

# The Controversy of Executive Remuneration: Pay Ratios and Other Approaches

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## SUMMARY

*The regulation of executive pay needs a radical rethinking. Due to the current emphasis on the consequences of the pandemic on companies, and the calls for fairer pay designs, increased scrutiny of pay, pay gap reporting and accompanying narratives is inevitable. Adopting a clear policy on pay can prove a solid tool in promoting positive perceptions and encouraging a persuasive response to any adverse scrutiny of pay issues. Yet, regulating executive pay is a balancing act. Societies and the law must preserve companies' freedom to decide their own executives' pay whilst safeguarding fairness within pay structures. Clearly, in making laws on executive pay, governments in western economies must accommodate for many conflicting policy views and variables: whether to allow company boards to exercise their powers of management free of (further) government limitation, or to extend regulation in order to tackle the general public's concern over executive greed and unethical pay structures.*

## I INTRODUCTION

The paper begins with an evaluation of the theoretical justifications of executive pay. It examines the reasons for the long-lasting controversy over remuneration structures and assesses the problematic nature of executive pay. Remuneration scandals affect societies on a regular basis and in a variety of ways; understanding why that is, is crucial. Four straightforward grounds are presented, with legal, economic, and ethical notions worthy of reflection. The second part considers the role UK law and regulation can play in bringing further improvements into this area. It is, indeed, pertinent to study this in light of the UK approach: London is the world's second-largest financial hub and Europe's biggest financial hub.<sup>1</sup> The paper first considers the controversial area of executive pay ratios; over the past few decades executive pay has been rising at a speedier rate than that of the average pay of the median worker, particularly in public companies. Notably, the UK has the highest pay ratios in Europe; according to a recent study, chief executives in the UK earn ninety-four times the income of their average employee, compared with ninety-one in France and eighty-nine in Germany.<sup>2</sup> A disproportionate pay ratio is the primary piece of evidence that executive pay is excessive and the number one statistic

backing calls for introducing fairness in the way pay is, in fact, organized. In response to this, the UK has made it a legal requirement for certain employers to disclose and explain the top people's pay and the gap between that and their average employee. Under new laws that came into force in 2020, UK listed firms with more than 250 employees have to disclose the pay ratio within their firm; essentially, this means they will have to justify executive pay packets, explaining why senior staff earn more than the average worker. This is part of an attempt to provide further transparency to pay arrangements in larger organizations, in the hope that the disclosure of the pay ratio will enable stakeholders to appreciate better how pay is determined within their investee company.

In addition, policy makers in search of progress should work towards the eradication of the current complexity within the remuneration structures; put simply, pay structures must not be too difficult to understand. The paper also suggests that the current bonus system undergoes a radical reappraisal to push firms to reflect more carefully before allowing large bonuses to be rewarded to the executive directors. These measures can potentially extend the protection granted to a firm's key stakeholders, inserting a fairer and more equitable pay structure within remuneration regimes.

## 2 EXECUTIVE REMUNERATION: WHY THE CONTROVERSY?

The proximal reason for the long-lasting controversy over executive pay is 'eventual' in nature, while its continued presence is driven by real and actual events.<sup>3</sup> In fact, its roots lie in a series of disreputable and well-publicized cases of scandalous pay packages. From this perspective, corporate scandals are not to be dismissed too readily; they are indeed what brings this significant subject at the forefront and, eventually, at the top of the legislative agenda. Who can forget the Enron scandal, on the trail of which it was discovered that Enron's executive Kenneth Lay's total compensation for the year 2000 alone exceeded USD 140 million, including USD 123 million in stock options.<sup>4</sup> After the company's collapse, it also emerged that Enron paid its executives huge performance-based bonuses for their success in reaching the desired stock price target, an accomplishment being primarily a result of their use of deceiving accounting practices (such as the mark-to-market accounting: the actualization of anticipated future revenues as present receivables). What is remarkable about the Enron case is its similarity in its narrative to other contemporaneous cases, such as Italy's Parmalat, the Netherlands' Royal Ahold, and France's Vivendi, as well as the case of Carlos Ghosn, the erstwhile charismatic leader of the Renault-Nissan-Mitsubishi Motors, who was arrested and jailed for concealing the real amount of his revenues for several years. Ironically, before his arrest, Ghosn, at 13 million euros a year, was only the third-highest paid executive in

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<sup>1</sup> Currently London's position as Europe's biggest financial hub is being challenged by Paris and Frankfurt. London has built itself into a world leader in forex trading (more than 30% of global currency trading goes through the UK capital) and according to the Global Financial Centres Index (which calculates the competitiveness of the world's top financial centres) London is 'fast catching up' with New York.

<sup>2</sup> Research from Vlerick Business School's Executive Remuneration Research Centre <https://www.vlerick.com/en/research-and-faculty/research-in-action/executive-remuneration-research-centre> (accessed 10 Feb. 2021).

<sup>3</sup> See R. K. Morck & L. Steier, *Never Waste a Good Crisis: An Historical Perspective on Comparative Corporate Governance*, National Bureau of Economic Research (2009), <http://www.nber.org/papers/w15042> (accessed 10 Feb. 2021).

<sup>4</sup> United States Senate, *The Role of the Board of Directors in Enron's Collapse*, Report prepared by the permanent subcommittee on investigations of the committee on governmental affairs (8 July 2002), <https://www.govinfo.gov/content/pkg/CPRT-107SPRT80393/pdf/CPRT-107SPRT80393.pdf> (accessed 1 Apr. 2021).

France. These cases indicate vividly that outrageous remuneration practices come hand in hand with the rapid expansion of a company's business, its media overexposure, and finally its eventual and speedy downfall amidst the revelations of questionable (at the very least) corporate practices.

It should be said that there is no precise or rigorous reason why executive pay should be 'problematic' as a matter of law. Like all company decisions, it could be regarded as a matter to be determined by the company and the shareholders; reviewing it under those auspices, this subject should not really provoke much controversy. However, remuneration scandals affect societies on a regular basis and in a variety of ways. Understanding *why* that is, is imperative. Four straightforward grounds can be put forward here, with key legal, economic, and ethical notions that carry with them various consequences worthy of reflection. These will be discussed below.

