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Directors' Remuneration: A Practical Critique of Corporate Governance Effectiveness

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INTRODUCTION

The attitude of deregulation and shareholder primacy that developed during the 1980s is being challenged by today's society in light of widening inequality. Despite directors' remuneration being predicted as problematic in 1932 by Berle and Means,[1] in the last thirty years top level pay has "sky-rocketed", contributing to inequality trends not seen since the 18th century. Thomas Picketty, an eminent French economist specialising in the study of inequality, has written that "the primary reason for the increased income inequality in recent decades is the rise of the supermanager in both the financial and nonfinancial sectors".[2] Research conducted by the High Pay Centre shows that although directors were well rewarded in the 1980s, levels were proportionate to the rest of society. However, "Since then some of them have enjoyed an increase of over 4000% to what are now multi-million pound packages".[3] The High Pay Centre claims that where income inequality persists, social unrest grows "with poorer groups pursuing their economic objectives outside the mainstream".[4] We may confidently assume that if income inequality is to be addressed, the current regulation of directors' remuneration will require reform. To this date, regulation has not been introduced with the specific purpose of tackling income inequality by controlling top level remuneration. Current "soft law" regulations can be found in the UK Corporate Governance Code (CGC), which is not legally binding. Instead, it operates on a "comply or

[1] A Berle and G Means, *The Modern Corporation and Private Property* (Transaction Publishers 1932).
[2] Thomas Picketty, *Capital in the Twenty-First Century*, (The Belknap Press of Harvard University Press 2014) 315.
[3] High Pay Centre, "Cheques with Balances: Why Tackling High Pay is in the National Interest", <http://highpaycentre.org/files/Cheques_with_Balances.pdf> accessed 16 October 2015.
[4] Ibid.

explain" basis. There is a reluctance to involve the black letter law in setting directors' pay, preferring to consider it a matter for each individual company.[5]

PART 1: SUBSTANTIVE GUIDANCE ON REMUNERATION

The express aim of directors' remuneration is to "promote the long term success of the company".[6] The literature has broadly taken this to be the combination of two subsidiary aims: attracting and retaining high quality directors, and aligning the interests of directors with those of the shareholders. Additionally, the CGC provides that the remuneration committee should look to position its firm relative to competition without paying "more than is necessary".[7]

The "no more than necessary" statement poses a theoretical contradiction. It has been taken to mean "no more than necessary [*to attract and retain high quality directors*]". If this was the intended meaning of the statement, it need not have been made because this is the exact purpose of regulation by the market. It is more likely that the purpose of including this statement was a reference to an underlying aim of reigning in directors' remuneration to an amount that may be widely considered acceptable. This underlying aim is further evidenced by the CGC guidance on setting remuneration levels, particularly through the adoption of a performance measurement.[8]

Performance measurements tend to be based in complicated economics, and there is very little guidance given on what types should be used. This is problematic when performance measurements are explained in financial reports which need to be voted on at the annual general meeting (AGM). If a shareholder is not comfortable with the language of finance and economics they "may choose to vote in favour of the report, blaming the outcome on their

[5] Dr E Ndzi, "Is the Law Doing Enough to Curb Excessive Directors' Pay?" [2015] Company Lawyer 189.
[6] UK Corporate Governance Code, D.1.
[7] UK CGC, Supporting Principle, D.1.
[8] UK CGC, Schedule A: The Design of Performance-Related Remuneration for Executive Directors.

lack of understanding".[9] Ndzi focused on shareholders' voting attitudes by arguing that shareholders need to be more active in their scrutiny of directors, stressing the importance of institutional investors in this endeavour. Conversely, Picketty has researched the growth of executive pay and found the estimation of a director's contribution to the firm's output to be "clearly impossible".[10] He explains that, unlike an assembly-line worker or fast food server whose marginal product may be estimated within a reasonable margin of error, "when an individual's job function is unique, or nearly so, then the margin of error is much greater". Once the hypothesis of imperfect information is introduced, "the very notion of 'individual marginal productivity' becomes hard to define". If, as Picketty claims, the estimation of a director's contribution to the firm's output is impossible, using performance measurements is folly.

