even if the vote turns out to be a mere formality. Shareholder Approval of Stock Compensation Plans, Exchange Act Release No. 48,108, 68 Fed. Reg. 39,995 (July 3, 2003). One potential problem with advance disclosure is that it might depress stock price and make at-the-money options that much more lucrative. Of course, one might adopt a rule that requires the option price to be set at a price determined before the disclosure. As things stand, management is effectively forced to guess about the effect that a grant will have on stock price, which may not be a bad thing. A related worry is that expensing itself may affect market prices if the expense is required to be disclosed in advance or simultaneously. The announcement of the expense may depress market price and either reduce the exercise price if it is to be set later or cause the options to submerge if the price has already been set. Neither alternative seems desirable. On the other hand, the market may ignore this element of expense as old information. *See* Jenkins, *supra* note 64 (arguing that expensing should not affect stock price because the market will react appropriately to raw information about options regardless of accounting rules).

tions came into favor as a result of the threat of takeover and as a way of encouraging management to maximize stock price. But it turned out they carried the additional benefit of forcing distributions. It is hard to understand why folks are so keen on reigning in option-based compensation.

The controversy over whether or not the grant of options should be expensed is another excellent example of how the partnership model may shed light on thorny issues of corporation law. If one thinks of a CEO as a hired gun, the problem of how to account for compensatory stock options is a can of worms. If one thinks of a CEO as a service partner working for a piece of the action, it seems not at all troubling that the grant and exercise of stock options should be seen as a nonevent for income statement purposes. And incidentally, the tendency of options to force distributions is yet another way in which corporations have become more like partnerships. Partnership law contemplates easy and frequent settling up among partners. Options and repurchases do much the same thing. Options are a powerful incentive to share the wealth.

V. CONCLUSION

In the 1930s, academics decried the separation of ownership from control and the rise of a managerial class with little or nothing invested in the business.[79] Now it seems the complaint is just the opposite. The classical view of the corporation is a business owned by the shareholders with management serving at their pleasure and paid primarily by salary and bonus. But it may be more accurate to think of a corporation as a partnership between management and investors. The ultimate question is: Which view best comports with what shareholders want? Do they want managers who see themselves as employees? Or do they want managers who act like partners working for piece of the action? This is not a rhetorical question. The answer may differ company-to-company. But we should not use accounting rules to stack the deck in favor of one model or the other. Only a Luddite would suggest that we should seek to discourage the use of options in favor of basing compensation on some manipulable number like earnings, particularly when earnings management seems to be a real problem. Indeed, because stock options ultimately depend on the stock market, which is exceedingly difficult to manipulate, they are essentially self-regulating. No rational CEO would want so many options that it would reduce stock price. If equity compensation has become the norm—particularly if it is as a result of a fundamental shift in the relationship between shareholders, managers, and corporations—we may need a new model of the relationship between a corporation and its CEO. Partnership law may be a good place to look

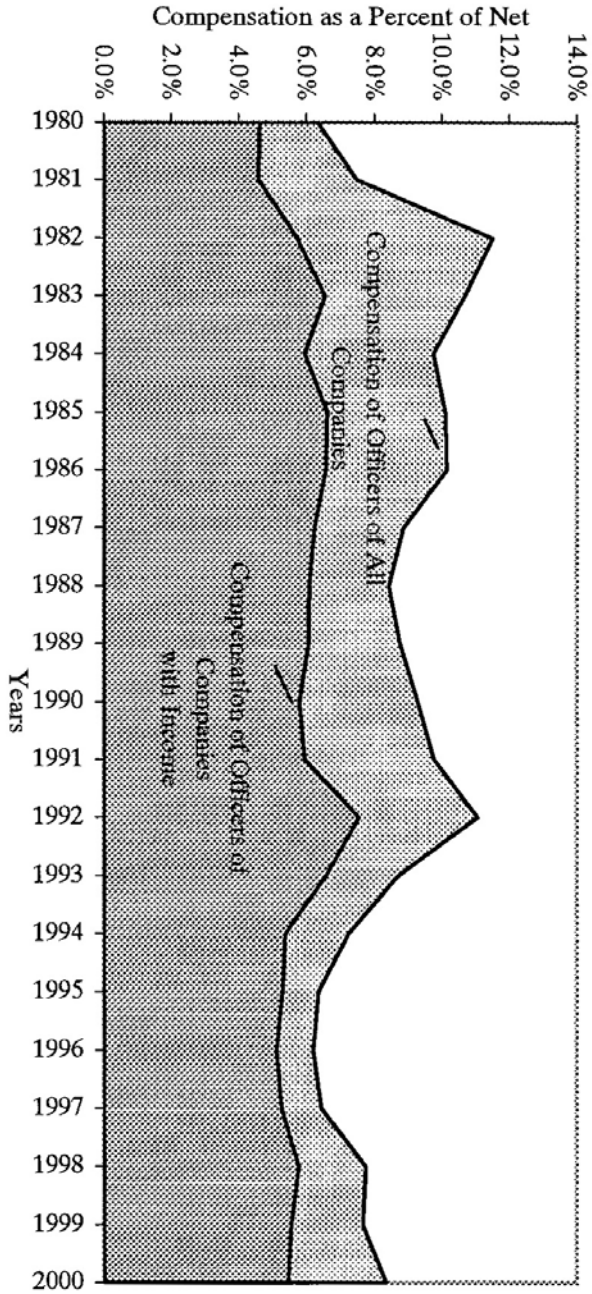
79. *See generally* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