## 2.1 Directors Are Overpaid for What They Contribute

Lucian Arye Bebchuk made explicit the reasons why shareholders do not receive a fair deal in terms of remuneration, especially under the classical arrangement where the board of directors determines the remuneration of its members.<sup>5</sup> According to Bebchuk, the internal mechanics and processes within companies result in the merging between the interests of the boards of directors and those of companies in a way that severs the link between actual performance and the compensation granted to directors. In particular, such remuneration is neither negotiated nor agreed at arm's length, thereby resulting in a seemingly unfair agreement. Bebchuk's proposition is to pre-emptively destroy the economic and philosophical rationales for unchecked executive compensation. Economically, the justification of the firm as the most rational expedient to minimize transaction costs (a theory owed to American economist Ronald Coase<sup>6</sup>) is not optimally materialized whenever there is leakage of resources 'because directors are captured or subject to influence by management, sympathetic to management, or simply ineffectual in overseeing compensation'.<sup>7</sup> Due to deviations from optimal contracting, executives can be remunerated in excess of the level that would be ideal for shareholders.<sup>8</sup> Accordingly, this excess pay forms rents in accordance with the 'rent-seeking' theory designed by Tullock,<sup>9</sup> whereby agents conspire to extract sources of revenues without creating any wealth themselves.<sup>10</sup>

In *Anarchy, State and Utopia*, Nozick suggests that every situation that evolves from a previously fair setting and from the mechanisms of free choice, cannot be deemed unfair itself, even if the eventual result appears somewhat imbalanced. Nozick provides an example: suppose that the local team wishes to hire basketball superstar Wilt Chamberlain, and that fans have agreed to fund his salary by dropping a quarter in a box before each game. At the end of the season, a million quarters have changed hands, Wilt Chamberlain is richer by 250,000 dollars, and everyone else's assets have shrunk by exactly twenty-five cents. However, in this regard there is nothing wrong with the trade-off<sup>11</sup>: it is an illustration of what is typically called the 'entitlement theory of justice'.<sup>12</sup> Nozick suggests that (at least) two presuppositions come to the fore here. The first one is that every fan has made the decision freely, with all relevant knowledge and understanding of the deal they were entering. Second, that the fans derived some utility from the deal, namely the joy of seeing the best player of the decade play for their team, for a whole season – a deal worth a lot more to them in value than twenty-five measly cents. Nevertheless, according to Bebchuk, these presuppositions are wrong: first, directors are far from forthcoming in the way they attribute and reveal their remunerations, and second, they extract a lot more than they add into the company (since the free market is powerless in the face of false or insufficient information). What can be shown here is that economic considerations are closely linked to ethical consideration (as will also be discussed below).<sup>13</sup>

## 2.2 The Fixed Part of Remuneration Is Too Large

The perception of executives lazily extracting rent from the firm was most prevalent during the twentieth century, right until the end of the century. This is the same theme that discerned in Berle and Means' *Modern Corporation and Private Property*, and later, in classic literature such as C. Wright Mills' *White Collar* which referred to what was soon to be jeeringly called the 'managerial class':

*They may be politically irritable, but they have no political passion. They are a chorus, too afraid to grumble, too hysterical in their applause. They are rear guards. In the shorter run, they will follow the panicky ways of prestige; in the long run, they will follow the ways of power.*<sup>14</sup>

According to Mills, eventually kudos is determined by power. On the political arena, 'the new middle classes are up for sale; whoever seems respectable enough, strong enough, can probably have them'.<sup>15</sup> That is how eventually,

<sup>5</sup> See L. Bebchuk, J. M. Fried & D. I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, National Bureau of Economic Research (2002), <http://www.nber.org/papers/w9068>; (accessed 1 Apr. 2021); L. Bebchuk & J. M. Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press) 2004.

<sup>6</sup> R. H. Coase, *The Nature of the Firm* (1937). Reproduced in O. Williamson, *The Nature of the Firm: Origins, Evolution and Development* (Oxford University Press 1993).

<sup>7</sup> Bebchuk & Fried, *supra* n. 5, at 5.

<sup>8</sup> *Ibid.*

<sup>9</sup> G. Tullock, *The Rent-Seeking Society* (*The Selected Works of Gordon Tullock*), Liberty Fund (2005).

<sup>10</sup> And who was by the way clairvoyantly anticipated in a classic article: G. Jones, *Unjust Enrichment and the Fiduciary's Duty of Loyalty*, 84 L. Q. Rev. 481–486 (1968).

<sup>11</sup> R. Nozick, *Anarchy, State and Utopia* (Basic Books 1974).

<sup>12</sup> R. Nozick, *Distributive Justice*, 3(1) Phil. & Pub. Aff. 45–126 (1973).

<sup>13</sup> This line of thinking has become so common a trope that the Church of England, for instance, has condemned excessive remuneration: 'Whether in the business world or the financial world, paying vast amounts to and for an individual does not guarantee exceptional performance'. And later adding 'Biblical visions of justice suggest a just remuneration policy should be impartial, render what is due to each, proportionate to contribution and based on normative judgements of God's justice. Market arguments for unrestricted pay policies are weak even in their own terms, as the markets in question are not sufficiently free to set reliable prices'. R. Higginson & D. Clough, *The Ethics of Executive Remuneration: A Guide for Christian Investors* 7 and 20 (2010).

<sup>14</sup> C. Wright Mills, *White Collar: The American Middle Classes* 353 (Oxford University Press 1956).

<sup>15</sup> *Ibid.*

prestige and kudos is achieved within the managerial class. Linking this to the rent extraction theory, the effectiveness of boards is doubtful given their tendency for indifference, their reliance on the Chief Executive Officer for information, and their lack of exposure to the share return of their company. This empowers CEOs to extricate pay in excess of the optimal compensation for shareholders.