It is generally accepted that the offer of a high salary will attract talented business people. The CGC proposes that a firm should look at similar firms to assist in determining the "necessary" level of remuneration to offer directors. High salaries are therefore defended by claims that pay should be competitive with firms all over the world to prevent directors from being tempted away for more money. As the CGC anticipated, setting salary levels looking outwards at other firms has led to the issue of "upward ratcheting".[11] This occurs where executive pay is increased to make the firm appear prodigious without a corresponding improvement in corporate performance. As witnessed in the last 35 years, there is no telling where "upward ratcheting" will stop, a sign that remuneration does not correlate with the value of the director's work. Consequently, the amount necessary to attract and retain high quality directors is more than any reasonable person would believe it ought to be. It would seem that if salary levels are to be brought back to reasonable levels, a good starting point would be to define "more than necessary".

[9] Ndzi (n. 5) 190.
[10] Picketty (n. 2) 330-333.
[11] Ibid.

The central concern of corporate governance is resolving the agency issue, which has existed since the dawn of incorporation and occurs where property rights of the owner are transferred to a third party.[12] Share options have long been viewed as the solution to the agency issue.[13] Shares are offered for purchase to a director at their current value to be redeemed at some point in the future. The theory is that if directors have shares, they will work particularly hard to increase the share value. Thus, the directors and shareholders have an interest in the share price increasing and their interests appear aligned. However, directors with shares have been known to manipulate share prices in the short term so that they may cash out. In response to this problem, the Walker Report 2009 proposed that 50 per cent of performance based remuneration should be in the form of long term incentives and that they should function on a five year deferral, allowing time for the directors' actions to be evaluated.[14] The current CGC states that share bonuses should not be exercisable for a minimum of three years.[15] However, there is a fundamental oversight behind issuing shares as a method of aligning the interests of directors and shareholders. Shareholders have invested their personal wealth in the firm and stand to lose that investment if the firm fails.[16] Since directors' shares are "bonuses", and by their very nature additional, directors stand to lose only the opportunity of future wealth. However, like a gambler playing with someone else's money, the director stands to benefit considerably if the share price increases. This position is what Baumol and Blinder describe as the "moral hazard".[17] The agent stands to benefit from taking increased risks of

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[12] MC Jensen and WH Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Capital Structure" [1976] 3 Journal of Financial Economics 305.
[13] C Perkin, "Directors' Remuneration - Enter the Customer" [2001] Journal of Business Law 166.
[14] Law Commission, "A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations" [2009] 117 <http://www.governance.co.uk/resources/item/256-the-walker-report-review-of-corporate-governance-in-uk-banks-and-other-financial-industry-entities-final-recommendations>.
[15] UK CGC, Schedule A (n. 9).
[16] The Insolvency Act places shareholders at the bottom of the list of creditors with rights to a portion of the assets of the firm on insolvency.
[17] W Baumol and A Blinder, *Microeconomics: Principle and Policy* (13th revised edn, Cengage Learning Custom Publishing 2015).

which the principal stands to bear the brunt. This is precisely the situation which Corporate Governance set out to prevent.

It seems that attracting high quality directors by offering large salaries makes it difficult to align their interests with those of the shareholders. This is because a director being paid a high salary may not feel personally invested in the shares. The suggestion that firms adopt performance measurements is unhelpful to remuneration committees. Measuring a directors' marginal productivity is largely futile, and complicated measurements may be abused to take advantage of shareholders without financial expertise. Current substantive guidance regarding remuneration is not conducive to achieving the underlying objective of reducing remuneration levels.

PART 2: PROCEDURAL GUIDANCE — INDEPENDENT DIRECTORS AND SHAREHOLDER 'SAY ON PAY'

Despite directors having no prima facie entitlement to remuneration, it is an accepted norm of company law that they ought to be paid.[18] The Companies Act and corporate governance have taken different approaches to regulating directors' remuneration. Other than the requirement that companies disclose their annual accounts which aggregate directors' remuneration,[19] the Act considers the issue one for the company's management, leaving it to the members to decide remuneration policy in the articles of association. However, the CGC takes a more proactive approach, stating that premium listed companies should have a "formal and transparent procedure for developing policy on executive remuneration… No director should be involved in deciding his or her own remuneration".[20]

The CGC provides that firms should establish a remuneration committee consisting entirely of independent "non-executive directors" (NEDs). The theory is that because NEDs are independent, their loyalties will lie with the firm and the shareholders resulting in rational and reasonable levels of

