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EXECUTIVE COMPENSATION IN CONTROLLED COMPANIES

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EXECUTIVE COMPENSATION IN CONTROLLED COMPANIES

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Conventional wisdom among corporate law theorists holds that the presence of a controlling shareholder should alleviate the problem of managerial opportunism because such a controller has both the power and incentives to curb excessive executive pay. This Article challenges that common understanding by proposing a different view based on an agency problem paradigm. Controlling shareholders, I suggest, may in fact overpay managers in order to maximize their consumption of private benefits, due to their close social and business ties with professional managers or for other reasons, such as being captured by professional managers. This tendency to overpay managers is further aggravated by the use of control-enhancing mechanisms, such as dual-class structures, which distort controllers' monitoring incentives.

The Article uses a novel approach to question conventional beliefs on executive pay by reviewing the ISS recommendations on say-on-pay votes, and finds empirical indications that compensation packages in U.S. controlled companies appear to be a bigger problem than initially predicted. I conclude by calling for a new regulatory approach: re-conceptualize the pay of professional managers in controlled companies as an indirect self-dealing transaction and subject it to the applicable rules that regulate conflicted transactions.

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I. INTRODUCTION

In 2010, Philippe Dauman, the Chief Executive Officer of Viacom, a leading media company, earned an important title. He was the highest-paid executive in corporate America with a compensation package totaling $84.5 million,[1] while the median compensation for CEOs at the 200 largest U.S. companies was $10.8 million in that year.[2] In fact, Dauman's total pay package represented approximately 12% of the company's reported net income during the equivalent period.[3]

Viacom's CEO's lucrative pay package, however, seems uncorrelated with performance. A report by an independent executive compensation advisory firm noted that his pay "deserves a black mark".[4] A prominent proxy advisory firm recommended that the company shareholders vote against the pay packages of Viacom's senior executives, pointing to certain problems in their design and condemning the use of mega-grant options that are "anything but shareholder friendly".[5] As one corporate governance expert summarized: "Viacom seems to be paying their executives entrepreneurial returns rather than managerial wages to run an established company with long-term assets. *There seems to be a disconnect there*."[6]

Interestingly, the CEO of Viacom does not manage a widely-held firm. Viacom has a controlling shareholder, the media mogul Sumner Redstone, who holds approximately 80% of the company's voting rights and who at least in theory should effectively monitor the compensation of the company's CEO.[7] How, then, can one explain the overly generous pay patterns in a controlled company such as Viacom? Is there an agency problem that induces a controlling shareholder to deviate from optimal

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[1] See Viacom's proxy statement, filed with the Securities Exchange Commission on January 21, 2011. During that year Mr. Dauman earned an average of $312,963 a day.

[2] Steven M. Davidoff, *Efforts to Rein in Executive Pay Meet with Little Success*, N.Y. TIMES (Jul. 12, 2011).

[3] *Id.*

[4] *See* Robin Ferracone, *CEO Pay: When Highly Paid Is Not Overpaid*, Forbes (Apr. 19, 2011) (a report by Farient Advisors LLC, an independent executive compensation advisory firm, showing that the pay of the Viacom CEO is not aligned with the company performance during the period 2008-2010).

[5] *See* ISS Proxy Advisory Services vote recommendations for Viacom's 2011 annual meeting (Feb. 23, 2011), at 15-16.

[6] Meg James, *Viacom Executives Again among America's Highest Paid*, L.A. TIMES (Jan. 27, 2012) (quoting Charles Elson, professor of law at the University of Delaware). In addition, a shareholder suit was filed against the company for overpaying its top two executives by $36.6 million from 2008 to 2011. *See*, Freedman v. Redstone, 12-cv-01052, U.S. District of Delaware (Wilmington).

[7] *See* Viacom's proxy statement, *supra* note 1.

contracting when determining the pay packages of professional CEOs?

While executive compensation has been extensively analyzed in the legal and financial literature and received high levels of attention from the media, the public, and policy makers, the discourse has focused mainly on *widely-held* firms and the special set of concerns they raise. Little attention has been devoted to the agency problem in designing the pay of professional managers in *controlled* companies. This Article aims to fill this gap.

Excessive executive compensation has long been one of the strongest manifestations of the classical shareholder–manager conflict in widely-held companies, as observed by Berle and Means[8] and developed by Jensen and Meckling.[9] Individual shareholders of widely-held companies are uninformed and suffer from a collective action problem, and are therefore unable to effectively monitor managerial pay packages. Institutional investors also suffer from inadequate incentives, conflict of interests and regulatory constraints that impede their ability to act like real owners.[10] These constraints enable managers to exert influence in designing their compensation contracts and to divert value to themselves at the expense of shareholders.[11]

Corporate law theorists, however, have taught us that the presence of a controlling shareholder should alleviate the problem of managerial opportunism. Controlling shareholders, the theory suggests, have both the ability and the incentive to monitor executive pay. Therefore, to the extent that the executives of controlled companies are professional managers not affiliated with the controllers, the common wisdom has long been that the controllers have an interest, which is aligned with that of other public shareholders, in restraining executive compensation to a level that maximizes shareholder value.[12]

References to this conventional wisdom can be found in the works

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[8] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, 139 (1932) (observing that managers "while in office, have almost complete discretion in management").

[9] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FINANC. ECON. 305, 309, 315 (1976) (noting that "there is good reason to believe that the agent will not always act in the best interests of the principal").

[10] *See, e.g.*, Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1048-1057 (2007).

[11] *See*, *e.g.*, Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1309 (2008); Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71-2, 75-6 (2003).

[12] *See infra* notes 13-15 and 27, and accompanying text.

of well-known law professors and financial economists. Jeffery Gordon and Ronald Gilson, for instance, stress that controlling shareholders may "devise more accurate incentive compensation for the management", and, therefore, that "the non-controlling shareholders get more focused monitoring at a relatively low cost".[13] Andrei Shleifer and Robert Vishny argue that "[t]he more serious problem with high powered [managerial] incentive contracts" appear when "these contracts are negotiated with poorly motivated boards of directors rather than with large investors."[14] And, Lucian Bebchuk and Assaf Hamdani explain that "[d]iversion of value through executive compensation… is a concern of lesser importance in CS companies [controlled companies] than in NCS companies [widely-held companies]… to the extent that the company's executives are professional managers not affiliated with the controller, the controller generally has an interest in setting executive compensation to maximize shareholder value…"[15]

Preliminary data presented in this Article reveals a more nuanced picture, showing that the compensation of professional managers in controlled companies appears to be a bigger problem than initially predicted. The Article uses a novel approach to question conventional beliefs on executive pay by reviewing the recommendations of Institutional Shareholder Services, Inc. (the ISS), the leading and the most influential proxy advisory firm in the United States, on say-on-pay votes in the 2011 and 2012 proxy seasons. The data provides an indication that the compensation packages of professional managers in controlled companies are unlikely to be accurately calibrated to maximize shareholder value.

The Article explores a few potential explanations for this "puzzle" of executive compensation in controlled companies that are based on an agency problem paradigm. Controlling shareholders, the first explanation suggests, may wish to overpay managers in order to maximize their consumption of private benefits of control, while providing professional managers with a premium for their "loyalty" and for colluding with tunneling activities. This tendency, according to the second explanation, is aggravated by the use of control-enhancing mechanisms, such as dual-class share structures, which further distort controllers' monitoring incentives. The third explanation explores situations where controllers are "weak",

[13] Ronald J. Gilson & Jeffrey N. Gordon, *Doctrines and Markets: Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 785, 792 (2003).

[14] Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 754-5 (1997).

[15] Bebchuk & Hamdani, *supra* note 11, at 1284 (also noting that while controllers might use generous compensation arrangements to induce managers to facilitate controllers' tunneling, managers usually have an incentive to cater to the controller preferences even without being paid for their cooperation).

such as second generation controllers, or biased due to their longstanding relationship with professional managers, and cannot be expected to exercise an impartial influence over the formulation of compensation contracts.

To be clear, the view presented in this Article is not that all controlling shareholders are useless in curbing executive pay of professional managers. It merely suggests that compensation practices of professional managers of controlled companies may have their own pathologies, and that minority shareholders cannot always trust controllers to effectively monitor the pay of professional managers. The proposed theory also advances the view that there is significant heterogeneity across U.S. controlling shareholders. Controllers vary in their identity, skills, or preferences, and such differences may impact their incentives and willingness to monitor executive pay.

The focus of this Article is on hired professional CEOs, who are not affiliated with the controllers, for two main reasons. On the theoretical level, paying excessive compensation to controllers who also serve in managerial roles (controllers-CEOs) has long been viewed as another mechanism for transferring private benefits to the controllers.[16] This mechanism for expropriating minority shareholders does not raise any new dilemma, and is consistent with the existing theory on agency problem between controllers and minority shareholders. On the normative level, the pay of controller-CEOs is often covered by rules that regulate related-party transactions, and, therefore, is already subject to special approval procedures.[17] The payment to hired professional CEOs, however, is currently not covered by these anti-self-dealing rules and deserves more exploration.

A close examination of executive compensation in controlled companies is warranted, as concentrated ownership is the most prevalent type of ownership in many countries around the world.[18] Even in the United States, where the model of large, widely-held firms is dominant, there is a significant fraction of controlled companies.[19] Furthermore, the need to take

[16] *See infra* note 25.

[17] *See* Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, *The Law and Economics of Self-dealing*, 88(3) J. FINANCE. ECON. 430 (2008) (surveying self-dealing rules around the world).

[18] *See*, *e.g.*, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 491-497 (1999), Mara Faccio & Larry H.P Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FINANC. ECON. 365 (2002), and Stijn Claessens, Simeon Djankov & Larry H.P Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FINANC. ECON. 81 (2000).

[19] *See*, Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FINANC. STUD. 1377, 1382 (2009) (using a sample of 375 U.S. public corporations and finding that the average size of the largest block is 26%), and Ronald Anderson,

CEO pay in controlled companies more seriously has increased recently due to the global shift toward say-on-pay regulation.

The adoption of say-on-pay rules in countries where most companies have controlling shareholders with presumably strong incentives not to overpay executives is not trivial and calls for a more in-depth discussion about the justifications for those rules. Recently, Randall Thomas and Christoph Van der Elst presented social and political explanations for this puzzling phenomenon.[20] The Article contributes to the discourse on the relationship between concentrated ownership and executive pay by suggesting an alternative explanation based on an agency problem paradigm, and by further broadening the taxonomy of controlling shareholder systems.

This global trend also highlights the importance of developing a regulatory solution that will best fit a controlled company. The solution this Article calls for is straightforward: re-conceptualize the pay of professional managers in controlled companies as an indirect self-dealing transaction and subject it to the applicable rules that regulate conflicted transactions.

Accordingly, this Article proceeds as follows: Part II lays out the background to the discussion on executive compensation in controlled companies, and explains the limitations of the conventional view. Part III presents the agency problem theory in designing executive compensation in controlled companies. Part IV shows evidence from the ISS on executive pay patterns in U.S. controlled companies that are difficult to understand within an optimal contracting framework. This Part also explains why existing empirical evidence does not undermine the agency problem theory and suggests a few potential avenues for future research. After Part V discusses the economic and regulatory impacts of the proposed theory, Part VI proposes a new regulatory solution.

II. CONTROLLERS' MONITORING POWER AND ITS LIMITATIONS

A. Ownership Structure and Executive Compensation

It is well known that the nature of agency problems differs greatly between companies with a controlling shareholder (CS companies) and those without a controller (NCS companies),[21] and that this difference, in

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Augustine Duru & David M. Reeb, *Founders, Heirs, and Corporate Opacity in the U.S.*, 92 J. FINANCE. ECON. 205, 207 (2008) (showing that in 2,000 largest industrial U.S. firms, founder-controlled firms constitute 22.3% and heir-controlled firms comprise 25.3%, with average equity stakes of approximately 18% and 22%, respectively).

[20] *See infra* notes 109 and 148.

[21] *See, e.g.*, Bebchuk & Hamdani, *supra* note 11. I follow the terminology of Bebchuk & Hamdani by referring throughout the paper to companies with a controlling shareholder

turn, affects the extent to which academics have been concerned by suboptimal compensatory arrangements. In NCS companies, the starting point for any debate on executive compensation recognizes that "managers suffer from an agency problem and do not automatically seek to maximize shareholder value."[22] Therefore, diversion of value through suboptimal executive compensation has long been a source of concern.

Against this background, two different approaches to executive compensation in NCS companies have evolved over time. On one side of the debate stand scholars who argue that although managers suffer from an agency problem, the board of directors, which works in shareholders' interest, overcomes this problem by effective arm's length bargaining with managers and through the use of incentives, such as equity-based compensation, to align the interests of managers and shareholders. This theory is known as the "optimal contracting theory".[23] On the other side of the debate, supporters of the "managerial power theory" claim that weak governance allows executives to influence their own pay, and they use that power to extract rents. According to this school of thought, because the board of directors is influenced by the firm's executives, it does not operate at arm's length in devising executive compensation arrangements, and such arrangements are unlikely to maximize shareholder value.[24]

While the debate over the optimality of executive compensation in NCS companies has been controversial, vocal, and has certainly attracted high levels of attention, the discourse on executive compensation in CS companies has long been one-sided. This narrow focus implies an assumption that the agency problem in CS companies, between controllers and minority shareholders, does not raise any special concern regarding the diversion of value through suboptimal executive compensation when controllers employ professional managers.[25] In such situations, the common

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as "CS companies", and to those without a controller as "NCS companies".

[22] Bebchuk & Fried, *supra* note 11, at 73.