### 2.3 The Variable Part of Remuneration Is Too Large (Excessive Risk)

In contrast to the classic approach, the views of Cassidy,<sup>16</sup> Madrick,<sup>17</sup> Hall and Murphy<sup>18</sup> are critical, insofar as they exhibit defiance against excessive preponderance of variable factors in executive remuneration. This sentiment is shared in European soft law: significantly, according to the European Commission Recommendation 2009:

4.1. *Where remuneration includes a variable component or a bonus, remuneration policy should be structured with an appropriate balance of fixed and variable remuneration components. The appropriate balance of remuneration components may vary across staff members, according to market conditions and the specific context in which the financial undertaking operates. Member States should ensure that remuneration policy of a financial undertaking sets a maximum limit on the variable component.*

4.2. *The fixed component of the remuneration should represent a sufficiently high proportion of the total remuneration allowing the financial undertaking to operate a fully flexible bonus policy.*<sup>19</sup>

The Recommendation also provides a specific remedy in case variable remuneration is unduly awarded, although there is no symmetric provision for fixed remuneration. Paragraph 15 states that financial undertakings 'should be able to reclaim variable components of remuneration that were awarded for performance based on data which has subsequently proven to be manifestly misstated'.<sup>20</sup> Conversely, the allocation of a variable remuneration can become an efficient means to castigate a director whose management is challenged, on the basis of the Basel III standards which allow for delays of payments or clawbacks where healthy remuneration policies are not in place. In its report for the year 2017, the French market regulation authority, the *Autorité des Marchés Financiers*, reveals four cases where mechanisms for such punishment were set up. Two of these penalize poor financial performance while the other two are motivated by financial considerations: first, at Société Générale, the *malus* could follow a decision taken by the directors that had significant results on the business' results or its public image; second, at AXA, this can happen when the operational result is negative for the year prior to the payment of the deferred remuneration; third, at BNP Paribas, this is possible where the executives 'lack

ethics'; and finally, at Foncière Des Régions no bonus will be paid in case of a degradation of the company's key indicators.<sup>21</sup>

Due to the directors' privileged position within the corporation, there is indubitably a risk that they could manipulate those factors that precisely enter into the computation of the variable part. Interestingly, share points, stock options, and other incentives which essentially reward positive changes in the company's stock prices, favour shareholders over and above any other stakeholder (essentially conveying the message that an increase in the perceived equity value of the firm is a satisfactory approximation of the company's health). A classic counterexample is the scenario known as 'gambling resurrection', where the company is in financial distress, the shareholders have a net interest in taking a 'gamble' on a risky endeavour, provided the gamble can procure a loan that would allow for the related investment. This has the result of increasing the value of the stock artificially, while the actualized value of the company decreases to the level of the net present value of the project.<sup>22</sup> It therefore follows that, even if we stick to strict financial criteria, what is good for the stock price is not necessarily good for the company. Evidently, this reasoning can be extended to any criticism over the excessively short-term standpoint of such criteria.

Hall and Liebman suggest that stock options are more readily accepted by the other stakeholders than bona fide bonuses.<sup>23</sup> As explained by Dial and Murphy, in relation to the case at General Motors, there was public outcry when the firm's executives were awarded large bonuses for raising the company's stock price. This outcry ended when the bonus plan was replaced with a stock option plan, 'even though the pay-outs under the two plans were virtually identical'. On a similar token, when compensation consultants were interviewed at seven leading firms, they expressed similar sentiments, referring to the huge public resistance to the granting of bonuses, even when the bonuses were as large as annual stock option gains.<sup>24</sup>

### 2.4 Too Much Is Too Much

In *Nicomachean Ethics*, Aristotle foresees with extraordinary clairvoyance the role, function and purpose of wealth and economics. Aristotle lays out two specific philosophies about the role of justice. The first kind of justice is retributive justice, which refers to what modern-day lawyers call criminal and public law. The main principle at work here is a principle of proportion: a man found guilty of a crime must receive a punishment in proportion to that crime. In this instance, the epistemological gap is immense when compared to the more primitive justice: the person who 'cut a hand' shall not have

<sup>16</sup> Views contrary to the classic approach started to appear around the late 1990s: J. Cassidy, *The Greed Cycle*, *The New Yorker* (2 Sept. 2002).

<sup>17</sup> J. Madrick, *A Theory of Corporate Greed*, *New York Times* (20 Feb. 2003).

<sup>18</sup> B. J. Hall & K. J. Murphy, *The Trouble With Stock Options*, 17 *J. Econ. Persp.* 49–70 (2003).

<sup>19</sup> Commission Recommendation (EC) No. 2009/385 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies.

<sup>20</sup> *Ibid.*

<sup>21</sup> AMF Report, 2017, <https://www.amf-france.org/en/news-publications/publications/annual-reports-and-institutional-publications/amf-annual-report-2017> (accessed 10 Apr. 2021).

<sup>22</sup> Aleksander Berentsen & Benjamin Müller, *A Tale of Fire-Sales and Liquidity Hoarding*, University of Zurich, Department of Economics, Working Paper No. 139 (June 2015), <https://ssrn.com/abstract=2642178> or <http://dx.doi.org/10.2139/ssrn.2642178> (accessed 1 May 2021).

<sup>23</sup> B. J. Hall & J. B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, CXIII(3) *Q. J. Econ.* 653–691 (1998).

<sup>24</sup> J. Dial & K. Murphy, *Incentives, Downsizing, and Value Creation at General Dynamics*, 37(3) *J. Fin. Econ.* 261–314 (1995).



their hand cut but will go to jail for a duration of time commensurate to their crime. The second kind of justice is distributive justice, which exists and survives through the notion of equality: if one provides work worth a certain quantity of drachmas, he or she shall be entitled to a number of drachmas. The person who has caused the loss of the neighbour's ox, will compensate the neighbour in exactly the same way, in other words, with the value of an ox. This is still the prevailing principle applicable to most modern systems of private law.<sup>25</sup>

Now, here is a question. There has always been a lot of critique over excessive pay: how did this evolve into a critique of income that centres on the flow of wealth rather than on its existence in a static mode? It could be said that this is the result of the coupling of the Aristotelian notions of distributive and retributive justices. Certainly, in *The Spirit Level*<sup>26</sup> there is a sense that inequalities of income are undesirable because they have plenty of negative effects: it is asserted that excessive income inequality is a worsening factor in a variety of indicators, including, but not limited to, physical health, mental health, drug abuse, education, imprisonment, obesity, social mobility, trust and community life, violence and child well-being. Further, it could be said that excessive income inspires feelings of disgust and repulsion: this might be the purest expression of the idea that too much is too much, in all its tautological enigma. This sense of unfairness originates partly from the phenomenon known as the 'decline of labour share', referring to decline in the percentage of GDP being allotted to labour in many industrialized nations over the recent period. As noted by Kaldor:

