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RESEARCH ARTICLE

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Standardization of compensation for senior executives and limited intervention of law

Abstract The determination of corporate executive compensation is a kind of affiliated transactions including special conflicts of interest in the company. The regulation of executive compensation by law is extremely necessary but plays a limited role, and the scope and mode of such role are specific. The due process and information disclosure system in determining executive compensation prescribed in company law and securities law, the policy guidance of the tax legal regime, and the active and prudential judicial review are the three aspects of the regulation of executive compensation by law, the common goal of which is to ensure and enhance the correlation between executive compensation and corporate performance, i.e., the realization of the principle of "performance-based compensation."

Keywords executive compensation, judicial review, information disclosure, limited intervention

摘要 公司高管薪酬的确定属于一种关联交易，内含了特殊的公司利益冲突。法律对高管薪酬的规制非常必要，但其作用是有限的，且其作用的范围和方式都是特定化的。公司法、证券法上高管薪酬确定的正当程序与信息披露制度、税收法制上的政策引导以及积极、谨慎的司法审查是法律规制高管薪酬的三个方面，其共同的目标是确保并加强高管薪酬与经营业绩之间的相关性，即"据绩给酬"原则的实现。

关键词 高管薪酬，司法审查，信息披露，有限干预

The determination of executive (including director, supervisor and officer, the

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same below) compensation is an affiliated transaction including conflicts of interest in the company. (Clark, 1999) Company law of most countries allows the Board of Directors (or Shareholders' Meeting) to determine the compensation of directors and the Board to determine the compensation of executives. In the US, when revising Section 141 of the General Corporation Law, the state of Delaware added Clause (h), providing that "Unless otherwise restricted by the certificate of incorporation or bylaws, the board of directors shall have the authority to determine the compensation of directors." Later, the same provision was made in Section 8.11 of the US Model Business Corporation Act. In the UK, Article 82 of Model Articles of Association stipulates that executive compensation shall be decided by the ordinary resolution of the Shareholders' Meeting, and Section 84 stipulates that the Board of Directors can decide the compensation for executive directors and executives. The standard practices of companies in US in determining executive compensation are as follows: "The articles of association authorize the Board of directors to appoint executives and determine their compensation. The details of the compensation are usually defined in the service contract between executives and the company. Normally top managers also receive remunerations as becoming directors. In the typical listed companies in the UK, most directors are full-time senior managers, and it is a standard practice to pay directors their expenses incurred for performing their duties.… However, the representation advantage of full-time managers in the board of directors may give rise to problems, i.e., it seems they decide their own remunerations as executives. In other words, the level of manager remunerations seems mostly determined by reliance on self regulation." (Cheffins, 1997) It is not difficult to see that the determination of executive compensation completely conforms to the core features of affiliated transactions: On the surface the transaction occurs between two parties (i.e., executives and the company), but in fact it is decided by one party, executives only.

Since the 1990's, executive compensation has gradually become a central topic attracting much attention in the UK and the US, as top managers make more money than the most majority of people in the UK and the US. According to a survey in 1994, the average remuneration of CEOs of large public companies in the UK was 351,000 pounds, over 20 times the average salary of ordinary employees, and such difference could be bigger in some companies. The compensation of the executive with the highest salary (usually the CEO) in some particular companies was over 100 times the average level of the employees in the same companies (Cheffins, 1997), and a survey in 1995 showed that in the 13 years between the 1980's and the 1990's, the average annual salary and bonus of executives had increased approximately by 149%. (Conyon, 1995) In the US, the absolute amount of compensation of CEOs of public companies and its difference from that of the ordinary employees are far higher/bigger than those of

their counterparts in the UK. (Ruxton, 1997) As an outstanding issue, the excessive executive compensation has attracted extensive attention and triggered controversies from the societies and economic and political circles in the UK and the US, and furthermore, certain factors have led to some concerns. For example, people find that executive compensation has nearly nothing to do with corporate performance. The calls for legal reforms are getting stronger and stronger, and legislative and judicial circles have given corresponding responses. For instance, company law and securities law have reinforced the requirements of considering executive compensation as an affiliated transaction and then enforcing full disclosure to all shareholders; stock exchanges stress more on the must of disclosing executive compensation of listed companies in detail and properly explaining its composition; tax law provides that excessive executive compensation shall be considered as taxable profits for which company income tax must be paid, and the company shall not withhold individual income taxes for executives; and the court has conducted judicial review on the resolutions of executive compensation. Nonetheless, up to today, how about the achievement of the standardization of executive compensation by legislation and judicature in the UK and the US? What experience and lesson we can learn for the executive compensation standardization system that is being established in China from the discussion on public policies regarding the tax regulation, judicial review and mandatory disclosure system of executive compensation? Those are worth in-depth exploration.

1 Dual experiences of law and market: Empirical analysis

In the UK, the Confederation of British Industries (CBI) representing the opinion on legal reforms of the business circle set up Richard Greenbury Committee to investigate on the remunerations of executives in 1995. A few months later, the Committee publicized its recommendations in its report and the attached Rules on Best Practices as follows: The improvement method for executive compensation was not legal control; on the contrary, companies themselves should take measures to handle the matters involved. However, the focus was not totally on self regulation. The Committee recommended that the stock exchange should support each element of the Best Practice Rules through its "Yellow Paper", and the stock exchange agreed to adopt its recommendations and in fact revised its Listing Rules to implement the recommendations of the committee. Before the 1990's, the fact that executives actually decided their own compensation had led to tremendous concerns, "…concerns that directors might be induced to irresponsibly determine the compensation of executives pushed many people to believe that the board of directors should delegate its power to