[23] For scholars supporting this view, s*ee ,e.g.*, Xavier Gabaix & Augustin Landier, *Why has XEO Pay Increased So Much?,* 123 QUART. J. ECON. 49 (2008); Steven Kaplan, *Executive Compensation and Corporate Governance in the U.S.: Perceptions, Facts, and Challenges* (National Bureau of Economic Research Working Paper 18395, 2012).

[24] *See, e.g.*, Bebchuk & Fried, *supra* note 11, at 71-6.

[25] As noted in the Introduction, I do not focus on the compensation to controller CEOs as such pay has already been described in the economic literature as another mechanism for rent extraction. *See*, Harry DeAngelo & Linda DeAngelo, *Controlling Stockholders and the Disciplinary Role of Corporate Payout Policy: a Study of the Times Mirror Company,* 56 J. FINANC. ECON. 153, 154-156 (2000) (providing evidence that family shareholders extract private rents through different ways, including excessive compensation schemes); Yan-Leung Cheung, Aris Stouraitis & Anita W.S. Wong, *Ownership Concentration and Executive Compensation in Closely Held Firms: Evidence from Hong Kong*, 12 J. EMP. FIN. 511, 521-528 (2005) (finding that the excess pay of owner-managers is not associated

perception has long been that controlling shareholders can monitor the compensation of professional managers effectively.

B. Unbundling Controllers' Monitoring Power

The premise that controlling shareholders have both the interest and the power to set the compensation of professional managers at a level that maximizes shareholder value relies on two main building blocks: first, it presumes that all controlling shareholders generally have an economic interest to monitor managers closely and to reduce managerial rent-extraction of shareholder wealth, while aligning their interests with those of minority shareholders.[26] If a controller does not monitor closely managerial rent-extraction then, the argument continues, any associated decrease in the firm's value will first and foremost be borne by the controller. Second, the theory assumes that all controlling shareholders have the power to monitor professional managers impartially and to exercise an unbiased influence over the process of formulating their compensation contracts. [27] In sum, it simply assumes an arm's length transaction between controllers and professional managers.

These underlying assumptions, however, do not always hold. To begin with, CS companies vary in their ownership structure and many other aspects, which, in turn, impact controllers' incentives to monitor executive pay effectively.[28] For instance, not all controlling shareholders hold a large stake of the controlled firm cash flow,[29] and the lack of substantial economic holdings may negatively affect their monitoring incentives.

Even if a controller maintains a large economic interest in a company, setting the compensation of professional managers at an optimal level does not necessarily maximize the economic interests of the controller. As further elaborated below, a controller may have a strong interest in maximizing its consumption of private benefits, even at the price of deviating from executive pay practices suggested by optimal contracting.[30]

Finally, not all controlling shareholders have the ability, power or willingness to monitor managers closely. Some controllers may lack the relevant business experience, and are more likely to develop strong dependency on their professional managers. Others may have judgment biases because of their longstanding relationship with professional managers. Such dependency or biases, in turn, impair the power or

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with better performance, and interpreting it as a sign of a rent extraction).

[26] *See supra* notes 13-15 and accompanying text.

[27] *See, e.g.*, Shleifer & Vishny, *supra* note 14, at 754-5.

[28] *See infra* notes 116, 131-133 and accompanying text.

[29] *See infra* note 70 and accompanying text.

[30] *See infra* Section III.A.

willingness of those controllers' to monitor executive pay closely.[31]

C. The Limitation of Market Forces

Market forces are also unlikely to impose tight constraints on controllers' ability to substantially deviate from an optimal contracting scheme. The market for corporate control, for instance, is totally unimportant in controlled companies, as a hostile takeover is not feasible even in the absence of antitakeover impediments.[32] The disciplinary effect of the market for capital is also more limited in the context of CS companies, as many controllers can rely on their own financial resources instead of turning to the capital market to raise funds.[33] In addition, controllers' failure to limit tightly managerial pay is likely to raise only slightly a firm's cost of capital.[34]

The managerial labor market is the only market force that, at least in theory, might have some effect on the level and design of compensation contracts in CS companies.[35] High level of executive compensation, it is argued, can be a reflection of supply and demand in the competitive labor market for executives, and in that sense a strong competition among controllers for recruiting super-star CEOs is similar to the market

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[31] See *infra* Section III.C.

[32] Bebchuk & Hamdani, *supra* note 11, at 1270; Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 421-423 (2003).

[33] In countries with large business groups, controllers can also allocate excess cash flow inside the business group, using "internal capital market" as a substitute for outside financing. *See, e.g.*, Tarun Khanna & Yishay Yafeh, *Business Groups in Emerging Markets: Paragons or Parasites?*, 45(2) J. ECON. LITER. 331 (2007). In addition, in such countries, the high degree of centralization, the interlocking ownership or control, and the thin market for trading shares provide additional explanations for the ineffectiveness of the market for capital.

[34] For an analysis of the limited effectiveness of the market for capital in constraining managerial pay, see, *e.g.*, Zohar *Goshen*, *Controlling Corporate Agency Costs: A United States-Israeli Comparative View*, 6 CARDOZO J. INT'L & COMP. L. 99, 113 (1998); Goshen, *supra* note 32, at 423 (noting that if the corporation does not have to turn to the capital market to raise funds, that market cannot control the majority's ability to expropriate minority shareholders"); and Lucian A. Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 778 (2002) (noting that excessive managerial pay will raise only slightly a firm's cost of capital).

[35] For a literature supporting the market view in the context of NCS companies, s*ee, e.g.*, Gabaix & Landier, *supra* note 23; R. Glenn Hubbard, *Pay Without Performance: A Market Equilibrium Critique*, 30 J. CORP. L. 717 (2005). It is also possible that scarcity of talented CEOs in certain sectors increases their relative bargaining power. See, Martijn Cremers and Yaniv Grinstein, *Does the Market for CEO Talent Explain Controversial CEO Pay Practices?* (REV. FIN., forthcoming, 2013).

competition among team owners for attracting talented NBA players. Relatedly, executive pay level could also be influenced, at least partially, by a recent increase in competition in the international managerial labor market for CEOs, especially in light of the growing convergence in international pay practices.[36]

True, the competition in the managerial labor market may have some effect on the level and design of executive pay in CS companies, but one should not infer from it that such pay level is solely a product of market forces. Since controlling shareholders have the power to hire professional CEOs, a strong competition between managers in order to influence the controllers' hiring decisions could actually reduce professional managers' bargaining power vis-à-vis controllers and negatively impact their pay level.[37] Moreover, when a premium is paid by controllers in order to recruit better managers, one would expect to see a positive connection between the premium and the performance of CS companies.[38] Evidence presented below shows, however, that managers of CS companies are not always paid for better performance.[39] This skeptical position toward the effectiveness of the managerial labor market is further corroborated by preliminary evidence from the ISS recommendations on say-on-pay votes presented in Part IV, which is difficult to understand within an optimal contracting framework. Finally, one could also raise a "race to the bottom" argument in the context of managerial pay, claiming that the level and design of executive compensation in U.S. CS companies is negatively affected by problematic pay practices in NCS companies that do not necessarily align pay with

[36] Nuno Fernandes, Miguel A. Ferreira, Pedro Matos & Kevin J. Murphy, *The Pay Divide: (Why) Are U.S. Top Executives Paid More?*, 1, 25-26 (2009), European Corporate Governance Institute, Finance Working Paper No. 255, available at http://rady.ucsd.edu/faculty/seminars/2010/papers/matos.pdf. (showing that executive pay is higher when foreign sales are higher, and when foreign firms are cross-listed on U.S. exchanges).

[37] This tendency is even more pronounced in countries with large business groups, as controlling shareholders control the nomination of numerous executive positions in all the companies that belong to the same business group.

[38] There can be other explanations for the premium paid to professional CEOs of CS companies, but such explanations do not have strong empirical support. See *infra* note 122 and accompanying text.

[39] *See, e.g.*, *infra* Section III.A.2. (showing that dual-class firms that pay higher salaries to their managers are not associated with better performance); Francisco Gallego & Borja Larrain, *CEO Compensation and Large Shareholders: Evidence from Emerging Markets*, 40 J. COMP. ECON. 621, 622-624 (2012) (researching executive compensation in Argentina, Brazil and Chile, and empirically rejecting the hypothesis that the premium paid to professional CEOs of CS companies is associated with better performance or with higher risk of being fired). See also evidence on executive pay in Israel (*infra* note 58) and Italy (*infra* note 59) (both showing the increase in executive pay in those countries was not associated with better performance).

performance.[40]

The international competition in the managerial labor market is also more limited than initially anticipated. The underlying assumption behind the international competition in the managerial labor market is that there is an easy transferability of managerial talent around the globe. This assumption is not always realistic. The "exit" threat of CEOs, especially those who manage firms that have dominant positions in the domestic market and that operate in industries that suffer from weak global competition, may be less reliable than initially assumed. Such CEOs, who often reach the top managerial position at a relatively late age, face personal, cultural and language barriers and they lack the knowledge of the relevant foreign market, and therefore their inter-market transferability and bargaining power is limited.

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In sum, this Part discusses the limitations of controller's monitoring power and of the market mechanisms. It is worth emphasizing that the view presented here is not that all controlling shareholders are useless in curbing excessive executive compensation. Certain controllers probably do impose some constraints on executive pay. However, for various reasons discussed in this Article, it is hard to believe that their monitoring power is always effective enough to ensure that the compensation of professional managers in CS companies does not substantially deviate from optimal contacting.

III. TOWARDS AN AGENCY COST THEORY

I now turn to discuss the agency problem theory in determining executive compensation in CS companies. This theory challenges the common wisdom that controlling shareholders generally have an interest in setting executive compensation to maximize shareholder value. In particular, I propose three explanations as to why compensation practices in a large number of CS companies are likely to substantially deviate from an arm's-length contracting between controllers and professional managers.

The first two explanations to the agency cost theory assume a

[40] This argument is based on the corporate governance externalities theory. *See and compare,* Viral V. Acharya & Paolo F. Volpin, *Corporate Governance Externalities,* 14(1) REV. FIN. 1, 29-30 (2010). Note that the externalities view is distinguishable from optimal contracting because it does not necessarily assume that a strong competition in the market for labor leads to optimal compensation schemes. As Acharya and Volpin clarified: "[O]ur model suggests that competition for talent is not necessarily a guarantee that observed pay and pay-for-performance sensitivity levels are efficient". *Id*.

rational controller who chooses not to closely monitor executive pay of professional managers since the private benefits such controller derives from not exercising tight monitoring on managers outweighs the monitoring benefits and the costs associated with such monitoring. The third explanation deviates from the rationality framework. It assumes a controller who is not a profit-maximizer, but who derives non-pecuniary benefits from the maintenance of family control over the firm, or from close social relationship with the company's professional CEO.

These different explanations are not mutually exclusive, as a single CS company may "suffer" from more than one type of agency problem at the same time. Also, as there is significant heterogeneity across controlled companies, some explanations may be more relevant to one type of controlled companies than to others. The purpose of this Part, however, is to show that from a theoretical perspective there are good reasons to believe that a large number controlled companies may be affected by at least one of the problems presented below.

A. Rent Extraction

1. Extra Pay in Exchange for Managerial Collusion

The rent extraction explanation suggests that controllers may be willing to pay professional managers extra compensation in exchange for their collusion with controllers' extraction of private benefits and as a premium for their loyalty to the controllers.

Controllers of CS companies often have opportunities to divert value from the company to themselves various forms of inter-company transactions such as selling (or buying) assets, goods or services in terms that favor the company in which the controlling shareholder has the larger equity stake.[41] They can also employ family members at the company,[42] use the company resources for their personal benefits,[43] receive financing on favorable terms using the controlled firm's assets as collateral,[44] or exploit company business opportunities through another company they owns.[45]

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[41] *See, e.g.*, Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000); Eric Friedman, Simon Johnson and Todd Mitton, *Propping and Tunneling*, 31 J. COMP. ECON. 732, 374-376 (2003), and Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 IOWA J. CORP. L. 1 (2011).

[42] *See supra* note 16 and accompanying text.

[43] *See, e.g.*, Atanasov et al., *supra* note 41, at 25-8.

[44] *See, e.g.*, Johnson et al., *supra* note 41, at 26.

[45] *See, e.g.*, Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59(2) J. FIN. 537, 540-41 (2004). Atanasov et al. *supra* note 41, at 8.

Such transactions are referred to in the literature as "tunneling".[46] Tunneling through any of the above-mentioned channels is usually achieved through collusion between controlling shareholders and professional managers.[47]

As managers may have a *de facto* veto right over related-party transactions, controllers who are interested in increasing the scope of tunneling may be willing to share the stake of the transferred private benefits (the "rent") with professional managers in form of higher compensation.[48] Then, by providing executives with excess pay packages, the controllers make it harder for those managers to resign or to resist value diversion activities and risk their job.

A rational, value maximizing controller will pay extra compensation to a professional manager if the additional private benefits such controller derives from overpaying the manager outweighs the prorated costs such controller incurs due to the payment of extra compensation and the decrease in the firm value as a result of the enhanced transfer of private benefits (in case such decrease actually occurs). Suppose, for example, that a controller has 30% of the outstanding shares of a company. Such controller is constantly engaged in self-dealing transactions that result in a loss of $50 per year to the company, but a private benefit in the same amount to the controller. In order to facilitate the transfer of private benefit the controller grants the professional manager additional compensation of $10 per year. As the *Table 1* shows, the controller would pay such extra compensation to the determinant of minority shareholders.