*It was known for some time that the share of wages and the share of profits in the national income has shown a remarkable constancy in 'developed' capitalist economies of the United States and the United Kingdom since the second half of the nineteenth century. More recent investigations have also revealed that whilst in the course of economic progress the value of the capital equipment per worker (measured at constant prices) and the value of the annual output per worker (also in constant prices) are steadily rising, the trend rates of increase of both of these factors has tended to be the same, so as to leave the capital/output ratio virtually unchanged over longer periods.*<sup>27</sup>

Keynes calls this statistical stability 'a bit of a miracle'.<sup>28</sup> He explains that the hoarding of 'new' growth by capitalists would be resented as a tremendous failure of economic growth. He also notes that if the divergence between capital and labour was indeed averred, it would be the cause of grave concern for lawmakers and also a legitimate discontentment for the have-nots. As Elsby et al. submit in their

ground-breaking paper, the phenomenon can be interpreted not in terms of division between different production factors, but as part of the growing inequality between categories of people, namely workers and capitalists.<sup>29</sup> This is also the interpretation favoured by the International Labour Organization.<sup>30</sup> According to Zingales, however, 'the capital share declines as fast as the labour share' and the big winner is 'the profit share'. Therefore, the real question is why corporations receive so much while investing so modestly. The additional distinction between capital share *stricto sensu* (defined as the 'product of the required rate of return on capital and the value of the capital stock') and profits is inspired by the works of economist Barkai, who proposes that it is actually mark-ups, not capital, that have offset the decline of the labour share, which of course does not suggest an efficient distribution.<sup>31</sup>

## 2.5 Is the Controversy Justified?

In considering the matter of directors' remuneration, one has to ask: is this a question for economists or for shareholders? The aforementioned concerns could be viewed as a problem from the economists' perspective; at the micro-economic level, they are close to a rent-extraction problem. Directors with a privileged rank not only benefit from their exclusive access to information but also from their unique power to retain that information for themselves, thereby making it more difficult to properly ascertain their shortcomings.<sup>32</sup> At the macroeconomic level, the question is whether an over-emphasis on the fixed component of remuneration would encourage laziness on behalf of the directors rather than a push for the promotion of shareholders' interests. However, too much emphasis on the variable part could lead to the very same directors artificially seeking high stock quotations, with possibly catastrophic results (the financial catastrophe of 2008 being a clear illustration of this).

Feynman provides a simple algorithm through which scientific research can be conducted; this algorithm could be applied in the setting of the aforementioned debate.<sup>33</sup> The first step would be to act upon a presumption: in this context, that company directors trick their way into extracting much more than they are actually worth. The second step is to draw inferences from the aforementioned presumption: directors, on a continual basis, trick shareholders into approving, explicitly or implicitly, a remuneration package that exceeds the value they add into the company. From a purely logical standpoint three issues could arise from this. First, companies that act in this manner would

<sup>25</sup> Distrust against excessive wealth has existed for a very long time; one can go back to the times of the Gospels, where according to Matthew and Luke, Jesus explicitly condemns the excessive love of wealth as an intrinsic evil (see Luke 16:10–15). The following renowned passage illustrates this: 'How hard it is for the rich to enter the kingdom of God! Indeed, it is easier for a camel to go through the eye of a needle than for someone who is rich to enter the kingdom of God'. Those who heard this were astonished, 'Who then can be saved?', they asked. Jesus replied, 'What is impossible with man is possible with God'. The Bible, King James Version, Matthew 19:23–27.

<sup>26</sup> R. Wilkinson & K. Pickett, *The Spirit Level*, Allen Lane, 352 (2009).

<sup>27</sup> N. Kaldor, *A Model of Economic Growth*, 67 Econ. J. 268, at 591–624 (1957).

<sup>28</sup> John M. Keynes, *Relative Movements of Real Wages and Output*, 49 Econ. J. 34–51 (1939).

<sup>29</sup> Michael Elsby, Bart Hobijn & Sahin Aysegul, *The Decline of the U.S. Labor Share*, Working Paper Series 2013–27 (Federal Reserve Bank of San Francisco 2013).

<sup>30</sup> International Labour Organization, *Global Wage Report 2012/13: Wages and Equitable Growth* (Geneva: International Labour Office 2013).

<sup>31</sup> Simcha Barkai, *Declining Labor and Capital Shares*, Working Paper Series Stigler Centre for the Study of the Economy and the State; University of Chicago Booth School of Business, New Working Paper Series No. 2 (Nov. 2016).

<sup>32</sup> Lucian Bebchuk & Michael Weisbach, *The State of Corporate Governance Research*, Review of Financial Studies, 23 (2003).

<sup>33</sup> Programme Transcript – Discovery – The Feynman Variations, Discovery: The Feynman Variations BBC World Service, Original broadcast 29 Sept. 2010, <https://www.bbc.co.uk/programmes/p00b6djp> (accessed 10 Apr. 2021).

underperform in comparison to competitors who have more stringent systems for keeping executive remuneration under control; in addition, shareholders might be incentivized to sell out, as they could potentially obtain a better rate of return, with a comparable risk, should they invest in other securities. Second, shareholders would, in general, elect to insert say-on-pay or other restrictive provisions within their firms' articles or by-laws.

Finally, shareholders would, in general and *ceteris paribus*, elect to incorporate their firms in jurisdictions where the default provisions for company law contain say-on-pay or other restrictive provisions.

The third and final step is to consider whether the aforementioned anticipated consequences have indeed occurred. This would be unlikely, for a number of reasons. First, while it is beyond the realm of debate that some executives are remunerated excessively, company shareholders can retain their shares for the long term, or at the very least until the company collapses. This supposes that the market is functioning poorly and that investors have no actual means to realize their investment. Of course, the example of Enron springs to mind here. Excessive remuneration was accidental to Enron's fall; at best, a pay disclosure could have signalled that the firm was unwisely managed. It is also frequently suggested that shareholders have the capacity to enact within their firms' constitution say-on-pay provisions; in some jurisdictions, such as the UK, this has been the default solution for quite some time. However, given the choice, shareholders almost always allow the board to determine the matter of executive remuneration.<sup>34</sup> According to Cheffins, while say-on-pay provisions can help normalize aberrant remunerations structures, there is a lot of scepticism as to whether they can, in fact, improve company performance.<sup>35</sup> Finally, shareholders neither prefer to incorporate in punitive jurisdictions, nor seek to transfer their company's seat in a different jurisdiction in order to obtain a supposed gain in corporate governance.