[18] *Hutton v West Cork Railway* Co (1883) 23 Chad 654.
[19] Companies Act 2006, s 412.
[20] UK CGC, D.2.

remuneration.[21] However, "no common consensus exists as to a unique definition of independence".[22] The CGC provides a reference point for situations in which a director may be considered to have lost their independence. Examples include having had a business relationship with the company in the past three years, having been employed by the company in the last five years, and having significant links to other directors on the board.[23] However, the "comply or explain" nature of the CGC means that if a director were to suffer a conflict of interests, the board may simply explain why it is not a problem. It is ultimately for the board to decide if a director is "independent in character and judgement".[24] As Tricker points out, the independence of members of the remuneration committee may be inherently compromised by the fact that they have been nominated to the board. This poses an unavoidable conflict of interest not considered in the CGC.[25] Appointment and recruitment to boards of directors is problematic in other ways, including a lack of diversity. In the Davis Report, it was stated that it is "imperative that boards are made up of competent high calibre individuals who together offer a mix of skills, experiences and backgrounds".[26] The report was concerned with the disproportionately small number of female directors. Principally, the argument was that women achieve better results in education yet are vastly underrepresented on boards of directors. According to the Trades Union Congress, corporate boards are drawn from elite schools, universities and clubs where pay that would generally be considered grossly excessive is taken for granted.[27] The question this raises is how effective a control on excessive remuneration can independent remuneration committees truly provide if NEDs

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[21] MB Hemraj, "Spotlight on Executive Remuneration" [2005] Company Lawyer 149.
[22] N Brennan and M McDermott, "Alternative Perspectives on Independence of Directors" [2004] 12(3) Corporate Governance: An International Review 325.
[23] UK CGC, B.1.1.
[24] UK CGC, B.1.1.
[25] B Tricker, *Corporate Governance: Principles, Policies, and Practice* (3rd edn, Oxford University Press 2015) 331.
[26] Law Commission, "Women on Boards" [2011] <http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31480/11-745-women-on-boards.pdf> accessed 11 May 2016.
[27] Trades Union Congress, "A Culture of Excess: The Pay of FTSE 100 Remuneration Committee Members" <https://www.tuc.org.uk/sites/default/files/Acultureofexcesspay2.pdf> accessed 11 May 2016.

are drawn from similar backgrounds with similar views on remuneration? The conclusion invariably reached in the vast literature on this issue is that the current approach to director impartiality is failing. Main and Johnston claim that:

> *"One of the doubts relating to the Cadbury Report (1992) was the assumption that the objectivity of the remuneration committee would control excessive executive pay. These doubts were reinforced by empirical research which showed that chief executives receive higher pay in firms which operate a remuneration committee, and not the reverse."*[28]

Although the Main and Johnston research is now dated, the underlying issue persists. Directors' remuneration continues to swell and the guidelines regarding independence remain broad, unenforceable, and open to manipulation by determined executive directors. If independence is to be pursued as a legitimate solution, greater emphasis must be put on creating diversity in the boardroom and a clearer, stricter definition needs to be given to independence. As Brennan and McDermott point out, independence is an unrealistic solution to the issue of director remuneration so long as it lacks a clear definition.

A further measure intended to curb excessive executive pay has been to increase transparency and involve shareholders.[29] According to Ferri and Maber, the objective of the law is to equip shareholders with the information required to properly assess the appropriateness of the firm's remuneration policy.[30] The major development came in 2002 with the introduction of the shareholder "say on pay" vote at the AGM.[31] The result of this vote was not binding upon the firm until 2013, but the law now provides for a three-yearly

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[28] Brian GM Main and James Johnston, "Remuneration Committees and Corporate Governance" [1993] 23 Accounting and Business Research 351.
[29] Companies Act 2006, s 420.
[30] F Ferri and D Maber, "Say on Pay Vote and CEO Compensation: Evidence from the UK" [2013] 178 Review of Finance 527.
[31] Directors' Remuneration Report Regulation 2002, para 2.