[46] *See, e.g.*, Johnson et al., *supra* note 41, and Atanasov et al., *supra* note 41.

[47] *See, e.g.*, Yan-Leung Cheung, P. Raghavendra Rau & Aris Stouraitis, *Tunneling, Propping, and Expropriation: Evidence from Connected Party Transactions in Hong Kong*, 82 J. FINANC. ECON. 343 (2006); Guohua Jiang, Charles M.C. Lee & Heng Yue, *Tunneling Through Intercorporate Loans: The China Experience*, 98 J. FINANC. ECON. 1, 2-4 (2010). While in many countries related-party transactions require the approval of independent directors or shareholders, such transactions are usually initiated by the managers, and will not be brought to the board approval without the support of those managers.

[48] Note that the provision of inflated pay packages in exchange for managerial collusion can be camouflaged by the parties as the high pay can be explained on many other grounds.

Table 1

	Additional Profits	**Extra Costs**
Controlling Shareholder	$50 (additional private benefit)	$18 (30% of $60 (which is the sum of the loss in the company value ($50) and the extra compensation ($10) to the CEO)).
Other Shareholders	0	$42 (70% of $60)

2. Why Would Controllers Pay Extra Compensation?

It may be argued that controllers, who in any event have the authority to hire and terminate managers, do not need to pay their managers extra compensation for inducing them to collude with value diversion activities. Since managers want to get hired or keep their job, they already have an incentive to cater to controller preferences.[49]

Excessive consumption of private benefits, however, may have an adverse economic effect on firm value. Executives who collude with controllers to facilitate such activities will be responsible for the resulting decrease in firm performance. Moreover, if tunneling or other value diversion activities receive negative media coverage or are found by courts to be illegal and harmful to shareholders, the reputation of such executives will be at risk, and they may even face legal sanctions. Therefore, it can be assumed that professional executives, who do not receive any direct benefit from colluding with tunneling, have weaker incentives to facilitate such activities.

Also, firing managers for not colliding with value diversion activities imposes costs on a controller. A change in the company leadership, and especially an unjustified one, may disrupt the company's operational activities and be associated with negative pubic coverage and a potential decline in the stock price. A controller also has to provide a persuasive explanation to other shareholders as to why the manager was fired by filing a public report. As a result, a controlling shareholder is less likely to use her authority to terminate managers very often.

Suboptimal compensation to professional managers may also be triggered by controllers' willingness to pay generous salaries to themselves

[49] *See*, *e.g.*, Bebchuk & Hamdani, *supra* note 11, FN 68.

or to their relatives. In a case where controllers (or affiliates of the controllers) also serve in managerial positions, other than the CEO position, they can influence their own levels of remuneration, and use it as another means of expropriating minority shareholders.[50] However, once controllers pay themselves (or their relatives) excess salaries they set a high threshold, and will have to pay professional mangers a compensation that is at least as high as the one awarded to themselves (or to their relatives).

3. Empirical Evidence on Rent Extraction and Excess CEO Pay

Obviously, systemic evidence on the direct link between minority expropriation and executive pay is hard to find due to the nature of tunneling activities, which may include a large number of complicated related-party transactions that are hard to track and financially assess. While in the United States there is a dearth of literature examining the association between minority expropriation and executive pay, evidence from other countries around the world shows such a positive association.

For instance, one study on Chinese firms shows that the pay-performance sensitivity of executive compensation is lower in firms where controlling shareholders tunnel resources for private benefits compared to other firms.[51] The authors of this study conclude that "executives may not care much about firm performance after all if controlling shareholders are able to provide non-pecuniary compensation to executives based on how they tunnel for the controlling shareholders".[52] Another study on Chinese public firms provides similar result, showing that increases in CEO compensation are associated with more likelihood of controlling shareholders' tunneling. The authors of this study summarize that "the nature of large shareholders is an important factor behind their supervision or collusion choices and it affects management compensation."[53]

A recent study on Italian family firms shows that they pay their board members (including members not affiliated with the controlling shareholder) more than other firms, and that such "excess compensation is negatively related to the firm's future performance".[54] The authors of the

[50] *See supra* note 16.

[51] Kun Wang & Xing Xiao, *Controlling Shareholders' Tunneling and Executive Compensation: Evidence from China*, 30 J. ACCOUNTING PUB. POLICY 89, 94-99 (2011) (using data on Chinese companies from 1999 to 2005).

[52] *Id.* at 97.

[53] Yongli Luo & Dave Jackson, *CEO Compensation, Expropriation and Balance of Power among Large Shareholders* 15 ADV. FINANC. ECON. 195, 204 (2012) (using data on public Chinese companies from 2001 to 2010).

[54] Roberto Barontini & Stefano Bozzi, *Board Compensation and Ownership Structure: Empirical Evidence for Italian Listed Companies*, 15(1) J. MGMT. GOV. 59, 77 (2011).

study interpreted this result as an evidence of rent extraction, arguing that families over-compensate their board members to "buy" their loyalty and allow them to expropriate minority shareholders.[55]

Finally, a study on institutional investors' voting patterns in Israel finds that institutional investors support for proposals related to compensation of professional CEOs of controlled companies tend to be low even when minority shareholders cannot influence outcomes. This tendency of institutional investors to oppose executive compensation proposals show, according to the authors, that the pay of professional managers is an important source of concern even in firms with controlling shareholders and can support the assertion that controllers provide professional managers with overly generous compensation arrangements to secure managerial cooperation with minority shareholder oppression.[56]

An indirect way to estimate the levels of private benefits enjoyed by controllers that is commonly accepted by financial economists is to examine the premium paid in connection with a transaction for a sale of a control block.[57] Based on the rent extraction explanation, one would anticipate that compensation of professional CEOs will be excessive and suboptimal in countries where controllers pay high premium for acquiring a control block, and thus are expected to enjoy high level of private benefits of control. Indeed, suboptimal pay patterns have been observed in some counties with concentrated ownership that are among the high private benefit countries, such as Israel,[58] Italy[59] and Brazil.[60]

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[55] *Id*.

[56] Assaf Hamdani and Yishay Yafeh, *Institutional Investors as Minority Shareholders*, 17(2) REV. FIN. 691 (2013) (researching institutional investors voting in 2006).

[57] Dyck & Zingales, *supra* note 45, at 539, 543-544 (studying control premium in 39 countries between 1990 and 2000).

[58] Dyck & Zingales found a mean of private benefit (as a percentage of equity) of 27% in Israel. *Id.*, at 544. *See* also Ronen Barak & Beni Lauterbach, *Estimating the Private Benefits of Control from Block Trades: Methodology and Evidence*, 2 INT'L J. CORP. GOV. 183, 192 (2011) (studying control premium in Israeli companies during the period 1993-2005. Their results for private benefits (32%) are similar to those of Dyck & Zingales). For a discussion on the suboptimal level of executive compensation in Israel, see reports by the Israeli Securities Authority (ISA), showing that while the average salary of all Israeli senior executives doubled between the years 2003-2009, the connection between firm performance and higher CEOs salaries is not statistically significant (ISA Economics Department, *Executive Compensation in Public Companies 2003-2011*, 5, 16-7, 27, *available at* http://www.isa.gov.il/Download/IsaFile_7531.pdf; and *Executive Compensation* (2010) *available at* http://www.isa.gov.il/Download/IsaFile_5029.pdf (in Hebrew)).

[59] According to the Dyck & Zingales study the control premium in Italy is 37%. *Id.*, at 563. A comprehensive comparative study, using a sample of developed European countries, shows that Italy is among the highest pay countries, and that bonuses for Italian CEOs are not significantly related to different performance measures. *See*, Martin J.

4. Tunneling in the United States

Finally, one may argue that while minority shareholder expropriation is relatively common in developing countries,[61] it barely exists in developed countries that have effective legal enforcement and corporate governance rules to protect monitory shareholders' interests. This assumption is not accurate. Although a developed country may have advanced rules with respect to interested party transactions, it should be recognized that, no matter how effective these rules are, they cannot address all the ways in which private benefits are extracted. Therefore, having advanced anti-self-dealing rules should not be a basis for concluding that tunneling activities have been adequately addressed by existing regulatory framework. Indeed, there is evidence that tunneling, and the associated expropriation of minority shareholders, is also widespread in developed countries.[62] Vladimir Atanasov, Bernard Black and Conrad Ciccotello show that even in the United States the existence of gaps in the overall system of anti-tunneling legal protections led to the exploitation of public shareholders by controllers.[63]

In Part IV, I present data on CS companies that the ISS recommended to vote against the compensation packages of their CEOs. A large number of these companies engage in various forms of self-dealing transactions or employ relatives of the controllers in managerial positions.[64]

Conyon, Nuno Fernandes, Miguel A. Ferreira, Pedro Matos & Kevin J. Murphy, *The Executive Compensation Controversy: A Transatlantic Analysis*, 5 INSTITUTE FOR COMPENSATION STUDIES 43-44, 47-53, 111-112 (2011).

[60] According to the Dyck & Zingales study the control premium in Brazil is 65%. *Id.*, at 563. For a discussion on the suboptimal level of executive compensation of professional managers in Brazilian CS companies, see, Gallego & Larrain, *supra* note 39, at 630-641.

[61] *See, e.g.,* Atanasov et al., *supra* note 41 (providing examples of tunneling in developing markets); and Bertrand, Mehta & Mullainathan, *supra* note 76 (discussing tunneling in India).

[62] For a discussion of tunneling in developed markets, see Atanasov, Black & Ciccotello, *supra* note 61, FN 1.

[63] *See*, *e.g.*, i*d*, at 25-36; Elizabeth A. Gordon, Elaine Henry & Darius Palia, *Related Party Transactions and Corporate Governance*, 9 ADVANCES IN FINANCIAL ECONOMICS 1 (2004) (researching related party transactions (RPTs) in the United States, and finding that weaker corporate governance mechanisms are associated with more and higher dollar amounts of RPTs, and that that industry-adjusted returns are negatively associated with RPTs); Conrad Ciccotello, C. Terry Grant & Gerry H. Grant, *Impact of Employee Stock Options on Cash Flow*, 60 FINANCIAL ANALYSTS JOURNAL 39 (2004) (discussing the severe effects of "repricing" stock options on the company cash flow and its dilution impacts).

[64] The New York Times Company, for instance, reports that seven family members of the controlling family work for the company (*see* The New York Times Company proxy statement filed with the SEC on March 19, 2013). Similarly, Marriot International Inc.

It is also a common practice for many of the sampled controlled companies to overpay their controllers for the use of aircrafts those controllers own. The example of Las Vegas Sands, Inc. (LVS) stands out with this respect. In 2011 alone, LVS paid $16.7 million to private companies controlled by LVS' controller for LVS' use of aircraft services.[65] Not surprisingly, the ISS, in its 2012 Report, expressed concern over LVS' continued provision of high levels of excessive perquisites to its controller without disclosed justification.[66] Martha Stewart Living Omnimedia, Inc. (MSLO) is another noticeable example of a CS company whose controller is constantly involved in tunneling. Although the company is managed by a professional CEO, its founder, Martha Stewart, is still involved in the management of the company. The ISS, in its 2012 report, critiqued "the year-over-year increase in perquisites afforded to Martha Stewart" noting that it "is of significant concern to shareholders…".[67]

Interestingly, the provision of excessive perquisites to the controllers of the above-mentioned companies is also accompanied by the payment of "generous" salaries to the companies' top executives. In the case of LVS, the ISS, voiced serious concerns over the pay package of LVS' Chief Operating Officer (a professional manager not affiliated with the controller).[68] Similar concerns were expressed over the preponderance of problematic pay practices in MSLO, such as guaranteed bonus payments to senior managers (and not just to the company's controller) during a time of poor TSR performance, which, according to the ISS, "have fueled a pay-for-performance disconnect for the second year in a row".[69]

B. Control-enhancing Devices

1. The Effect of Control-enhancing Devices on Executive Pay

Controllers of many public firms around the world often use control-

employs six members of the Marriott family in managerial positions, and there are additional relatives of those executives who are also employees of the company, but whose names were not disclosed in the public filings (*see* Marriot International Inc. proxy statement filed with the SEC on April 5, 2013).

[65] LVS, on the other hand, charged the private companies controlled by LVS' controller only $1 million with respect to their use of LVS' aircrafts. *See* Las Vegas Sands Corp. proxy statement filed with the SEC on April 27, 2012.

[66] ISS Proxy Advisory Services vote recommendations for Las Vegas Sands' 2012 annual meeting (May 21, 2012), at 14-15.

[67] ISS Proxy Advisory Services vote recommendations for Martha Stewart's 2012 annual meeting (May 10, 2012), at 18.

[68] *See supra* note 66.

[69] *See supra* note 67.

enhancing devices, such as pyramids and dual-class shares to maintain their control.[70] Control-enhancing devices are mechanisms that separate cash flow rights and voting rights, and in their presence, controlling shareholders do not have to keep a large equity stake in order to exercise control over a majority of the firm voting rights.[71]

How does the divergence between ownership rights and control rights affect the compensation of professional managers? The divergence has a dual effect. First, it negatively affects controllers' willingness to incur the monitoring costs. Second, it positively affects controllers' tendency to divert private benefit or to take excess risks, and such tendency, in turn, induces controllers' willingness to overpay professional CEOs. In other words, the existence of control enhancing mechanism aggravates the agency problem presented in Sections III.A. and III.C. I now turn to discuss these two effects in greater details.