In reflecting how the board should be remunerated, we need to consider the reasons for the dramatic rise in executive remuneration. In this regard, a key issue is whether any specific combination of variable and fixed components is the most optimal one in terms of incentivizing executives. Equally, it could be argued that this question should be determined by the company's shareholders; why this should be of interest to legislators remains unclear. Taleb suggests that poorly understood, or rather poorly distributed risks, can have dramatic macroeconomic effects.<sup>36</sup> Still, one should wonder what role the law should play in the regulation of executive pay, at least beyond a strict minimum. Certainly, in relation to the law's contribution to this debate, it is important to keep in mind that the core interests of the company do not always coincide with those of the shareholders. In

addition, a rising stock price does not necessarily represent the interest of all shareholders: paradoxically, some shareholders might be more appreciative of a company's dividend distribution than others. Further, there are various stakeholders to consider when developing a targeted approach, for instance suppliers, employees, and others. At any rate, incorporating other variable elements in the remuneration mix could be a good way to hedge the appetite for risk: bonds, low-beta stocks, negative-beta stocks, could restrain the appetite for risk, provided, of course, that the package allows shareholders to select the board that they believe the company deserves.

### 3 REMUNERATION IN THE UNITED KINGDOM

UK company law does not exert much control over the remuneration of directors. Rather, the constitution of the company determines the question of pay; the courts have restricted grounds for reviewing the pay levels rewarded to directors. According to the model articles for public companies, directors are permitted to receive such remuneration as the company determines. It also states that their remuneration can take any form. Therefore, the board of a company has the freedom to determine the level of remuneration directors receive, with the only restriction related to listed companies, that are required to adhere to the UK Code of Corporate Governance. Since the board has the freedom to determine the form of remuneration, recently there has been a significant increase in the use of performance-related pay.

Responding to concerns regarding the lack of balance in the area of executive pay, the UK Government has recently introduced significant reforms to make CEO pay fairer and more appropriate. The UK Corporate Governance Code 2018<sup>37</sup> features a combination of broad principles and more specific provisions, some of which require disclosures to be made in order to achieve full compliance.<sup>38</sup> The Code addresses some of the issues that have caused public concern over executive pay, including the complexity of remuneration packages, how executive pay compares to wider company pay policy, and the role of incentives in driving behaviour. According to Principle D1 remuneration levels 'should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose'. All new long-term incentive schemes (including bonuses related to service and/or performance over periods longer than one financial year) must be approved by the shareholders.<sup>39</sup> According to a supporting Principle, the performance-related elements of executive remuneration should

<sup>34</sup> As Balsam and Yin show, say-on-pay provisions can work well in that they *do* curb remuneration whilst making it more incentive-based: Steven Balsam & Jennifer Yin, *The Impact of Say-on-Pay on Executive Compensation* (19 Mar. 2012), <https://ssrn.com/abstract=2026121> (accessed 1 Feb. 2021).

<sup>35</sup> B. R. Cheffins & R. S. Thomas, *Should Shareholders Have a Greater Say Over Executive Pay?: Learning from the US Experience*, presented at 'Corporate Governance: Reassessing Ownership and Control', Faculty of Law, Cambridge University (19 May 2001).

<sup>36</sup> Nassim Taleb & Avital Pilpel, *On the Unfortunate Problem of the Nonobservability of the Probability Distribution* (2004), <https://www.fooledbyrandomness.com/knowledge.pdf> (accessed 10 Feb. 2021).

<sup>37</sup> The UK Corporate Governance Code sets out the fundamental corporate governance framework for companies listed on the main market of the London Stock Exchange.

<sup>38</sup> Financial Reporting Council, *The UK Corporate Governance Code*. (Pub Ref: UP/FRC-BI12001) (Financial Reporting Council, London 2012). All UK listed companies must comply with the Code (otherwise they have to explain why they do not), although there is nothing to stop other companies complying with it should they deem necessary. These Companies are to report on how they have applied the main principles of the UK Corporate Governance Code and either to confirm that they have complied with the Code's provisions or – where they have not – to provide an explanation.

<sup>39</sup> Principle D.2.4.

promote the company's long-term success.<sup>40</sup> Further, a big part of pay should be designed in such a way so as to link rewards to corporate and individual performance. The Code also includes procedures whose intent is to limit the conflicts of interest that inevitably arise if executives are in charge of setting their own pay: in the interests of transparency (an important component of the new Code) directors should refrain from having any involvement in setting their own pay. A remuneration committee should be established by the board, which should consist of at least three, or in the case of smaller companies, two independent non-executive directors.<sup>41</sup> Directors' service contracts must last up to a period of one year or less,<sup>42</sup> and in addition, the company reserves the right to remove a director before the expiration of their period in office by ordinary resolution, notwithstanding any agreement between the director and the company.<sup>43</sup>

Notably, from 2020, new reporting regulations oblige all large listed companies to report and explain the 'pay ratio' of their chief executive to their median employee. They are also required to explain how company boards consider stakeholder interests.<sup>44</sup> More specifically, under new laws, quoted companies with more than 250 UK employees are legally required to disclose their executive pay ratios; according to The Companies (Miscellaneous Reporting) Regulations 2018 these companies are required to publish, as part of their directors' remuneration report, the ratio of their CEO's total remuneration to the median (50th), 25th

and 75th percentile full-time equivalent remuneration of their UK employees.<sup>45</sup> Companies must also publish supporting information, including the reasons for changes to the ratios from year to year and, in the case of the median ratio, whether, and if so how, the company considers this ratio to be consistent with the company's wider policies on employee pay, reward and development.