binding vote by shareholders on the quoted company's remuneration policy.[32] To increase the effectiveness of shareholder involvement, the Stewardship Code states that institutional investors should "seek to vote all shares held" and "should not automatically support the board".[33] Proponents of the "say on pay" argue that it gives shareholders a voice, and that it will encourage remuneration committees to challenge executive directors about their pay. Ferri found an improved sensitivity between directors' remuneration and firm performance since the introduction of the say on pay vote.[34] Critics of the "say on pay" claim that directors are still able to take advantage of ill-informed shareholders without the financial expertise required to make sense of the complicated report.[35] Of FTSE 100 firms in 2014, most "say on pay" votes resulted in more than 75 per cent in favour of the remuneration reports and no report was voted down. This points to a lack of shareholder engagement with the issue of curbing excessive pay. Instead, shareholder concerns lie with administrative costs involved in hiring new directors, organising massive shareholder meetings, severance pay, and the destabilising effect of a negative shareholder vote on market confidence.[36] That being said, Ferri and Maber have found the "say on pay" to have succeeded in two areas. Firstly, it has increased investor confidence, and second, it has successfully applied pressure to some firms to remove controversial practices. However, the High Pay Centre released an analysis of the first executive pay awards following the 2013 reforms and came to the disappointing conclusion that the regulations were being flouted and pay was still on the rise.[37] High Pay Centre Director, Deborah Hargreaves said:

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[32] Enterprise and Regulatory Reform Act 2013, s 79, inserting s 439A into the Companies Act 2006.
[33] Stewardship Code 2012, Principle 6.
[34] F Ferri and D Maber (n. 30).
[35] SM Bainbridge, *The New Corporate Governance in Theory and Practice*, (Oxford University Press 2008) 57-72.
[36] F Ferri and D Maber (n. 30).
[37] High Pay Centre, "High Pay Centre Briefing: The Effect of Executive Pay Reforms" [2014] <http://highpaycentre.org/pubs/high-pay-centre-briefing-the-effect-of-executive-pay-reforms> accessed 19 May 2016.

> *"These figures show that the new regulations are not enough to bring top pay back to a level that is sensible, fair or proportionate."*[38]

The conclusion that can be reached at this stage is that procedural requirements designed to curb excessive pay are returning minimal success. Salaries used to attract high quality directors continue to increase. Share options encourage short term risk taking and fail to align the interests of directors and shareholders. NEDs are poorly equipped to challenge determined executives, and shareholders lack the engagement and organisation to properly scrutinise remuneration policies.

PART 3: SCOPE FOR REFORM?

Sir Desmond Pitcher (alongside many others) argue that directors' remuneration is not a matter of public interest.[39] Pitcher argued that the company is owned by the shareholders and that the duty of disclosure was owed to them only: "It is not a matter for the general public to debate".[40] Many have argued that this is not the case. Citing the far reaching ramifications of the 2008 financial crisis, Alessandra argues that top level pay contributes to a risk driven attitude which can have severe consequences for the general public.[41] Anthony Atkinson argues that the concept of supply and demand is important but that it only sets the boundaries in which the value of a service may be judged, and that often this bears little relation to its actual value, or "marginal product".[42] Atkinson believes that current market outcomes are based upon the relative bargaining power of participants. Where a person enters into a zero-hours contract, they do so because they have no power to negotiate a better bargain. He argues that a nation-wide attitude change regarding earnings needs to take place which accepts the importance of supply and demand in a

[38] Ibid.
[39] Saleem Sheikh, "The Greenbury Report: Fond Hope, Faint Promise?" [1995] Journal of International Banking Law 471.
[40] Ibid.
[41] S Alessandra, "Pay Day" [2011] 103 European Lawyer 49.
[42] Anthony B Atkinson, *Inequality: What can be done?* (Harvard University Press 2015) 151.

globalised economy, but does not leave remuneration to be "determined purely by market forces". Atkinson refrains from giving specific regulatory suggestions, preferring to set the tone for a national conversation involving all stakeholders and resulting in a "code of best practice for pay above the minimum". As the aim of remedying income inequality is inherently long term, Atkinson advocates the voluntary code, considering it more likely to survive changes in government than statute.