On the costs side, as only a small fraction of the CEO compensation and the decrease in firm value is borne by a minority controller who uses a control-enhancing device, the latter has weaker incentives to monitor the CEO than a controller who holds 50% of the firm cash flow. Suppose, for example, that the cost of monitoring the CEO is $20, and that the enhanced monitoring will reduce CEO pay and increase firm value by $100. Since the monitoring cost remains constant (regardless of the size of the equity stake held by the controller), it would be economically inefficient for a minority controller, who holds 10% of the firm cash flow, to closely monitor a professional manager, as such controller will incur all the monitoring costs ($20), but will receive only $10 of the additional profits (10% of $100). However, for a controller who holds 50% of the firm cash flow it would be efficient to closely monitor the CEO, as such controller will bear the same costs ($20), but will receive $50 of the additional profits.

One may still argue that although only a small fraction of the extra compensation is borne by a minority controller (say 10% instead of 50%), such controller still incurs some of the losses caused by providing

[70] *See* Lucian A. Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights in* CONCENTRATED CORPORATE OWNERSHIP 295, 298-301 (2000) (presenting a theoretical description of these mechanisms); Ronald W. Masulis, Cong Wang and Fei Xie, *Agency Problems at Dual-class Companies*, 64(4) J. FIN. 1697-1727 (2009) (discussing dual-class firms in the United States); Claessens, Djankov & Lang, *supra* note 18 (discussing the separation of voting rights from cash-flow rights via pyramid structures and cross-holdings in East-Asian countries); Faccio & Lang, *supra* note 18, at 381-393 (showing that dual-class shares and pyramids are prevalent among Western European countries).

[71] Bebchuk, Kraakman & Triantis, *id.*, at 298-301 (describing the effects and distortions created by control-enhancing mechanisms).

professional CEOs with excessive compensation.[72] Therefore, the argument continues, such controller still has certain incentives to pursue optimal contracting schemes. True, the use of control enhancing mechanism does not fully eliminate controller's incentives to closely monitor professional managers. However, it clearly weakens such incentives, and this negative effect becomes greater as the divergence between cash flow and control rights widens.[73]

The divergence between cash flow rights and control rights has another negative effect on controller's incentives. Such divergence leads to certain misalignment of interests between the minority controller and other shareholders, and to distortions in controller's business decisions. For instance, the divergence increases controllers' tendency to divert private benefits of control to their own pocket, or to follow high risk activities. By holding only a small fraction of the firm cash flow rights, such controllers are able to capture the full private benefits from operating the company or from any potential increase in the firm cash flow,[74] but they do not bear the full economic consequences of a potential decrease in firm value due to an enhanced transfer of private benefits or excess risk taking.[75] Indeed, it is well established in the economic literature that the incentives to expropriate minority shareholders increase in the presence of control-enhancing devices,[76] and that holding asymmetric positions lead to excess risk

[72] If the monitoring costs in the above-mentioned example were $2 (instead of $20), it would be efficient even for a minority controller to exercise additional monitoring, and to receive an additional profit of $10, while bearing costs of $2.

[73] Bebchuk, Kraakman & Triantis, *supra* note 70 (showing that when two companies with separation of cash flow rights and voting rights are identical except that the controller own 20% of cash flow rights in one but only 15% in the other, the agency costs in the latter company can be expected to be more than twice the agency costs in the former).

[74] For instance, if a risky strategy succeeds and the level of the firm cash flow increases, the controller may be able to use some of the excess cash flow for empire building, to divert the additional profits to its pockets, or to gain other non-pecuniary interests such as increased political clout.

[75] Lucian A. Bebchuk, *Corporate Pyramids in the Israeli Economy: Problems and Policies* 1, 7-11 (A report prepared for the Committee on Increasing Competitiveness in the Israeli Economy, 2012), available at: http://mof.gov.il/Lists/CompetitivenessCommittee_4/Attachments/3/Opinion_2.pdf.; *See* also Bebchuk, Kraakman & Triantis, *supra* note 70, 298-301.

[76] *See*, *e.g.*, Marianne Bertrand, Paras Mehta & Sendhil Mullainathan, *Ferreting Out Tunneling: An Application To Indian Business Groups*, 117(1) Quart. J. Econ. 121 (2002) (presenting evidence about the significant volume of tunneling taking place in firms using control enhancing devices); Paul A. Gompers, Joy Ishii and Andrew Metrick, *Extreme Governance: An Analysis of Dual-class Firms in the United States*, 23(3) REV. FINANC. STUD. 1051 (2010) (evidencing that control enhancing structures are associated with increased agency costs and reduced firm value); and Chen Lin, Yeu Ma, Paul Malatesta, & Yuhai Xuan, *Ownership Structure and the Cost of Corporate Borrowing*, 100 J. FINANC.

taking.[77] As described in Section III.A., such enhanced tendency to divert private benefits may induce controllers to pay professional CEOs a premium in exchange for facilitating these activities.

To see how the divergence negatively affects controllers' monitoring incentives, consider the same hypothesis that was presented in Section III.A. with one change: the controlling shareholder is now a minority controller who holds only 10% of the outstanding shares of a company, but controls at least 50% the company's voting rights through the use of a control-enhancing device. As shown in the table below, such minority controller has reduced incentives to closely monitor professional managers' pay, and increased incentives to intensify her value diversion activities at the expense of other shareholders.

Table 2

	Additional Profits	**Extra Costs**
Controller I (30% of the economic rights)	$50 (additional private benefits)	$18 (30% of $60 (the sum of the loss in the company value and the extra CEO pay))
Other Shareholders	0	$42 (70% of $60)
Controller II (10% of the economic rights, and 50% of the voting rights)	$50	$6 (10% of $60)
Other Shareholders	0	$54 (90% of $60)

ECON. 1 (2011) (finding that "tunneling and other moral hazard activities by large shareholders are facilitated by the divergence between control rights and cash-flow rights"). *See* also Bebchuk, Kraakman & Triantis, *supra* note 70, 298-301 (presenting a model that proves this argument).

[77] *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION, 89 (2004) (explaining that asymmetric positions can produce substantial inefficiencies and may lead to expansion decision that is value decreasing for other shareholders), and Gerard Sanders & Donald C. Hambrick, *Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance*, 50(5) ACAD. MGMT. J. 1055 (2007) (finding that stock options prompt CEOs to make high-variance bets).

2. Empirical Evidence on Executive Pay in Dual-Class Firms

The impact of the divergence between control and cash flow rights on executive compensation has been examined in a number of empirical studies. Ronald Masulis, Cong Wang and Fei Xie, studying U.S. dual-class companies and using a sample that also covers professional CEOs, found that the CEO compensation in dual-class firms is higher than that in a matched sample of single class firms, and that such executive pay increases as the divergence between voting and cash flow rights grows.[78] Another study on Canadian family firms presented a similar result.[79] According to the authors of that study, the result implies that families that control dual-class firms are also more "willing to share the wealth of the company with non-family executives than is the case in single class companies".[80] A few additional empirical studies also supported the finding that dual-class firms pay more to their professional CEOs.[81]

Another strand of studies examined the effect of control-enhancing mechanism on the pay–performance sensitivity of executive pay (although without differentiating between professional managers and controller-CEOs). One study, researching executive compensation in Germany, showed that the link between performance and pay is dramatically weaker in companies where cash flow rights deviate from voting rights.[82] Similarly, another study, researching Chinese listedfirms, showed that the divergence between control rights and cash flow rights has a negative effect on the pay–

[78] Masulis, Wang & Xie, *supra* note 70, at 1703-1705. Their results were confirmed for both professional CEOs and controllers-CEOs, although they found that the excess control rights measure has a stronger effect, both statistically and economically, on compensation of the latter. *Id.*, at p. 1707-8.

[79] Ben Amoako-Adu, Vishaal Baulkaran & Brian F. Smith, *Executive Compensation in Firms with Concentrated Control: The Impact of Dual Class Structure and Family Management*, 17 J. CORP. FIN. 1580, 1585-1590 (2011) (researching companies listed on the Toronto Stock Exchange (TSX) between 1998 and 2006 and using a sample that also covers non-family executives).

[80] *Id.*, at 1594.

[81] *See, e.g.*, Surjit Tinaikar, *Voluntary Disclosure and Ownership Structure: an Analysis of Dual Class Firms*, 8.2 J. MANAG. GOV., Chapter 6 (2012) (finding that CEOs in U.S. dual-class firms receive higher total compensation than CEOs in a matched sample of single class firms); Ettore Croci, Halit Gonenc & Neslihan Ozkan, *CEO Compensation, Family Control, and Institutional Investors in Continental Europe*, 36 J. BANK. FIN. 3318, 3319-3322 (2012) (researching CEO pay in Continental Europe and finding that dual-class firms pay more to their CEOs (including professional CEOs)).

[82] *See*, Alfred Haid & B. Burcin Yurtoglu, *Ownership Structure and Executive Compensation in Germany*, 16-18 (Working Paper Series, 2006), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=948926*. (using a sample of German companies over the period from 1987 to 2003).

performance relationship.[83]

In sum, the empirical evidence clearly shows that the agency cost created by the separation of cash flow rights and voting rights lead to the payment of compensation at levels which are not optimal for minority shareholders.

C. "Weak" or Biased Controllers

While corporate law theorists taught us that holding a large stake in a company provides controllers with the power to monitor managers,[84] there are some exceptions where controllers are "weak" or lack the required business skills, and thus may develop a dependency on hired professional CEOs. In addition, even "strong" controllers can be biased due to their longstanding professional and social relationship with hired managers. In both instances, controlling shareholders are unwilling or unable to exercise their monitoring power to the benefit of other shareholders, and the latter cannot rely on the former to effectively set the compensation of professional managers at a level that maximizes shareholder value.

1. Second-Generation Controllers

In a firm where the founder is absent and replaced by a family member of the founder, such second-generation controller sometime lacks the business expertise, the talent, or the motivation of the founder. In order to maintain the family lock on control, the second-generation controller has to place in the CEO position a more capable, business-savvy and talented outside professional manager. The "weak" controller is then likely to develop a dependency on strong professional managers. This, in turn, may affect the controller's ability to have an arm's length negotiation with professional managers. The agency problem public shareholders face in this instance is more similar to a vertical agency problem (between managers and public shareholders), which is widespread at NCS companies, rather than to a horizontal agency problem (between controllers and minority shareholders).[85]

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[83] Jerry Cao, Xiaofei Pan & Gary Tian, *Disproportional Ownership Structure and Pay–Performance Relationship: Evidence From China's Listed Firms*, 17(3) J. CORP. FIN. 541 (2011) (using a sample of Chinese listed companies from 2002 to 2007).

[84] *See, e.g.,* John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 894 (1987) ("the large shareholder is the most effective monitor of management in the corporate setting"). See also *supra* notes 13-15 and accompanying text.

[85] This explanation, in its broader formulation, may apply to any controller who lacks the relevant business expertise or has time constraints, and therefore is prone to develop a

True, in such situation there is a likelihood that a new controller who can manage the company better than the second-generation controller will emerge and try to purchase the company's control block.[86] Although it may not be economically efficient, second-generation controllers may resist such change in control and insist on keeping control within the family in order to preserve its psychic benefits of control, and the family heritage, tradition or special set of values.[87]

It is well established in the economic literature that firms run by decedents of the founders underperform other family firms managed by hired CEOs, and this result was confirmed in a wide range of studies.[88] Also, consistent with this evidence, another study showed that family firms run by second-generation controllers have relatively poor management practices.[89] Such mediocre performance as evidenced in a large body of

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dependency on her professional managers. Consider, for instance, controllers of large business groups that feature extensive industry diversification. Such controllers cannot be familiar with all different types of businesses within the group and they may lack time for real monitoring. As a result, those controllers may become more dependent on their managers, and agree to pay them a premium for their services. *See* report by the Israeli Securities Authority from 2010, *supra* note 58, at 30 (showing that CEOs who work for business groups (rather than for individual firms) receive higher compensation than CEOs of unaffiliated companies).

[86] Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. ECON. 957, 961-4 (1994) (developing a framework for analyzing transactions that transfer a company's controlling block from an existing controller to a new controller).

[87] *See*, Ronald Anderson & David M. Reeb, *Founding Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301, 1302-3 (2003) ("founding families have concerns and interests of their own, such as stability and capital preservation that may not align with the interests of other investors or the firm"); and Alessio M. Pacces, *Control Matters: Law and Economics of Private Benefits of Control*, page 9, ECGI-Law Working Paper Series No. 131/2009 9 (2009), at http://ssrn.com/abstract=1448164 (noting that protecting controller's psychic private benefits can harm other shareholders by preventing efficient changes in control in the future).

[88] *Id.* at 1316-7, 1321 (finding that the existence of founder descendants is unrelated to market performance, unlike the cases of hired CEOs and founder-CEOs); *See* also Morten Bennedsen, Kasper Meisner Nielsen, Francisco Perez-Gonzalez & Daniel Wolfenzon, *Inside the Family Firm: The Role of Families in Succession Decision and Performance*, 122 Q. J. ECON. 647, 669-670, 684 (2007) (finding that family successions have a large negative causal impact on firm performance and they underperform relative to professional CEOs); Francisco Pérez-González, *Inherited Control and Firm Performance,* 96 AM. ECON. REV. 1559, 1574-1578 (2006) (firms where incoming CEOs are related to a founder or a large shareholder underperform relative to firms that promote unrelated CEOs); Belen Villalonga & Raphael Amit, *How Do Family Ownership, Control and Management Affect Firm Value?*, 80 J. FINANC. ECON. 385, 399-400 (2006) (showing that when descendants serve as CEOs, firm value is destroyed, and minority shareholders in those firms are worse off than they would be in nonfamily firms).