### 3.1 Pay Ratios and Other Related Matters Affecting Pay in the UK

Let us now turn to one of the most contested areas within pay: pay ratios. The question of pay ratio has long been a tricky subject in corporate governance. It has also been a controversial subject from a societal philosophical perspective. Plato, as early as the fourth century BC reasoned that the highest earners in an organization should receive no more than five times that of the lowest paid. An over-ambitious and idealistic expectation, maybe. More fitting perhaps, management guru Peter Drucker suggested a more realistic ratio of 20:1. Whatever our expectations, there is little doubt that the current pay ratios in most western societies are out of line with economic reality. Presently, the UK has the highest pay ratios in Europe<sup>46</sup>; according to a recent study, chief executives based in the UK earn ninety-four times the income of the average employee, compared with ninety-one in France and eighty-nine in Germany. It has been shown that the ratio of executive-worker pay of a large banking institution frequently surpasses 100 times.<sup>47</sup> Importantly, a recent report by the CIPD, the professional body for human resources and people development, that scrutinized the annual reports of the FTSE 100 firms, found that executive pay remains high, with little or no change over the years. According to the report, there is little evidence to justify the pay packages awarded to top executives; although there has been a marginal drop in executive pay over the examined year, the median UK employee would still need 119 years to earn what the median FTSE 100 CEO receives in twelve months. Median FTSE 100 chief executive pay is 117 times higher than that of the median UK full-time worker.<sup>48</sup> The latest statistical evaluation shows that the median FTSE 100 CEO pay, which includes salary, bonus, long-term incentive plan, benefits, and pension contributions, was GBP 3.46 million (compared with GBP 3.97 million in the previous year). Other senior FTSE 100 executives have also received large earnings.<sup>49</sup> However, evidence to justify CEO pay levels remains weak: company size and performance (measured by changes in the company's share price) as well as investor opposition have limited weight over matters of pay. Notably, according to the

<sup>40</sup> Principle D.1 adds the following paragraph: 'The performance-related elements of executive directors' remuneration should be stretching and designed to promote the long-term success of the company'. Financial Reporting Council, *supra* n. 38.

<sup>41</sup> Principle D.2.1. *Also see* Principle D.2.2. and D.2.3. This brings a change from the Combined Code that required the remuneration committee to be made up exclusively of non-executive directors: Combined Code, Principle B.2.1 and B.2.2. According to para. B.2.1. 'The board should establish a remuneration committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors' (emphasis added). The Financial Reporting Council, *The Combined Code on Corporate Governance* (Pub Ref: 1-84140-816-6) (Financial Reporting Council, London 2006).

<sup>42</sup> Principle D.1.5.

<sup>43</sup> Section 168 Companies Act 2006. Early termination, however, can result in two types of payment being made to directors: compensation for loss of office and the other is damages for breach of service contract. As substantial payments can be made to directors following early termination, restriction of service contracts to a period of one year in accordance with the Code would reduce the possibility of such payments being made.

<sup>44</sup> Britain, a country with the sturdiest rules on executive pay of any major financial centre, derives most of its rules from EU legislation. The last few years have seen an explosion of reforms to the regulation of the country's financial industries, including reforms to the remuneration and bonuses rewarded to executives of large financial institutions. These reforms were heavily influenced by the EU's policies and measures; it is EU initiatives that have affected the domestic requirements (such as the clawback and malus provisions) of the UK Corporate Governance Code and the Investment Association's principles of remuneration. The current UK Remuneration Codes derive much of their present form from European legislative packages and regulations, particularly CRD IV and the practical details of CRD IV are set out in the revised SYSC Remuneration Code. In recent years we have seen the implementation of CRD III and IV, AIFMD, UCITS V and Solvency II, all of which encompass regulation linked to remuneration. These rules have already been implemented in UK regulation.

<sup>45</sup> This legal requirement also falls within the Corporate Governance Code.

<sup>46</sup> Research, from Vlerick Business School's Executive Remuneration Research Centre, <https://www.vlerick.com/en/research-and-faculty/research-in-action/executive-remuneration-research-centre> (accessed 10 Apr. 2021).

<sup>47</sup> As Groom notes, 'companies with lower-paid workforces sometimes have even bigger gaps: US chief executives at Walt Disney and Coca-Cola, for instance, are respectively paid 653 and 427 times more than the median pay of their employees', <https://www.ft.com/content/c0ecff02-a84a-11e3-a946-00144feab7de> (accessed 18 May 2021).

<sup>48</sup> Research by the CIPD Centre, <https://www.cipd.co.uk/about/media/press/high-pay-day-2020#ref> (accessed 3 Apr. 2021).

<sup>49</sup> *Ibid.*



calculation for 'High Pay Day', an independent, non-partisan think tank,<sup>50</sup> the average FTSE 100 CEO earned GBP 3.46 million in 2018, which is equal to GBP 901.30 an hour, compared to the median full-time worker, who earned GBP 14.37 an hour.<sup>51</sup>

A disproportionate pay ratio is the primary piece of evidence that executive pay is excessive, and the number one statistic that backs calls for fixing pay within organizations. According to an independent Treasury report, employees are not as productive in firms that are characterized by large pay gaps between the employees and the wider workforce. The dominant feeling within such firms is that decisions on pay are unfair.<sup>52</sup> Poor rewards result in negative behaviours or lack of interest towards one's work, while well rewarded employees are consistently productive, efficient and useful to their organizations.<sup>53</sup> Research shows that employees who have little or no confidence in the degree of fairness characterizing their managers' decisions, tend to feel detached from their job, and even have a higher tendency for mental health problems than unemployed people.<sup>54</sup> In addition, a variety of studies point to a strong link between narrow pay gaps and enhanced firm performance, whilst wide gaps between top and bottom pay point to a negative impact on performance. Consequently, firms that appear to remunerate employees according to their contribution within the organization, tend to benefit in terms of employee morale and productivity.

In response to widespread concern about the gap between CEO pay and pay for the average worker, UK legislation has recently introduced some important changes. Legislation requires large listed companies to report and explain the remuneration of their CEOs, a legal requirement that also falls within the Corporate Governance Code. The rules, that came into force in 2020, apply to large UK listed companies with over 250 employees. They make it a statutory requirement for UK listed companies to justify the remuneration of those at the top and to explain how those salaries relate to wider employee pay. In particular, under changes to the Companies Act 2006, companies are required to disclose annually the ratio of their CEO's pay to the median, lower quartile and upper quartile pay of their UK employees, and provide a supporting narrative to clarify the reasons for the executive pay ratios. Directors who fail to disclose CEO pay ratios, the required information or the explanatory information, will be committing an offence.