POTENTIAL REFORMS

Lord Wedderburn suggests that a practical first step in curbing excessive directors' remuneration would be the induction of workers into the boardroom.[43] He argues that in France, Germany, and Scandinavian countries, workers have the right to be heard at the board level. Paul Davis supports this view, and claims that having workers' views represented on the board comes with additional benefits for the efficiency of the firm.[44] As well as reducing the level of directors' remuneration, increased transparency may go some way toward tempering public unrest and the perceived injustice of large salaries. Furthermore, as workers tend to seek job security in the long term, they are naturally invested in the long term health of the firm. Their contribution to the boardroom may prove a valuable element in overcoming the agency issue at the core of Corporate Governance.

The enforcement of a maximum pay ratio is another reform suggestion intended to reduce income inequality. In the 1970s, the top percentile earned three times the median, but today earns five times the median.[45] This has induced pressure to introduce a pay limit ratio between the top and bottom earners in the firm. In 2013, Switzerland held a public referendum on whether executive pay should be limited to 12 times that of the lowest paid workers. The proposal was defeated. However, the results show considerable support for

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[43] B Wedderburn, "The Future of Company Law: Fat Cats, Corporate Governance and Workers" [2004] Liverpool Institute of Employment Rights 49.

[44] P Davis and SB Neto, "Co-Operative Leadership, Management and Governance. A Values Based Approach for Improved Performance and Competitive Advantage" [2010] 5 Economia Solidaria e Acao Co-operativa.

[45] AB Atkinson and S Voitchovsky, "The Distribution of Top Earnings in the UK Since the Second World War" [2011] 78 Economica 440.

what is quite an invasive regulation with 35 per cent of voters supporting the limit. In the UK, the High Pay Centre has been campaigning for a maximum pay ratio which "would recognise the important principle that all workers should share in the company's success and that gaps between those at the top and low and middle earners cannot just get wider and wider".[46] The TSB Bank is adopting a remuneration policy sporting a pay ratio of 65, while the fair trade organisation, Tradecraft, "does not expect the best paid member of staff to be paid more than six times the full time equivalent salary of the lowest paid member of the UK staff".[47] The adoption of a pay ratio was proposed back in 1994 by an MP, Denis McShane. He proposed that the UK introduce a ratio multiple of 20. Opponents argued that it may lead to some firms dispensing with their lowest paid workers and outsourcing labour. Opponents also argued that it would create a disparity between different types of firms depending on their reliance upon labour. In firms which employ mostly highly skilled professionals, such as law or accountancy firms, top pay would not be significantly altered. If these issues can be addressed, the introduction of a maximum pay ratio may prove a highly effective method of curbing income inequality.

CONCLUSION

For directors that do not act responsibly, it is unrealistic to believe that the current regulation is capable of generating a culture of responsibility in the corporate world. The theoretical reasoning behind share options aligning directors' interests with those of shareholders, independent directors effectively controlling executives, or a vast and diverse group of shareholders effectively scrutinising directors' remuneration packages, is proving unrealistic in practice. Investors made a stand in April targeting Weir Group, Shire, Standard

[46] High Pay Centre, "Reform Agenda: How to Make Top Pay Fairer" [2011] <http://highpaycentre.org/pubs/reform-agenda-how-to-make-top-pay-fairer> accessed 19 May 2016.

[47] Traidcraft, "Impact and Performance Report" [2013] 55, <http://serv1.datalog.co.uk/docs/01333367_TRAIDCRAFT-PUBLIC-LIMITED-COMPANY_2013-03-31.pdf > accessed 19 May 2016.

Chartered and Reckitt Benckiser for their exorbitant remuneration packages.[48] This action should be commended. However, regulation is required if income inequality on a national level is to be effectively addressed. The Executive Remuneration Working Group made a statement in April in which they referred to the current approach to executive pay in UK listed companies as "not fit for purpose".[49] The Group's foremost indictment was of the failure of remuneration policy to align the interests of directors with the interests of the company and shareholders. Current pressure on the legislature to address inequality is drawing into sharp focus the ineffectiveness of current director remuneration regulations.

48 "Investor Rebellion Over Executive Pay Gathers Pace", *BBC News* (London, 28 April 2016), <http://www.bbc.co.uk/news/business-36165707> accessed 12 May 2016.
49 The Investment Association Executive Remuneration Working Group, "Interim Report" (April 2016), <http://www.theinvestmentassociation.org/assets/files/press/2016/20160421-execremwginterimreport.pdf> accessed 12 May 2016.