[89] Nicholas Bloom and John Van Reenen, *Why Do Management Practices Differ across Firms and Countries?*, 24(1) J. ECON. PERSP. 203, 205, 217-219 (2010) (family

empirical literature suggests that second-generation controllers may lack the experience or the talent of the founder, and thus are more easily captured by professional CEOs, who, in turn, may demand higher compensation.

Interestingly, a recent empirical study confirmed this explanation. Francisco Gallego and Borja Larrain, researching executive pay packages in Argentina, Brazil, and Chile, found a premium of around 30% for professional CEOs working in family firms. The study showed that the premium comes mostly from family firms with absent founders, where children of the founder are involved in management or the board of the company, and that those second-generation controllers have to pay a substantial wage premium in order to attract a professional manager.[90] According to the authors of the study, this result supports the hypothesis that second-generation controllers are more easily captured by professional CEOs because they may lack the experience of the founder.[91]

2. Biased Controllers

Controllers may also develop along the years a close personal affinity with their professional CEOs that may negatively affect their ability to have an arm's length negotiation with such professional CEOs. A number of studies already highlighted the negative impact of the social and business ties among members of the board of directors on their ability to act in the interests of shareholders and to remain independent.[92] It is expected that

managed firms "have a large tail of badly managed firms).

[90] *See* Gallego & Larrain, *supra* note 39, at 630-641.

[91] An alternative interpretation to this empirical finding can be that professional managers ask for compensation if they do not have access to the business expertise of the founder. *See*, *e.g.*, Gallego & Larrain, *id.*, at 623; and Marrianne Bertrand & Anroinette Schoar, *The Role of Family in Family Firms*, 20 J. ECON. PERSP. 73, 76-78 (2006) (claiming that having a business-savvy founder is arguably the critical resource behind the success of many familyfirms). Note, however, that professional CEOs of large public companies are already very savvy and experienced businessmen, and it is hard to believe that, at their career stage, they attribute high value to the lack of access to the business expertise of the founder.

[92] *See*, *e.g.*, Bebchuk, Fried & Walker, *supra* note 34, at 768 (discussing literature on social dynamics among board members and describing the important role they play in determining managerial compensation at the expense of shareholders' interests), Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U.L.Q. 821, 858-860 (2004) (showing that friendship and collegiality among board members create a structural bias that may affect directors' ability to act in the interests of shareholders), Reed E. Nelson, *The Strength of Strong Ties: Social Networks and Intergroup Conflict in Organizations*, 32 ACAD. MGMT. J. 377, 380 (1989) (finding that people with strong ties to each other attempt to avoid conflict).

such ties will grow stronger, the longer board members serve together.[93] There is also evidence that network ties between directors and CEOs weaken the intensity of board monitoring.[94]

Similarly, controllers and professional managers who work together for a long period of time are likely to develop close social and business ties. Such ties, in turn, may negatively influence controllers' ability to remain unbiased and to have an arm's length negotiation with professional managers. Moreover, when biased controllers bear only a small fraction of the company costs, as in the case of minority controllers, they have even a greater tendency to provide overly generous salaries to professional managers with whom they have longstanding relationship.

The example of The New York Times Company stands out in this regard. Janet Robinson, who was the CEO of The New York Times Company from December 2004 to December 2011, worked for 28 years at the company. The longstanding relationship that was created between the company's controller and Ms. Robinson might have negatively affected the ability of the former to impartially monitor the compensation of the latter. Indeed, the ISS expressed concerns about the pay levels of Ms. Robinson, noting that her total compensation was nearly three times ISS' peer group median.[95]

D. Putting the Pieces Together: Re-visiting the Viacom Case

The theoretical explanations presented in this Part provide a useful tool for explaining the puzzle paused by the Viacom case. First, Viacom is controlled through a dual-class share structure, and features a high divergence between ownership rights and control rights. The controller of Viacom holds nearly 80% of the company's voting rights, but a substantially lower percentage (approximately 7%) of the firm cash flow rights,[96] which may lead to severe distortions in his ability to effectively monitor the pay package of the company's CEO.

Second, there is evidence showing that the controller of Viacom is

[93] *See*, Yaron Nili, *The "New Insiders"? The Limited Case for Capping Board Tenure* (Working Paper, 2013) (discussing the effects of longer board tenure on directors' ability to remain independent and surveying related literature).

[94] *See, e.g.*, Byoung-Hyoun Hwang and Seoyoung Kim, *It Pays to Have Friends*, 93 J. FINANC. ECON. 138 (2009).

[95] ISS Proxy Advisory Services vote recommendations for The New York Times Company's 2012 annual meeting (April 5, 2012), at 11-12.

[96] The data on Mr. Redstone's combined ownership rights is not directly disclosed in the company's proxy statement, but a calculation based on the information provides therein suggests that his combined ownership rights (as a percentage of both Class A and Class B common shares) is approximately 7%. See, Schedules 14A of Viacom Inc., filed with the SEC on January 21, 2011 and January 27, 2012.

likely to extract private benefits on a large scale from the company. In 2010 and 2011 he was awarded $15 million and $21 million, respectively, for serving as executive chairman of Viacom.[97] Paying himself generous salaries induces Mr. Redstone to treat his executives similarly, and in practice sets a high threshold for determining the compensation of his professional managers.

In addition, Mr. Redstone controls Viacom through other subsidiaries, which are often involved in related party transactions with Viacom. One of these subsidiaries, for instance, licenses films in the ordinary course of business from Viacom, and payments made to Viacom in connection with these licenses for fiscal year 2011 amounted to approximately $30 million.[98] Related party transactions on a large scale and with companies that are under the common control of the controller may provide great opportunities for tunneling, and when such opportunities exist, they are sometimes exploited.[99]

Third, the CEO of Viacom has served in executive positions in Viacom for a very long period of time: he has been the company CEO since September 2006, and prior to that, from 1987-2000, he held several positions at former Viacom, including Deputy Chairman and member of its Executive Committee.[100] It appears that during all these years the company's controller and its CEO developed special relationship. As one executive close to the company puts it, the CEO of Viacom, Philippe Dauman, is "the son Sumner [the Viacom's controller] wishes he had." Although the daughter of the controller serves on the company board, Mr. Redstone already said once, "I think, that Philippe will be my successor."[101] Such close ties between a controller and a professional CEO obviously affects the ability of the former to impartially monitor the latter.

CBS, another company that is controlled by Mr. Redstone suffers from similar "symptoms": dual-class structure with high divergence between voting and cash flow rights, the payment of overly generous salaries to the controller for serving as executive chair (over $20 million in 2011), and a longstanding relationship between the controller and the CEO, who has served in executive positions with the company since 1995.[102] In light of these symptoms, it is not surprising that CBS also received in 2011 a negative recommendation from the ISS, which criticized its compensation

[97] *Id.*
[98] *Id.*
[99] Atanasov, Black & Ciccotello, *supra* note 41, at 42.
[100] Schedules 14A of Viacom Inc., *supra* note 96.
[101] Amy Chozick, *The Man Who Would Be Redstone*, N.Y. TIMES DEALBOOK (Sep. 22, 2012).
[102] Schedule 14A of CBS Corporation, filed with the SEC on April 23, 2012.

practiced by noting that "[t]he link between pay and performance is not clear, since the company does not utilize specific metrics or goals to determine bonus payouts or long-term incentive awards, and the CEO is guaranteed mega option grants for next year, in addition to increasing RSU grants through 2014."

IV. EXECUTIVE PAY IN CS COMPANIES: EMPIRICAL EVIDENCE

This Part begins with presenting and analyzing evidence from the ISS on executive pay patterns in U.S. CS companies. The results of this analysis, as shown below, provide preliminary indication that the existence of a controller is not necessarily associated with an enhanced monitoring of CEO pay packages. I, then, re-examine existing empirical evidence on executive compensation in companies with large share ownership and suggest potential avenues for future research.

A. The Problem with Executive Pay in CS Companies: Evidence from the ISS

1. ISS Recommendations on Say-on-pay Votes

Since the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act, most U.S. public companies have been required to conduct an advisory vote on executive compensation proposals (say-on-pay votes) as of 2011.[103] All shareholders, including controlling shareholders, are allowed to participate in such say-on-pay votes. Since many controllers exercise substantial influence over the voting rights of the companies they control, the results of say-on-pay votes held in controlled companies have very little, if any, indicative value. But, the voting recommendations of the ISS, the largest and most influential shareholders proxy advisory firm in the United States, are expected to be a useful indicator in determining whether compensation patterns in U.S. controlled companies deviate from optimal contracting.

ISS recommendations matter for two main reasons. First, in analyzing the compensation package of any company, including a controlled one, the ISS uses several matrixes that are useful for determining whether the package is accurately calibrated to maximize shareholder value. For instance, the primary causes for issuing a negative recommendation, as reflected in the ISS guidelines, are a pay for performance misalignment, problematic compensation practices, or poor responsiveness to

[103] *See* Section 14A(a) to the Securities Exchange Act of 1934, and the rules thereunder subsequently adopted by the SEC, as part of the Dodd-Frank act.

shareholders.[104] The ISS pay-for-performance test examines the alignment of CEO pay and total shareholder return, and how that alignment compares to that of the company's peer group over a one-year, three-year and five-year period. In determining company compensation practices, the ISS also assesses, among other things, problematic practices related to non-performance-based compensation elements (such as multi-year guaranteed payments), options backdating, completeness of disclosure, lack of rigorous goals, and other relevant special circumstances.[105] An ISS negative recommendation can, therefore, provide a good indication that a given executive pay package is suboptimal.

Second, the ISS recommendations have a significant influence on the actual results of say-on-pay votes and can dramatically change the outcome of a vote.[106] For instance, of the S&P 500 companies that received a negative ISS recommendation in 2012, 21% experienced failed say-on-pay votes, as compared to the overall average failed votes of 2.7%.[107] Moreover, even when companies do receive a majority vote despite a negative ISS recommendation, the level of shareholder support is substantially lower. According to a recent study, "a negative ISS recommendation results in average support of 65% versus 95% for those with a positive ISS recommendation."[108] It has also been said that, "[t]hese [proxy] advisors' recommendations for, or against, a company's pay plan carry very substantial weight with their institutional clients, and can dramatically change the outcome of a vote".[109]

[104] *See, e.g.*, ISS, *ISS' 2013 U.S. Proxy Voting Summary Guidelines*, 38-41 (Dec. 19, 2012).

[105] *Id.*

[106] *See, e.g.*, James F. Cotter, Alan R. Palmiter & Randall S. Thomas, *The First Year of Say-on-Pay under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967, 969, 981-3, 1010-11 (2013) (showing that ISS has played a significant effect on shareholder say-on-pay voting, and that its recommendations "are more explanatory than any other factor identified in say-on-pay voting").

[107] David Katz & Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz, *"Say-on-pay" in the 2012 Proxy Season*, THE HARVARD LAW SCH. FORUM ON CORPORATE GOVERNANCE & FIN. REGULATION (Aug 21, 2012, 9:15 AM), http://blogs.law.harvard.edu/corpgov/2012/08/21/say-on-pay-in-the-2012-proxy-season/; See *also* Cotter et al., *id.* (showing similar effects of ISS recommendations during the 2012 proxy season).

[108] John D. England, *Say-on-pay Soul Searching Required at Proxy Advisory Firms*, Pay Governance (Jun. 20, 2012), *available at* http://www.paygovernance.com/Includes/pdf/SOP_Soul_Searching.pdf. *See* also, Cotter et al. *id.*

[109] Randall S. Thomas & Christoph Van der Elst, *The International Scope of Say-on-pay* 4 (Vanderbilt Law and Economics Research Paper No. 13-22, 2013), *available at* http://ssrn.com/abstract=2307510).

2. Ownership Structure and Negative Recommendations

The conventional wisdom suggests that the number of CS companies that receive negative recommendations from the ISS should be negligible, especially with respect to CS companies managed by professional CEOs. In order to examine this hypothesis, I first collected data from the Voting Analytics database on say-on-pay votes at companies included in the Russell 3000 Index during the 2011 and the 2012 proxy seasons. Then, I crossed-referenced the data received from the Voting Analytics database with information obtained from FactSet on the insider ownership and dual-class structure of these companies,[110] and excluded from the list companies that FactSet did not provide data on them. The final sample included 2,566 observations for 2011, and 2,290 observations for 2012. In total, there are 2,820 companies in my sample, and 589 of them (20.9%) have concentrated ownership.[111] Finally, in order to distinguish between controller-CEOs and hired professional CEOs, I also collected data from FactSet on the identity of the CEOs of the sampled controlled companies and their ownership interest and voting power.[112] Out of the 589 CS companies on my sample, 392 companies (67%) have professional managers.[113] The results are summarized below:

[110] The data is as of December 31, 2010 and 2011.

[111] Companies with concentrated ownership were defined as companies where at least 30% of the economic or voting interests are held by insiders and shareholders who own at least 5% of the common stock (excluding institutional investors). I used a relatively high cutoff of insider ownership to confirm that a controller has indeed the ability to monitor CEO pay.

[112] Companies with professional CEOs were defined as companies were the CEO is not the largest shareholder or an affiliate of such shareholder.

[113] This result is in line with another study researching U.S. family firms in the 1990s, which found that 55% of the CEOs of these firms were professional CEOs. *See* Anderson & Reeb, *supra* note 87, at 1314. Considering that controllers of family firms tend to be more involved in the management of their companies than other type of controllers, the slightly lower percentage of professional managers in the Anderson & Reeb sample, which includes only family firms, is not surprising.