for that model. At the very least, thinking of the CEO as a partner may be a good heuristic for sorting out the interests of managers and shareholders.

APPENDIX

Table I
Compensation of Officers -- 1980 to 2000
(corporations with $250 million or more in assets)

							Compensation of Officers (billions)			Compensation as a Percent of Income		Companies with Loss		
Year	Number of Returns	Number with Income	Number without Income	Net Income (billions)	Income of Companies with Income (billions)	Loss of Companies without Income (billions)	All	Companies with Income	Companies without Income	All	Companies with Income	Compensation as Percent of Total Compensation	Percent of Companies with Loss	Losses as a Percent of Income
1980	2877	1972	905	158	173	15	10	8	2	6.3%	4.6%	20.0%	31.5%	8.7%
1981	3141	1765	1376	147	175	28	11	8	3	7.5%	4.6%	27.3%	43.8%	16.0%
1982	3188	1740	1448	113	157	44	13	9	4	11.5%	5.7%	30.8%	45.4%	28.0%
1983	3420	2078	1342	131	168	37	14	11	3	10.7%	6.5%	21.4%	39.2%	22.0%
1984	3663	2356	1307	164	202	38	16	12	4	9.8%	5.9%	25.0%	35.7%	18.8%
1985	4052	2893	1159	178	212	34	18	14	4	10.1%	6.6%	22.2%	28.6%	16.0%
1986	4471	3243	1228	197	244	47	20	16	4	10.2%	6.6%	20.0%	27.5%	19.3%
1987	4794	3523	1271	248	289	41	22	18	4	8.9%	6.2%	18.2%	26.5%	14.2%
1988	5094	3756	1338	320	362	42	27	22	5	8.4%	6.1%	18.5%	26.3%	11.6%
1989	5450	3974	1476	308	363	55	27	22	5	8.8%	6.1%	18.5%	27.1%	15.2%
1990	5589	3984	1605	301	363	62	28	21	7	9.3%	5.8%	25.0%	28.7%	17.1%
1991	5933	4370	1563	286	353	67	28	21	7	9.8%	5.9%	25.0%	26.3%	19.0%
1992	6269	4830	1439	316	371	55	35	28	7	11.1%	7.5%	20.0%	23.0%	14.8%
1993	6798	5400	1398	391	441	50	34	29	5	8.7%	6.6%	14.7%	20.6%	11.3%
1994	7043	5623	1420	442	485	43	32	26	6	7.2%	5.4%	18.8%	20.2%	8.9%
1995	7537	6258	1279	568	607	39	36	32	4	6.3%	5.3%	11.1%	17.0%	6.4%
1996	8212	6787	1425	646	686	40	40	35	5	6.2%	5.1%	12.5%	17.4%	5.8%
1997	9017	7514	1503	730	781	51	47	41	6	6.4%	5.2%	12.8%	16.7%	6.5%
1998	9669	7772	1897	659	745	86	51	43	8	7.7%	5.8%	15.7%	19.6%	11.5%
1999	10380	8196	2184	758	867	109	58	48	10	7.7%	5.5%	17.2%	21.0%	12.6%
2000	10883	8200	2683	815	971	156	68	53	15	8.3%	5.5%	22.1%	24.7%	16.1%