This increased level of transparency is the UK's bid to confront the low levels of employee productivity at work, by attempting to improve working conditions overall. Certainly the 2021 AGM season and beyond, will be a challenging time for remuneration committees. Put simply, pushing for disclosure will shame companies into lowering the ratio, because an excessive pay ratio suggests that a firm's executives are being disproportionately rewarded, at the expense of other employees. High director and employee pay ratios promote unscrupulous and unjust corporate values

within companies, resulting in calamitous internal work dynamics. Pay variations can lead to a decline in employees' productivity and if pay disparities appear unduly large, lower-paid workers can feel they are treated unfairly, with negative effects on the loyalty and commitment they show to their companies. Disclosing pay ratios can push companies into constraining excessive pay.

That is why the aforementioned revisions to the legislation are welcome. There is, however, a risk that firms might treat the new rules as a mere 'tick-box' exercise than as a good opportunity to fully explain CEO pay levels and to present a clear rationale for why CEOs are paid what they are.<sup>55</sup> In addition, it is not clear why the requirement to produce such a report only applies to quoted companies.<sup>56</sup> Indeed, non-quoted large companies might also consider producing a ratio report, in order to reassure their employees, as well as their external stakeholders, that the pay ratios within their firms are fair. Yet still, although not all large companies are required to adopt it, the new reporting requirements send a clear message that increased workplace transparency is a central theme within the UK corporate governance arena.

Further improvements can be made. For a start, understanding executive remuneration should not be a complicated process reserved for the sophisticated few. Provision 40 of the UK Corporate Governance Code tackles simplicity and states that 'remuneration structures should avoid complexity and their rationale and operation should be easy to understand'. But keeping remuneration structures simple requires a conscious effort; the reality is that too often remuneration designs are complex and very difficult to read.<sup>57</sup> This can be counter-productive. Companies should present pay packages in a more simplified form and must also ensure there is a closer inter-connection between pay and well-defined measures of performance. As noted, 'complex incentive plans can be just as confusing for CEOs as they are for shareholders. Smaller, simpler and more immediate bonuses could be both more motivational for CEOs and easier to understand for stakeholders'.<sup>58</sup> For this reason, the CIPD and the High Pay Centre recommend that 'single figure reporting requirements and guidance should be extended to cover key management personnel and pay for the top 1% of earners disclosed, to further improve transparency and ensure this area of reporting practice improves'.<sup>59</sup> A worthy idea that can help promote trust within the remuneration systems, whilst enabling

<sup>55</sup> *Ibid.*

<sup>56</sup> The definition of 'quoted' is set out within the Companies Act 2006 and covers UK-incorporated organizations which are quoted on the following: UK Official List, New York Stock Exchange, NASDAQ and a recognized stock exchange in the European Economic Area. Further, even where the UK quoted and incorporated organization is a subsidiary of a non-UK incorporated parent, the UK organization must produce a pay ratio report for its executives if it meets the employee threshold.

<sup>57</sup> This is identified and discussed at length in BIS's earlier paper: Department for Business, Innovation and Skills, *Executive Remuneration*, Discussion Paper (2011), [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/31660/11-1287-executive-remuneration-discussion-paper.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/31660/11-1287-executive-remuneration-discussion-paper.pdf) (accessed 21 Mar. 2021).

<sup>58</sup> Research by the CIPD Centre, [https://www.cipd.co.uk/Images/ftse-100-executive-pay-summary-report\\_tcm18-62885.pdf](https://www.cipd.co.uk/Images/ftse-100-executive-pay-summary-report_tcm18-62885.pdf). (accessed 18 May 2021)

<sup>59</sup> *Ibid.*

<sup>50</sup> 'High Pay Day' is an independent, non-partisan think tank that focuses on the causes and consequences of economic inequality, with a particular interest in top pay.

<sup>51</sup> High Pay Centre bases its report on the CIPD report, <https://highpaycentre.org/about/> (accessed 10 May 2021).

<sup>52</sup> High Pay Centre report, <https://highpaycentre.org/about/> (accessed 10 May 2021).

<sup>53</sup> Research by the CIPD Centre, *supra* n. 49.

<sup>54</sup> *Ibid.*

investors to see how much of their money goes into their firm's executive pay.<sup>60</sup>

A well-structured remuneration plays a huge role in aligning the activities of management with a company's purpose, strategy and performance. Imbalanced remuneration systems can hurt a company's long-term strategy by making executives focus their energy on short-term gains. Clearly, this is not a cure-all solution to the agency problem. However, clarity here can help align the interests of management and other stakeholders and can also help management focus on the company's long-term success. Clarity within remuneration structures can result in the redesigning of their remuneration systems so that they match their long-term strategic objectives. All in all, cleverly designed pay arrangements, share options and other long-term incentives can add value to corporations and are clever ways to safeguard the alignment between the objectives of directors and shareholders, thereby reducing the discrepancies between these two key corporate participants.

Linked to this, it is important to address how reward influences behaviour. The way remuneration works means that executives are normally remunerated on the basis of short-term performance through incentive structures that push risk-taking behaviour, thus instigating asset price bubbles and financial instability.<sup>61</sup> Remuneration structures incentivize executives to pursue risky routes, because potentially these will breed high returns that are instant, and also profits that might eventually prove false. We only have to look at the global financial crisis of 2008 for a clear illustration of this: during that time, remuneration policies, acting in conjunction with capital requirements and accounting rules, granted executives the incentives to take unwarranted risks. Executives received excessive payments in reward for activities that may have appeared profitable at the time but consequently proved damaging to their companies, and in some cases, to the entire financial system.<sup>62</sup> Behavioural science has a lot to offer here: the way executives are rewarded does not necessarily bring improved company performance. There is so much complexity in the current remuneration structures and the targets are so far remote that they fail to motivate positive executive behaviour. In fact, they have the opposite effect; they result in misaligned incentives that have to be eradicated.<sup>63</sup>