Table 3

	Say-on-Pay votes			**ISS Negative Recommendations**		
	NCS	**CS**	**CS with Professional CEOs**	**NCS**	**CS**	**CS with Professional CEOs**
2011	2,073	493	310	248 (12%)	89 (18.1%)	58 (18.7%)
2012	1,994	296	208	262 (13.1%)	44 (14.9%)	32 (15.3%)

The data presented in *Table 3* provides a preliminary indication that the percentage of CS companies receiving negative ISS recommendations is actually higher than the percentage of NCS companies with negative recommendations in both 2011 and 2012.[114] This result is further corroborated by running a simple bivariate probit regression (model 1), where the ISS recommendation is the dependent variable (1=Against; 0=For) and ownership structure is the independent variable (1=CS; 0=WH).[115] I found a positive and significant effect of the concentrated ownership dummy variable on the probability of an Against ISS recommendation ($p<0.01$). The results show that, holding year constant, the predicted probability of an "against" recommendation is 12.5% for a NCS company, and 16.9% for a CS company. In other words, when moving to CS ownership structure the probability of an against recommendation increases by 4.4% on average.

The result remains substantially similar, even when controlling for firms' market value and industry (model 2), as the predicted probability of an "against" recommendation is 11.5% for a NCS company, and 15.5% for a CS company. The ownership structure dummy variable remains highly significant at 1% error level ($p<0.01$). This result suggests that excess executive pay in CS companies cannot be explained only by suboptimal pay

[114] The total number of controlled companies in the sample may be overestimated because of double counting of block ownership (for instance, attributing the same block to different family members, and ignoring large blocks that are reported not in the customary ownership table but instead noted only in text). To partially correct this problem, I read a large number of proxy statements, including all proxy statements of all controlled companies that received negative recommendations. Since the number of controlled companies with negative recommendations should be accurate, an overestimation of the total number of controlled companies actually reduces the percentage of CS companies with negative recommendations.

[115] Probit regression is a nonlinear regression model used when the dependent variable is binary (can only take two values). Probit regression results in predicted values ranging from "0" to "1," or, the probability of something occurring.

practices in a couple of specific industries.

I then added another dummy variable for professional CEOs (model 3) in order to examine whether the result remains similar even when I neutralize the effect of controller-CEOs. I still found a positive and significant effect of the professional CEO dummy variable on the probability of an Against ISS recommendation ($p<0.05$), showing that a CS company managed by a professional CEO still has a higher likelihood to receive a negative recommendation (by approximately 4%) than a NCS company. This result rebuts the possibility that controllers-CEOs who extract rent through the payment of excess compensation to themselves are the main trigger for the suboptimal compensation arrangements in the sampled CS companies.

In sum, the data presented in *Table 3* and *Table 4* shows that the existence of a controller is not necessarily associated with an enhanced monitoring of CEO pay. The result is also significant for CS companies managed by professional CEOs who are not affiliated with the controller.

Table 4: Results of Probit Regressions

	Model 1	**Model 2**	**Model 3** (professional managers)
Controlled Companies	.1917 *** (.0643)	.1855 *** (.0696)	.1984 ** (.0806)
Log Market Cap	_____	-.0011 (.0176)	.0001 (.0176)
Constant	-51.2515 (83.2102)	-153.651 (86.9292)	-157.257 (87.0905)
Year Fixed Effect	Yes	Yes	Yes
Industry Fixed Effect	_____	Yes	Yes
Observations	4856	4634	4635
Pseudo R^2	0.0027	0.0166	0.0174
Log Pseudolikelihood	-1893.2319	-1728.0193	-1728.6367

NOTE: ***$p<0.01$; **$p<0.05$; robust standard errors in parenthesis below the coefficients.

Predicted Probabilities

Ownership Variable	**Model 1**	**Model 2**	**Model 3** (professional managers)
NCS Companies	.1253 *** (.0057)	.1166 *** (.0057)	.1159 ** (.0050)
CS Companies	.1692 *** (.0147)	.1570 *** (.0153)	.1593 ** (.0181)

NOTE: Delta-method standard errors in parenthesis below the margins.

I also hand-collected additional information on the controllers of the sampled CS companies that yields a result that is consistent with the view that significant heterogeneity exists across controlling shareholders in the United States.[116] Firms managed by their founders and family firms consist 57% of the sampled CS companies, and even within this subgroup there is some additional variation: certain firms are managed by their founders' heirs, in others there is a minority blockholder, and in certain instances founders transferred the control to outside blockholders, but retain a minority stake in the companies they founded. Approximately 30% of the sampled CS companies are controlled by a private investor or a group of investors, mostly private equity firms or venture capital firms.[117] Others are controlled by another large public entity, or a foreign entity, and only 1% of the sampled CS companies are controlled by the government. I also examined whether companies controlled by private equity firms and venture capital investors have lower likelihood to receive a negative recommendation compare to other controlled firms, but the results were not significant.

Finally, in order to receive additional information on the sampled CS companies with professional managers that received negative ISS recommendations, I reviewed the proxy statements of those companies. Approximately 27% of those companies have a dual-class structure. This percentage is three times higher than the total percentage of the dual-class

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[116] S*ee* Henrik Cronqvist & Rüdiger Fahlenbrach, *Large Shareholders and Corporate Policies*, 22(10) REV. FINANC. STUD. 3941 (2009) (discussing the significant heterogeneity across blockholders, and its influence on investment, financial, and executive compensation policies).

[117] These groups of investors often have voting agreements in place, or their directors' nominees are on the board. This, in turn, enables them to exercise closer control on professional managers.

companies in the Russell 3000.[118] 63.4% of those CS companies where involved in related-party transactions with their controllers.[119] And, on average, a professional CEO of such a CS company serves 10 years in the company she manages (the median is 8 years).[120] Indeed, a CEO who works together with a controller for such long period of time is expected to develop close social and business ties with the controller.[121]

Before proceeding further, two comments should be made. First, the reliance on ISS recommendations as a proxy for the effectiveness of executives' compensation packages is not immune from criticism, as any third-party estimates may be subject to certain inaccuracies or methodological biases. However, given the complexity associated with collecting and analyzing large-scale data on the structure and effectiveness of pay packages of the Russell 3000 companies on the one hand, and the extensive analysis that the ISS performs on each these companies as well as the importance institutional investors attribute to the ISS say-on-pay recommendations on the other hand, the use of ISS recommendations as a proxy has an interesting indicative value. Obviously, the empirical data presented in this Part should be a starting, not an ending point, for an extensive empirical analysis of executive compensation in U.S. controlled companies and the agency problem that may be associated with it.

Second, while the analysis presented in this Section provides

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[118] *See*, GMI Rating, *Dual-class Social Media Companies: Performance-ownership Link?*, (Sep. 10, 2012), *available at* http://www3.gmiratings.com/home/2012/09/dual-class-social-media-companies-performance-ownership-link-2/ (mentioning that only 268 companies (9%) on the Russell 3000 have dual-class structure).

[119] True, not every single related party transaction necessarily extracts resources from the controlled companies to controllers' hands as such transactions can be, and sometime they are, at market rate. However, as the literature on tunneling shows, related party transactions provide great opportunities for tunneling, and when "opportunities exist", they "are sometimes exploited", even by U.S. controlling shareholders. Atanasov, Black & Ciccotello, *supra* note 41, at 42 (providing examples for tunneling activities in the U.S.).

[120] This data includes the total number of years a CEO was employed by her firm (and not just the length of her CEO tenure) until the year in which the recommendation was given.

[121] It is difficult to compare this data to other studies on CEO turnover because it does not include information on the full tenure of a CEO, and it also counts for the number of years such CEO was employed by her firm before assuming the position of CEO. The average period presented above is relatively long considering, for instance, that the average CEO tenure in large U.S. companies is less than six years. *See* Kaplan, *supra* note 23, at 11 (presenting data on CEO turnover in Fortune 500 firms from 1998 to 2010). Another recent study researching S&P 500 companies shows that CEOs at companies with high pay had an average tenure of 9.9 years – 32% longer than their self-selected peers. *See*, IRRC Institute, *Compensation Peer Groups at Companies with High Pay* (June, 2012), *available at* http://www.irrcinstitute.org/pdf/Final-Compensation-Peer-Groups-at-Companies-with-High-Pay_June2010.pdf.

preliminary evidence that compensation packages in controlled companies are a bigger problem than initially predicted (an interesting result in and of itself given the long standing premise that the existence of a controlling shareholder substantially improves the monitoring of executive pay of professional CEOs), such analysis does not rule out other potential explanations for the extra compensation paid to professional CEOs of CS companies. For instance, such pay premium may compensate professional CEOs for the higher risk of being replaced or for the loss of managerial private benefits due to enhanced monitoring by hands-on controllers.[122] While examining the validity of these theories is beyond the scope of this Article, it is worth noting that they have little, if any, empirical support in the financial literature.[123]

B. Re-examining Past Empirical Evidence

The relation between share ownership and executive pay has been examined in a number of empirical studies. While some of these studies found that CEO compensation is lower when there is an external blockholder,[124] or that there is a negative correlation between the equity ownership of the largest shareholder and the amount of CEO pay,[125] a

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[122] *See* Gallego & Larrain *supra* note 39, at 622-641 (empirically examining and rejecting these two explanations). Note that the financial literature surveyed in the Gallego & Larrain provides only theoretical (not empirical) support to these two explanations. Also, in regimes where most of the companies are controlled ones, as it is often the case in many countries around the world, professional managers often have very few, if any, alternatives to work for NCS companies. The lack of such alternatives, in turn, further reduces the bargaining power of professional CEOs and their ability to demand higher pay.

[123] *Id.*

[124] John E. Core, Robert W. Hothausen & David F. Larcker, *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance,* 51 J. FINANC. ECON. 371, 388-389 (1999) (finding that CEO compensation is lower when there is an external blockholder who owns at least 5% of the equity). See also, Marianne Bertrand & Sendhil Mullainathan, *Agents With and Without Principals*, 90 AMER. ECON. REV. 203-208 (2000) (finding that CEOs in companies without a 5% (or larger) outside shareholder tend to receive more pay associated with profit increases that are entirely generated by external factors rather than by managers' own efforts).

[125] *See* Richard M. Cyert, Sok-Hyon Kang & Praveen Kumar, *Corproate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence,* 48 MGMT. SCIENCE 453 (2002) (finding that doubling the percentage ownership of a large outside shareholder is associated with a 12% to 14% reduction in a CEO's non-salary compensation). *See* also, Julie Ann Elston & Lawrence G. Goldberg, E*xecutive Compensation and Agency Costs in Germany*, 27(7) J. BANK. FIN. 1391, 1408 (2003) (finding that the greater the ownership concentration the less the ability of executives to extract higher levels of compensation), and Feng Li & Suraj Srinivasan, *Corporate Governance When Founders Are Directors,* 102 J. FINANC. ECON. 454, 460-461 (2011) (CEOs in companies where founders serve as directors of the company have higher pay-

closer examination of the empirical evidence suggests that it is unlikely to undermine the agency problem theory presented in this Article

To begin with, some of the above-mentioned studies use a low threshold to identify the presence of a large shareholder, and therefore they do not effectively distinguish between outside investors that hold more than 5% of the company share and holders of a controlling block.[126] Such distinction is important as outside blockholders do not have the same incentives as controllers to engage in value diversion activities at the expense of the other public shareholders, and the interests of outside holders of non-controlling block are generally more aligned with those of other public shareholders.[127] Including outside blockholders and controllers in the same bucket actually overestimates controllers' monitoring effects.

Moreover, certain empirical studies do not distinguish between a controller who is also part of the management and hired professional managers.[128] As noted, such distinction is consequential for prompting the understanding of pay patterns and managerial incentives in CS companies. Since the majority of the empirical studies support the hypothesis that controller-CEOs receive lower compensation compared to professional CEOs,[129] a non-nuanced empirical research, which treats controller-CEOs

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for-performance sensitivity than CEOs in non-founder firms).

[126] *See, e.g.*, Core et al., *supra* note 124 (using a threshold of at least 5% to identify an external blockholder); Bertrand & Mullainathan, *supra* note 124 (same); Fernandes et al., *supra* note 36 (same).

[127] *See, e.g.*, Jay C. Hartzell & Laura T. Starks, *Institutional Investors and Executive Compensation*, 58(6) J. FIN. 2351 (2003) (finding that institutional ownership is negatively related to the level of CEO compensation in the United States, and that ownership by institutions positively affects the pay-for-performance sensitivity); and Henry L. Tosi Jr. and Luis R. Gomez-Mejia, *The Decoupling of CEO Pay and Performance: An Agency Theory Perspective*, 34 ADMIN. SCI. Q. 169, 181 (1989) (showing that CEOs exercise less influence over their own compensation when companies have 5% external shareholders).

[128] *See, e.g.*, Conyon et al., *supra* note 82, Elston & Goldberg, *supra* note 125, and Haid & Yurtoglu, *supra* note 82.