Compensation as a Percent of Net
14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
Compensation of Officers of All Companies
Compensation of Officers of Companies with Income
Years
1980
1981
1982
1983
1984
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1990
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1992
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1996
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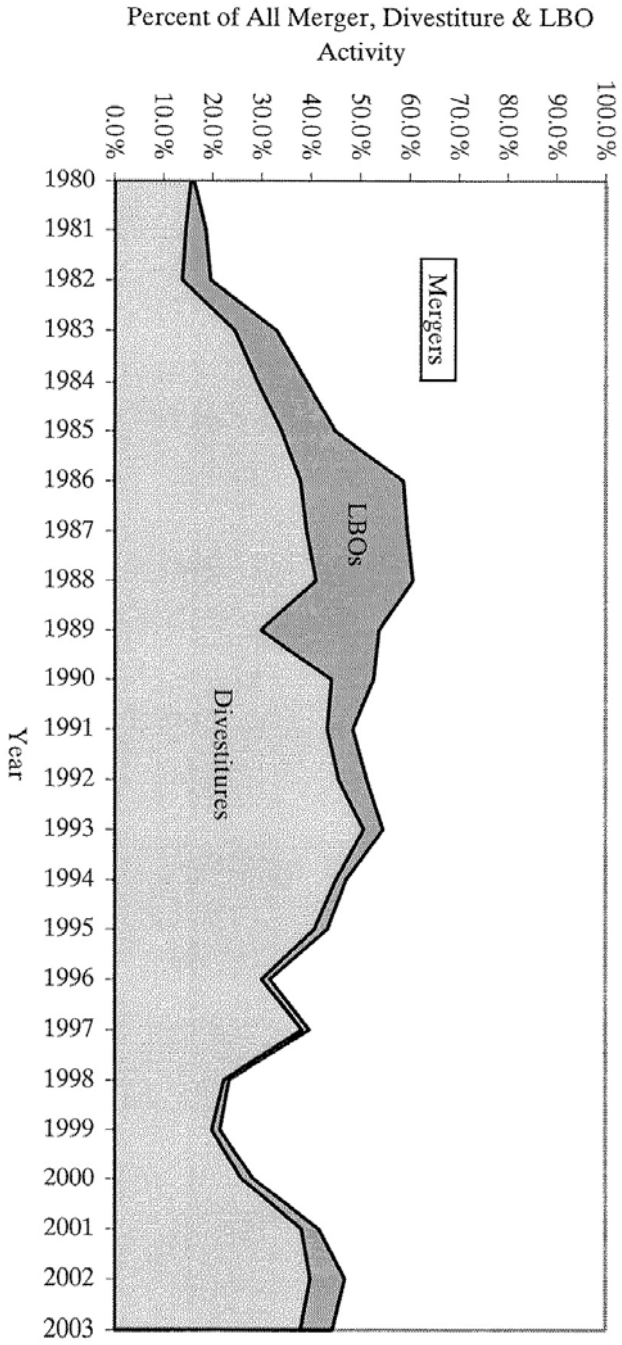
2000

Graph I

Table II

Mergers, Divestitures & Leveraged Buyouts -- 1980 to 2003

YEAR	ALL MERGERS	DIVESTITURES	Leveraged Buyouts (LBO)	TOTAL DIVESTITURES & LBOs	DIVESTITURES AS PERCENT OF ALL	LBOs AS PERCENT OF ALL	DIVESTITURES & LBOs AS PERCENT OF ALL
1980	32.8	5.1	0.2	5.3	15.5%	0.6%	16.2%
1981	46.8	6.8	1.9	8.7	14.5%	4.1%	18.6%
1982	60.7	8.4	3.5	11.9	13.8%	5.8%	19.6%
1983	52.7	12.9	4.5	17.4	24.5%	8.5%	33.0%
1984	153.2	44.8	15.3	60.1	29.2%	10.0%	39.2%
1985	149.6	51.0	16.3	67.3	34.1%	10.9%	45.0%
1986	223.1	84.7	46.5	131.2	38.0%	20.8%	58.8%
1987	198.8	77.8	40.5	118.3	39.1%	20.4%	59.5%
1988	281.8	115.8	55.2	171.0	41.1%	19.6%	60.7%
1989	316.8	94.9	75.5	170.4	30.0%	23.8%	53.8%
1990	205.6	90.8	17.6	108.4	44.2%	8.6%	52.7%
1991	141.5	61.4	7.3	68.7	43.4%	5.2%	48.6%
1992	125.3	57.2	7.2	64.4	45.7%	5.7%	51.4%
1993	420.4	213.4	16.4	229.8	50.8%	3.9%	54.7%
1994	524.9	236.9	10.6	247.5	45.1%	2.0%	47.2%
1995	895.8	365.3	23.6	388.9	40.8%	2.6%	43.4%
1996	1059.3	319.0	17.4	336.4	30.1%	1.6%	31.8%
1997	1610.0	616.0	24.0	640.0	38.3%	1.5%	39.8%
1998	2480.0	555.0	27.0	582.0	22.4%	1.1%	23.5%
1999	3402.0	678.0	58.0	736.0	19.9%	1.7%	21.6%
2000	3440.0	892.0	86.0	978.0	25.9%	2.5%	28.4%
2001	1688.0	644.0	60.0	704.0	38.2%	3.6%	41.7%


Percent of All Merger, Divestiture & LBO Activity
100.0%
90.0%
80.0%
70.0%
60.0%
50.0%
40.0%
30.0%
20.0%
10.0%
0.0%
Mergers
LBOs
Divestitures
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
Year

Graph II