The aforementioned type of performance-based pay is commonly attributed to the agency theory. The theory demonstrates that optimal contracting pay that depends on a firm's performance can solve a classic problem within the financial markets: that of moral hazard. 'Moral hazard' refers to the scenario whereby directors receive very large compensation to create value for their firms, whilst a large part of their pay is linked to the firm's performance. Safe with the knowledge that they will remain at their job for a short period of time only, they follow risky routes because, as anyone who

knows a bit about extraordinary returns would argue, without risky strategies, quick, exceptional returns cannot be enjoyed. This comes easy to executives as they are gambling with other people's money, jobs, and pensions, whilst feeling safe that their remuneration packages are protected.<sup>64</sup> What we learn here is that the wrong type of remuneration structures can incite the wrong type of incentives, causing distrust amongst shareholders and more generally, the wider body of stakeholders.<sup>65</sup> As noted by Bebchuk and Fried, design flaws within pay arrangements cause damage to shareholders (and companies) both by increasing pay levels and by relying on practices that twist the incentives granted to directors.<sup>66</sup>

Finally, a practical solution can be considered, directly linked to bonus payments: treating bonus payments in the same way that dividends are treated for the purposes of distribution rules (or dividends rules) under capital maintenance law. A bold step, it can help to outlaw the excess payments observed in recent years. The mechanics of this proposal would not be too complicated to implement; in fact this would even be rather simplistic.<sup>67</sup> Large institutions would find themselves acting more responsibly for the simple reason that a distribution cannot be allowed except out of profit.<sup>68</sup> According to section 829 Companies Act 2006, 'distribution' means every description of distribution of a company's assets to its members, whether in cash or otherwise; distributions can be made only out of profits available for the purpose: a company's profits available for distribution are its accumulated, realized profits. Companies are not permitted to use estimated or expected profits; only realized profits form part of the dividend payments. Bonuses, in a similar way to distributions, are generally rewards for making a contribution towards the profits of the institution. For instance, one has to look at the average bonus paid to investment banks compared to the High Street bank. In the former case, bonuses are much larger; despite the fact that retail bankers work hard, their accomplishments do not generate profits to the level generated by a successful securities trader.<sup>69</sup>

Company law should treat bonuses as a way of distribution, although the distinction is that this type of distribution would be payable to employees rather than the shareholders. Bonuses would not become unlawful; rather, it would become more difficult for companies to authorize them, as it would be easier for the liquidator to retrieve them on the grounds that they were illegally made. This re-definement would push institutions to reflect more carefully before allowing large bonuses to be paid to their executives. It will also grant more protection to the key stakeholders by precluding institutions that are undergoing difficulties to allow large bonuses, particularly since a distribution cannot be allowed except out of profit (section 830(1)). The question would be rather simple: has the company made a profit? If so, there would be nothing illegal about granting the permission to authorize a bonus payment.<sup>70</sup>

<sup>60</sup> *Ibid.*

<sup>61</sup> D. Arsalidou, *Rethinking Corporate Governance in Financial Institutions* (Routledge 2015).

<sup>62</sup> This is the conclusion reached by Lord Turner in a review in 2009: Financial Services Authority, *The Turner Review, A Regulatory Response to the Global Banking Crisis* (Pub Ref: 003289, 2009) (The North Colonnade, Canary Wharf, London 2009).

<sup>63</sup> L. Bebchuk, A. Cohen & H. Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008*, Harvard Law School Discussion Paper No. 657 (Feb. 2010).

<sup>64</sup> Arsalidou, *supra* n. 61.

<sup>65</sup> The ways in which CEOs pursue their own interests include consuming perks, investing based on their own interests, and others.

<sup>66</sup> Bebchuk & Fried, *supra* n. 5.

<sup>67</sup> Under s. 829(1) of the Companies Act 2006.

<sup>68</sup> Section 830(1) CA 2006. For further discussion, see D. Arsalidou, *The Regulation of Executive Pay and Economic Theory*, 5 J. Bus. L. 431–456 (2011).

<sup>69</sup> R. Alexander, *More Bonuses: Is There a Solution?*, 31 Co. Law. 129–130 at 130 (2010).

<sup>70</sup> Arsalidou, *supra* n. 61, Ch. 2.



## 4 CONCLUSIONS

Why the relentless interest in executive pay? Research in this area is consistently clear: executive pay is one of the weightiest business ethical questions that dominates the field of corporate governance. That many harbour negative feelings towards pay structures is well established. The trickier question is what to do about it. In thinking of responses, we need to be realistic. To a large extent market forces dictate what happens. But market forces can only go so far. The impact of misaligned remuneration practices goes a lot further than a few executives securing enormous gains from their company. If a company is seen to persistently increase executive pay against a backdrop of pay disparities, it can devastate trust in business and can undermine the long-term prosperity of corporations. This is bad for shareholders, employees and companies and can be particularly catastrophic to a company's reputation.

When problems exist regarding the structure of executive pay and the laws that govern it, it is appropriate to consider ways to improve matters. This article considered some responses to the most heated trials and tribulations stemming directly from the design of executive pay. Changes discussed here, such as those relating to the newly introduced pay gap reporting requirements, will help upgrade the corporate governance and business environment of the UK, preserving its

reputation as a world leading place to work and invest. Due to the present interest on the impact of Covid-19 on executives and the wider workforce, and given the amplified emphasis on fairer pay structures, the increased evaluation of pay designs is a positive move. With this in mind, companies must be aware that pay transparency is likely to remain a priority going forward.

The last decade has seen corporate governance playing a greater role in the UK. As a result of constant criticisms, there have been attempts at all levels to realign remuneration systems, with a strong focus on the much-criticized financial services industry. Now, under legislative changes, publicly listed firms with more than 250 UK employees must disclose the ratio between CEO pay and the pay of their average worker and provide an accompanying explanation of the reasons for their executive pay ratios. The pay ratios regulations will hold the UK's largest businesses to account for excessive pay rewards. Coupled with calls for more simplicity within the remuneration designs, as well as calls for the reformulation of the bonus payment system, matters can advance. Implementing certain basic measures can bring forward significant improvements to the present pay policies and arrangements. The system can be fixed, provided policy makers in search of solutions, address real-world rather than tick-boxing practices, to tackle persisting key deficiencies within current pay structures and designs.