[129] A large number of empirical studies show that executive compensation of controller-CEOs is indeed lower than that of professional CEOs. These studies suggest that controller-CEOs need less incentive-based compensation just by holding a large block of shares; that family ties can increase controllers' commitment to the firm and make them more prone to accept lower pay; that controllers enjoy higher job security; or that they may elect to maximize value diversion through other means, such as related-party transactions. *See, e.g.*, Croci et. al, *supra* note 81, at 3319-3321 (showing that family CEOs have more moderate compensation than professional CEOs); Daniel L. McConaughy, *Family CEOs vs. Nonfamily CEOs in the Family-controlled Firm: an Examination of the Level and Sensitivity of Pay to Performance*, 13 FAM. BUS. REV. 121, 126-129 (2000) (same); and Luis R. Gomez-Mejia, Martin Larraza-Kintana & Marianna Makri, *The Determinants of Executive Compensation in Family-Controlled Public Corporations*, 46 ACAD. MGMT. J. 226, 226, 232-235 (2003) (same). Note, however, that there are also a handful of studies supporting the opposite view by showing that controller-CEOs actually tend to extract rent

and professional CEOs as members of the same group, underestimates the compensation level of professional CEOs. A recent study that made this distinction found that when professional CEOs are among the top five managers of a firm, there is no difference between family-firm compensation incentives and compensation incentives offered to executives in non-family firms.[130] This finding suggests that professional CEOs of family controlled firms are not paid less than CEOs of non-family firms.

In addition, there is significant heterogeneity across controlled firms that should not be ignored.[131] Controlling shareholders vary in many aspects: the use of control-enhancing devices, their identity (i.e., founders, second-generation controllers, foreign controllers or private investors), and their ability and willingness to engage in value diversion activities. All of these different characteristics are not semantic,[132] and may have an impact on controllers' incentives to effectively monitor executive pay.[133] Therefore, a more nuanced study of CS companies' compensation patterns should attempt to take these factors into account.

C. Avenues for Future Research

The theory presented in this Article gives rise to a few interesting avenues for future research on executive compensation in controlled companies. The first avenue of research could focus on the potential impact of tunneling (or other value diversion activities) on the level and design of executive compensation of professional managers in CS companies. A positive association between these two parameters could support the view that controllers who engage in tunneling activities may be willing to share the extracted rent with professional managers.

The second avenue of research could explore the impact of the heterogeneity across controlling shareholders on the level, design and pay-performance sensitivity of executive pay of professional managers. For this purpose, it would be interesting to compare the pay patterns in family firms

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through the payment of excessive compensation to themselves. See, *e.g.*, Samuel Cohen & Beni Lauterbach, *Differences in Pay between Owner and Non-owner CEOs: Evidence from Israel*, 18 J. MULTI. FINANCE. MGMT. 4, 12-13 (2008).

[130] Zhi Li ,Harley E. Ryan Jr. & Lingling Wang, *The Economics of Executive Compensation in Family Firms*, (Working Paper Series, 2011).

[131] Cronqvist & Fahlenbrach, *supra* note 116.

[132] *Id. See* also Villalonga & Amit, *supra* note 88, at 385 (emphasizing the importance of three fundamental elements, ownership, control, and management, while examining whether family firms are more valuable than non-family firms, and concluding that family ownership destroy value when descendants serve as CEOs, or the founder uses control-enhancing mechanisms).

[133] Cronqvist & Fahlenbrach, *supra* note 116 (finding that executive compensation policies are systematically related to the presence of particular large shareholder).

or dual-class firms, where the agency problem between controllers and minority holders is expected to be more severe, to those found in companies controlled by private equity shops or to CS companies with a substantial minority blockholder, where controllers, at least in theory, are less likely to expropriate minority holders.

A third possible direction of future research could focus on the relationship between professional managers and controlling shareholders and its impact on executive compensation. In that regard, it would be interesting to examine whether close social or professional ties between professional managers and controllers have a systemic effect on the compensation structure of professional managers. Close business ties can be measured by the number of years professional managers and controllers work together, any prior professional acquaintance between them (i.e., by having the CEO serve as a board member in another company affiliated with the controller), and by examining whether the CEO has worked in subordinate positions within the controller's firms before assuming the CEO position. It could also be interesting to examine a potential association between certain CEO characteristics, such as age and experience, and controller's value diversion activities.

V. ECONOMIC AND REGULATORY IMPLICATIONS

In this Part, I discuss the economic and regulatory implications of the agency cost theory in determining CEO pay. Section A shows that controllers' absolute influence over managerial pay might distort managers' and controllers' incentives. Section B explains how the elimination of controllers' absolute influence over managerial pay can enhance managerial independence. Finally, Section C addresses the regulatory implications of the theory and suggests that it could help explaining the recent adoption of rules that regulate executive pay in countries with concentrated ownership.

A. *Distortion of Incentives*

Controllers' absolute influence over the compensation arrangements of their professional managers might result in distortion of incentives and in value diversion activities that could well impose a larger cost on shareholders than excessive compensation per se. Managers, who are well "rewarded" for colluding with tunneling, will have a reduced incentive to block such inefficient activities even at the expense of decreasing the value of the companies they manage. As a result, controllers, who know that managers are more likely to cooperate with such undesirable activities, may increase the volume of value diversion.

Controlling shareholders may also have interests of their own, which do not align with the interests of other investors, such as entrenchment,[134] capital preservation, massive distribution of dividends,[135] or the entry into new businesses about which the controllers know little but which are alluring personally.[136] Well-rewarded professional managers are more likely to cater to those controllers' interests despite their potential adverse effects on the firm value.

In fact, while the conventional theory views the determination of compensation packages of professional managers in CS companies as an issue which is unaffected by, and unrelated to, the agency problem between controllers and minority holders, the theory presented in this Article suggests that such determination of CEO pay should be seen as part of the problem itself. Granted, the tension between controllers and minority shareholders has existed, and will continue to exist, even if controllers do not have any control at all over the design of professional managers' pay packages. However, providing controllers with a full discretion on this matter aggravates this agency problem and the distortion of incentives.

B. Executive Pay as a Tool to Enhance Managerial Independence

The elimination of controllers' absolute influence over the design of compensation arrangements of professional managers will not only reduce the distortion of incentives, but it can also work to alleviate the agency problem between the controllers and minority shareholders. Providing minority shareholders or independent directors that are not affiliated with the controller, with more "say" over the level and the design of executive pay of professional managers can enhance the independence of professional managers and encourage such managers to better protect the interests of minority shareholders in CS companies.

This idea that executive pay can be used to overcome the agency problem in CS companies has already been raised in the past. Contrary to the conventional view among financial theorists that managers of CS

[134] *See supra* note 87.

[135] Eran Azran, *How IDB Group Learned to Get Behind in Business*, HAARETZ (Aug. 2, 2012) (criticizing the controlling shareholder's aggressive dividend payout policies while the profits at the group's subsidiaries plunged).

[136] A controlling shareholder decision to acquire a media or entertainment company may be motivated by her desire to increase her consumption of non-pecuniary private benefits rather than firm value. *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1663-64 (2006) (mentioning the transformation of certain businesses associated with the Bronfman family from liquor and oil to entertainment); Nati Tucker, *NGO Demands Probe of Alleged Misconduct at Maariv under Nochi Dankner*, HAARETZ, Jan. 2, 2013 (A minority holder in a newspaper claims it was mismanaged in order to suit the needs of the controlling shareholder).

companies need less incentive-based compensation just because controllers can effectively monitor them,[137] Sharon Hannes recommended that the use of equity-based compensation in controlled companies be increased in order to better align the interests of professional managers and minority shareholders and to overcome managers' tendency to cater to controller preferences.[138] As he noted: "executive stock compensation can work to alleviate the agency problem between the controlling shareholder and the minority, and not only between management and a dispersed shareholders body".[139]

Increasing the portion of equity-based compensation can motivate managers to be less inclined to cooperate with controllers' value diversion, but it may not suffice. As long as controllers exercise full discretion over the design of executive pay, professional managers will still have an incentive to cater to the controllers' preferences. In order to further diminish the managerial bias toward controllers, it is, therefore, recommended to take Hannes' approach one step forward and provide minority shareholders, or independent directors, with some additional power over the approval process of executive pay.

A comprehensive analysis of my suggested regulatory solution is presented in Part VI. The goal of this Section, however, is to show that the identity of the company organ that approves executive pay is a key issue not only in NCS companies, but also in CS companies, and that the elimination of controllers' exclusive power over the determination of compensation arrangements of professional managers will encourage the latter to become more effective protectors of minority shareholder rights.

C. Regulatory Implications

The need to re-examine existing theory on executive compensation in CS companies has special importance nowadays due to the global shift toward say-on-pay regulation in countries with a high level of concentrated ownership. As one study states, "the historical U.S. monopoly on the controversy surrounding CEO compensation has also disappeared."[140] Recently, in March 2013, Swiss voters voted in favor of adopting a binding say-on-pay rule that attracted high levels of attention and was considered

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[137] Thomas & Van der Elst, *supra* note 109, at 65-6 (referring to studies supporting this view).

[138] Sharon Hannes, *Options for Managers in Markets with Concentrated Control: The Case of Israel*, 36 HEB. U.L. REV. 49 (2006) (in Hebrew).

[139] Sharon Hannes, *Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation*, 105 MICH. L. REV. 1421, 1447 (2007).

[140] Fernandes et al., *supra* note 36, at 26.

"groundbreaking legislation".[141] Switzerland is not alone. Binding or advisory say-on-pay rules have already been introduced in other European countries, including Belgium,[142] France,[143] Germany,[144] Netherlands,[145] and Sweden,[146] and the European Commission is also considering a proposal to regulate executive pay across the Union members. This rule is expected to trigger pressure for changes in other EU countries that are still considering the issue.[147]

The global trend toward say-on-pay rules has important implications. First, it calls for an in-depth discussion about the justification for the adoption of these rules in countries where most companies have controlling shareholders with presumably strong incentives not to overpay executives. Randall Thomas and Christoph Van der Elst presented social, political, and structural explanations for this puzzling phenomenon.[148] The Article contributes to the discourse on the relationship between concentrated ownership and executive pay by suggesting an alternative explanation based on an agency problem paradigm and by further broadening the taxonomy of controlling shareholder systems. Second, this

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[141] Helena Bachman, *On Executive Comp, the Swiss Aren't Neutral – Will the U.S. Be Persuaded?*, TIME, BUSINESS & MONEY (Mar. 7, 2013). The adopted proposals will go to the federal government, which will draw up appropriate legislation.

[142] Robbert Gerritsen, European Research, *Belgian Companies to Hold Say-on-Pay Votes This Year,* ISS Report (Feb. 29, 2012) *available at* http://blog.issgovernance.com/gov/2012/02/belgian-companies-to-hold-say-on-pay-votes-this-year.html. Following the passage of The Law on Corporate Governance and Executive Remuneration in Belgium on April 6, 2010, companies have been required to annually seek a non-binding shareholder approval of the remuneration report. The law also provides for best practices on severance pay and on variable pay. Companies deviating from these guidelines will need to put the deviation to a binding shareholder vote.

[143] In June 2013 the French Corporate Governance Code introduced a "say-on-pay" rule, and companies can choose either to comply by providing an advisory vote on executive remuneration or to explain why they did not do so. *See*, Thomas & Van der Elst, *supra* note 109, at 32-5.

[144] *Id.*, at 5, 42-6. Currently, Germany has a voluntary, although widely employed, voluntary shareholder vote on executive pay. A new legislative proposal that would make say-on-pay mandatory and binding has already been approved by the German Parliament, and is waiting to be executed.

[145] *Id.* at 46-52. The Netherlands already adopted a binding say-on-pay vote.

[146] *Id.* at 52-55. Sweden already adopted a binding say-on-pay vote.

[147] *Id.*.at 85. In 2005, the EU enacted a law that requires member countries to have a company's remuneration policy approved by the general meeting of shareholders (*see* Commission Recommendation and Complementing Recommendations 2004/913/EC and 2005/162/EC).

[148] *Id.* at 1. Among other things, they mention political responses by left-leaning parties to social pressures against rising levels of income inequality, the strong support of say-on-pay legislation by foreign institutional investors, and the movements at larger public companies toward increased dispersion of ownership in several European countries.

global trend highlights the importance of developing a regulatory solution that will best fit a CS company. The next Part attempts to undertake this task.

VI. TOWARDS A NEW REGULATORY SOLUTION

In this Part, I put forward a proposal for a new regulatory approach to CEO pay in CS companies. My suggestion is straightforward: conceptualize the pay of professional managers in CS companies as an indirect form of related-party transaction, and subject it to rules regulating conflicted transactions, which usually stipulate special approval procedures. Section A explains why existing say-on-pay rules are less effective in mitigating the agency problem presented in this Article. Section B describes in greater details the recommended regulatory solution and addresses possible concerns. Section C presents more moderate applications of the regulatory solution, and in Section D, I propose certain changes to disclosure rules.

A. The Ineffectiveness of Existing Say-on-Pay Rules

Most say-on-pay rules that regulate executive pay in public companies are unlikely to mitigate the agency problem presented in this Article. A typical say-on-pay rule, such as the one enacted in the United States, applies to both NCS and CS companies, without taking into account the different ownership structure of a CS company and its implication on the overall effectiveness of the rule. It is often the case that controlling shareholders of CS companies have the ability to use their voting power to approve compensation packages even if they are suboptimal for other shareholders. This, in turn, makes the typical say-on-pay arrangement, which usually requires a vote by the shareholders as a whole and does not have different voting requirements for CS companies, less effective for CS companies.

To see how this problem affects minority shareholders, assume, for instance, a typical regime where the say-on-pay rule requires a simple majority vote by the shareholders as a whole for all companies. Assume, further, that a compensatory arrangement negotiated by the controller and the professional manager is suboptimal for other public shareholders and they plan to reject it. In a case where a controller exercises control over more than 50% of the voting rights, a vote by other public shareholders will have no influence on the say-on-pay vote result. In a case where a controller holds less than 50% of the voting rights, a simple majority vote may *de-facto* become a super majority vote for the other public shareholders, and the exact threshold will depend on the controller's voting rights percentage.

For instance, if a controller holds 35% of the voting rights of a company, then 77% of the other public shareholders, who hold the rest of the voting rights (65% of the voting rights), will have to vote against the executive pay proposal in order to reject it.

The need to adopt a regulatory solution that provides minority shareholders with an additional layer of protection is further corroborated in light of the limited disciplinary role that proxy advisory firms play in the context of CS companies. A NCS company that faces an unfavorable shareholder vote, and nonetheless ignores investors' concern and does not take appropriate corrective actions, may face a potential withhold vote recommendation for some or all of the company's directors.[149] Such a disciplinary tool is significantly less powerful when it comes to CS companies. Since a controlling shareholder exercises significant control over directors' election process, receiving a withhold vote recommendation from a proxy advisory firm may have limited effect, if any, on the election of the directors nominated by controller, and consequently on controller's incentives to be more attentive to proxy advisory firms and other public shareholders.

Indeed, when controllers face no sanctions for failing their say-on-pay votes, they are more likely to ignore shareholders' concerns, and to use their voting power to approve compensation packages that are suboptimal for other shareholders.[150] The results of the say-on-pay votes presented in Part IV support this view. Say-on-pay votes in only four out of the 117 sampled CS companies (3.4%), which received negative commendations from the ISS in 2011 or 2012, failed. The failure rate among NCS companies that received negative ISS recommendations is significantly higher: 14.6% in 2011, and 20.7% in 2012. This comparison shows that controllers do not hesitate to use their power to approve pay packages that are perceived to be problematic.

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[149] The ISS, for instance, views a favorable vote of less than 70% as an indication of sufficient investor concern with a company's pay practices. *See supra* note 104.

[150] Australian Parliament was also uncomfortable with a non-binding vote that imposed no penalty on nonresponsive boards, and decided to attach severe consequences to boards' failure to respond to high levels of shareholder dissent in a say-on-pay vote by adopting the two-strike rule. The rule gives shareholders an opportunity to "spill the board" if the company remuneration report receives negative reception at two consecutive years, and some evidence shows that its adoption led to a decrease in executive pay. See Thomas & Van der Elst, *supra* note 109, at 18-26. Also, there are some indications that the adoption of Amendment 16 to the Israeli Companies Law in May 2011, which requires the approval of controller-CEO pay packages by a majority of shareholders unassociated with controlling shareholders every three years has led to a drop in senior CEO compensation. *See, e.g.*, Eran Azran, *Salaries for Top Executives Declined in 2012*, HAARETZ (Jun. 7, 2013).

B. Reconceptualizing CEO Pay as a Related-Party Transaction

The agency problem theory presented in this Article suggests that controllers cannot always be trusted to effectively monitor CEO pay because they may be biased and are likely to use their exclusive discretion over the determination of CEO pay to maximize their consumption of private benefits. If the payment to professional CEOs departs from optimal contracting and there is a high likelihood that controllers will use CEO pay to maximize their value diversion activities, then such payment should be viewed by courts and regulators as an indirect form of self-dealing. The prescription for self-dealing is straightforward: subject it to rules that regulate related-party transactions. If professional managers of CS companies are often viewed as the long arm of the controllers, or as closely connected to the controllers, then there is a compelling reason to subject them to the same rules controllers are subject to if the latter serve in managerial rules. To be clear, to the extent a given jurisdiction also adopted a say-on-pay rule, the suggested regulatory change is not proposed to replace it, but rather to serve as an additional layer of protection for minority shareholders in CS companies.

This reconceptualization, of course, will have different regulatory implications, depending on the anti-self-dealing rules of the applicable jurisdiction. In Delaware, for instance, self-dealing transactions are subject to the "entire fairness" standard, and the interested party must demonstrate that the transaction is a product of a "fair dealing" and reflects a "fair price".[151] To meet the fair dealing test and to shift the burden of demonstrating the transaction was unfair to the opposing party, the controller should have the conflicted transaction approved by a committee of independent directors or by majority of disinterested shareholders.[152] In other jurisdictions self-dealing transactions may only be performed with the approval of majority of disinterested shareholders.[153]

My proposal is not difficult to implement. True, a proposal to transfer additional power to public shareholders generally entails high costs and has certain disruptive effects. In order to bring a matter to a shareholder vote, a company has to convene a shareholder meeting, file a proxy statement, publicly disclose certain information, and hire proxy solicitors

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[151] Weinberger v. UOP, Inc., 426 A.2d 1333 (Del. Ch. 1981), rev'd, 457 A.2d 701 (Del. 1983).

[152] According to NYSE rules a U.S. company with more than 50% of the voting power held by a controlling shareholder does not have to satisfy the majority independent board requirements of Section 303A.01. Therefore, the implantation of the proposed solution may require certain changes to such company's board composition.

[153] *See*, for instance, the Israeli Companies Law, 1999.

and legal advisors. The "heavy costs" argument, however, becomes substantially weaker when it comes to the approval of executive pay. As noted earlier, many jurisdictions around the world, including the United States, already adopted say-on-pay rules which require public companies to conduct an advisory vote on executive compensation proposals. Therefore, a proposed rule, which requires a binding vote instead of an advisory one, will barely impose any additional costs on companies. Moreover, concerns about any potential costs of the proposed rule may also be addressed, at least partially, by exempting certain companies, such as small-cap companies, from its application. Significantly low pay packages that are below a certain threshold could also be exempted from the application of the rule.

Another concern that the proposal may raise relates to the traditional allocation of powers between controllers and other public shareholders of CS companies. One may argue that the design of pay packages of professional managers is within the exclusive prerogative of controllers, and providing disinterested shareholders with some power to approve CEO pay undermines controllers' ability to efficiently macro-manage the companies' business affairs. Relatedly, there is also a concern that uninformed shareholders will fail to approve efficient compensation packages negotiated by unbiased controllers or that the recruiting of new CEOs will become more difficult.[154]

Even those concerns are not strong enough to reject the proposed regulatory solution. One should remember that even if shareholder approval of executive pay becomes binding, controllers (or directors nominated by the controllers) will sill exercise significant influence over the formulation of CEO pay. Controllers (or directors nominated by the controllers) will still make the hiring decisions and will play an active role in negotiating and designing the managerial compensatory arrangements, as well as the general compensation policies. Also, the suggested arrangement could be applied *ex-post*, enabling shareholders to express their opinion only after the managerial pay package is determined by the controllers or the board.

If controllers manage to negotiate compensatory arrangements that maximize firm value, then there is no reason to believe that other shareholders, whose money is also on the line, will reject it. This is especially true in countries with a developed capital market, such as the

[154] One could argue that existing anti-self-dealing rules already protect minority investors from value diversion activities through related-party dealings, and therefore there is no need for an additional layer of protection by subjecting executive pay to anti-self-dealing rules. One should remember, however, that a controlling shareholder can use her dominant position to consume private benefits in various forms, which are not covered by existing anti-self-dealing rules (see the discussions in Part III.A.1 and III.C.).

U.S. market, where institutional investors, which are more informed and sophisticated than most dispersed shareholders, often hold a large majority of the companies' shares.[155] Since say-on-pay votes have been enacted in many countries only recently, it is also expected that as time passes institutional investors would gain more expertise and "would intelligently evaluate the executive pay packages being proposed for top managers".[156] Additionally, it is often the case that U.S. institutional investors base their voting decisions on recommendations of prominent proxy advisory firms.[157] Such proxy advisory firms are repeat players that review and analyze many compensatory arrangements every year. If an "efficient" controller manages to negotiate a value-enhancing compensatory agreement, then proxy advisors are likely to support it, and their recommendations do matter to institutional shareholders.

Finally, unlike other technically neutral business decisions within the prerogative of the controlling shareholder that may create in reality an indirect conflict of interests between the controller and other public shareholders (such as the decision to expand into a different industry), the determination of executive pay has broad impacts, and it is not limited to a one-time event. As noted in Section V.B., providing minority shareholders with more say on executive pay is necessary to mitigate what is a *general* tendency of professional managers to cater to the controllers' preferences. The proposed rule will cause professional managers to better internalize the interests of minority shareholders in all future situations of indirect conflict of interests without having to hold a shareholder vote each time a specific business decision arises such indirect conflict.

C. Moderate Applications of the Proposed Rule

If legislators still find it difficult, for political or other reasons, to impose anti-self-dealing rules on compensatory arrangements of professional managers of CS companies, they may consider more moderate applications of the proposed rule that still provide minority shareholders with some protection.

The first alternative is to apply anti-self-dealing rules only to CS companies where the agency problem between controllers and minority shareholders is likely to be more severe (i.e., in the case of dual-class

[155] *See, e.g.*, Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 864-65 (2013) (showing that in 2011 U.S. "institutional investors owned over 70% of the outstanding stock of the thousand largest U.S. public corporations").

[156] Thomas & Van der Elst, *supra* note 109, at 4.

[157] *See* supra note 106-109 and accompanying text.

companies, where controller's ownership interest is below certain threshold, or when the number of years a CEO is employed by a controller exceeds certain threshold). The Israeli say-on-pay rule followed a somewhat similar approach, stipulating that in a company with three or more tiers of the pyramidal structure, which feature high divergence between controller's ownership rights and voting rights, a majority vote of disinterested shareholders should be binding and not advisory.[158] This more nuanced approach adjusts the chosen anti-self-dealing regime to the specific characters of certain CS companies.

Another alternative is to have a lower voting threshold for approving the compensation of professional managers by disinterested shareholders. For instance, if the procedural requirement for approving a conflicted transaction in a given jurisdiction is a mandatory majority of the minority vote, regulators could use a lower threshold (i.e., 33% of the disinterested shareholders) just for the approval of the pay packages of professional managers.

Regulators could also apply the anti-self-dealing rules to CEO pay less frequently. For instance, the proposed rule could be applied when a compensatory arrangement with a professional CEO is executed or renewed under substantially different terms, and in case the same arrangement remains in place for a long period, once every few years. Relatedly, the rule could be applied only in the year after an advisory resolution on professional managers' pay does not receive a majority of the votes cast. It is likely that this two-step process would further encourage companies to be more responsive to the concerns of their shareholders.[159]

D. Enhanced Disclosure

Finally, I also suggest amending existing disclosure rules to require controllers to disclose in clearer and more uniform way additional information regarding the scope of their relationship with professional managers, such as the exact number of years that the professional managers work for the controllers, and prior business or personal acquaintance

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[158] *See*, Avi Licht, Ronnie Talmore & Haim Sachs, *Israel's Executive Compensation Reform*, at HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Jan. 7, 2013, 9:09 AM), *available at* http://blogs.law.harvard.edu/corpgov/2013/01/07/israels-executive-compensation-reform/#3b (describing the Israeli say-on-pay model).

[159] *See* and compare, Robert C. Pozen, *The (Advisory) Ties That Bind Executive Pay*, at HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, (Nov 4, 2013, 9:30 AM), *available at* http://blogs.law.harvard.edu/corpgov/2013/11/04/the-advisory-ties-that-bind-executive-pay/ (suggesting to hold a binding vote only after a non-binding vote fails).

between the parties. Such transparency would highlight for all investors the extent to which controllers are able to impartially monitor professional managers. It is also recommended that controllers, and in particular controllers of dual-class firms, will be required to disclose in a uniform and coherent way their total voting rights and equity interests, as this information is not always reported in the customary ownership table.[160] Viacom's proxy statement, for instance, indicates that its controller holds approximately 80% of the company's voting shares, but the company also has another class of non-voting shares, and the proxy statement does not clearly indicate the *combined ownership interests* of its controller in *all* of the company shares.[161] A clear disclosure of the combined equity interests and voting rights of all controlling shareholders would enable investors to better evaluate the magnitude of the distortions created by the use of dual-class structure, and the overall effectiveness of controllers' monitoring power.

VII. CONCLUSION

More than a decade ago, Lucian Bebchuk and Jesse Fried published the seminal work on the role and significance of managerial power theory and rent extraction in executive compensation.[162] Their work cultivated a vivid debate on executive compensation in U.S. companies with dispersed ownership. The discourse on the optimality of executive compensation in CS companies, however, has been more monolithic, and the common wisdom suggests simply that the presence of a controlling shareholder usually cures the problem of managerial opportunism. This Article aims to fill this vacuum by presenting a comprehensive theoretical framework for understanding the relationship between concentrated ownership and executive pay.

Controllers' willingness to maximize their consumption of private benefits, the distortion of incentives created by the use of control-enhancing mechanisms, and the dependency, or biases, that certain controllers develop due to their lack of business expertise or their longstanding relationships with professional managers, are the main drivers behind the different explanations for the existence of an agency problem in designing executive

[160] In some instances, the combined voting or ownership rights is noted only in text, and in other instances such information is not fully disclosed.

[161] See *supra* note 96. Assuming the two classes of shares have the same par value, the combined ownership interest reflects controller's number of shares as a percentage of the total number of shares of the company, including both the voting and non-voting shares. This information is not explicitly mentioned in the proxy statement and has to be manually calculated by the shareholders.

[162] Bebchuk & Fried, *supra* note 77.

pay in CS companies. At the end of the day, these different theoretical explanations have one thing in common: they all subscribe to the view that minority shareholders cannot always trust controllers to effectively monitor the compensation of professional managers. The Article's suggested theory could also help explain a recent puzzling phenomenon attracting much attention, the rise in say-on-pay rules in many European countries with high levels of concentrated ownership.

Undermining the myth of optimal executive compensation in CS companies is just the first step toward a richer discussion on how concentrated ownership influences executive compensation. I hope that subsequent legal and empirical studies will shed more light on this important and interesting topic.