the compensation committee whose members were all or mainly non-executive directors".[1] In the middle 1990's, most listed companies had actually established compensation committees. But the ensued problem was that the compensation committee itself could not avoid the influence by executives; on the contrary, it was common for the chairman or CEO to join the compensation committee, which means that top managers retain the position of direct impact on remunerations. The Committee's report recommended that the compensation committee should entirely consist of the non-executive directors who had no individual economic interest in the decisions made. For this reason, the stock exchange revised the "Yellow Paper", requesting companies to make disclosure if anyone of individual interest in the decisions make joined the compensation committee. Those measures are playing their due roles, as establishing a compensation committee entirely composed of outside directors has become a general practice thereafter. In addition, the company law and the "Yellow Paper" of the stock exchange also require companies to disclose details related to executive compensation for further opening to the public to a larger extent.

What has been explored above is the power of directors in determining executive compensation. Then, what power or influence do shareholders have in this respect? In summary, since in most cases the articles of association of companies in the UK authorize the board of directors to handle executive compensation, shareholders may directly influence executive compensation only when law or the "Yellow Paper" of the stock exchange grants authorization to them. Specifically, the power of shareholders with respect to executive compensation is reflected in the following aspects:

Firstly, the power for approval of some matters. According to Section 319 of the Companies Act 1985, the employment contracts between the company and directors for a term more than five years must be approved by shareholders in the form of resolution. According to Section 312, before a company pays compensation to the directors who are to resign their jobs, approval shall be acquired from shareholders. Moreover, according to the provision of the "Yellow Paper", before introduction of the plan on directors' acquisition of newly issued stocks or stock options, approval shall be obtained from shareholders in the form of resolution.

Secondly, the right of information. Company legislation and rules of stock exchanges enhance the provisions of mandatory information disclosure so as to provide potential help for shareholders. According to the Companies Act 1985, companies must disclose total compensation paid to directors in their financial reports, including any amounts received according to the service contracts of

[1] See Guinness plc v. Saunders, 714.

executives. Similarly, financial reports must list the total compensation of the chairman and the director of the highest salary (normally the CEO), and must indicate the number of the directors falling in each rank of intervals of 5000 pounds. In addition, compensation for directors who have left their jobs must also be disclosed. But according to the Companies Act 1985, companies are not required to list the compensation for each director or provide details of the compensation of each officer, such as salary, stock options and bonus. However, as a result of the legal reform in 1995, listed companies are required to disclose such kind of information.

Thirdly, shareholders' litigation rights. As prescribed by law, two causes of actions are available to the shareholders who object to the executive compensation policies of a company: Illegal procedure, where the procedure of approving the compensation of executives is illegal,[2] and substantive violation of law, where the decision to pay the compensation constitutes the breach by directors of fiduciary obligations to the company they work for. But in the UK, executive compensation is rarely challenged in the latter cause, which is different from the US.[3] What needs to be mentioned here is that no matter for what cause shareholders initiate a litigation, such litigation shall be proceeded through the media of the company, i.e., the nature of litigation is shareholders' derivative action. Nonetheless, in the company legislation and case law in the UK, there are some obstacles for shareholders to exercise the subrogation right of such action, which is particularly obvious in public companies. This makes the judicial remedy available to the shareholders of public companies a far cry from ideal.[4]

In short, on the one hand, the level of executive compensation of companies is too high to bear in the UK, and it was attributed to the insufficient control by the board of directors and shareholders which needs to be corrected by law;

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[2] In Guinness plc v. Saunders tried by the House of Lords in 1990, the judgment indicated that if the due procedure for approving the executive compensation arrangement was not followed, the court could annul the arrangement. The brief fact of the case is as follows: In 1986 Cuinness Company made a hostile takeover bid to Distillers Company, and formed a committee comprised of shareholders under the board of directors to make critical decisions. The committee agreed to pay 5.2 million pounds to one of the shareholders — Mr. Ward for his attorney service related to the bid. Guinness Company later started a lawsuit requesting to claim the money back and was supported by the judgment of the House of Lords. The critical basis of the judgment was that it was stipulated in the company's Articles of Association that the board of directors had the authority to give special compensation for jobs done beyond the scope of the directors' general duties. The Lord Chancellor thought that since it was the committee rather than the board of directors that approved the compensation, it was illegal in procedure.

[3] See the latter part of the discussion on the cases of the US above.

[4] See Cheffins' discussion on Section 459 of the Companies Act 1985 and the principle of ultra vires of the case law of the UK. See Cheffins B R (1997), 719.

on the other hand, from discussion regarding the measures and recommendations of legal reforms on the enhancement of the role of the board of directors and shareholders, as well as the introduction of direct government management and the enhancement of information disclosure, people find that the role of all those measures of legal reform is limited and they are not able to effectively change the fact that the procedure of deciding compensation matters is almost innately beneficial to the management. The whole society thinks that is a problem but fails to find an effective solution. Perhaps, executive compensation is a topic for which it is much easier to find a problem than to solve the problem.

In the US, the substantive rules of the company law that regulate executive compensation include directors' duty of loyalty and the principle of business judgment, mainly the latter. As for major restriction on executive compensation, "…the general description by the judge is that it must be based on executives' contribution to the society, and there must be 'reasonable correlation' between the amount of the compensation and the value of the contribution to the company". (Clark, 1986) On the one hand, the US courts admit that the determination of executive compensation involves certain factors of factual affiliated transactions, but on the other hand, courts seldom apply the principle of fairness used in review of affiliated transactions. Compared with the judicial review of other types of affiliated transactions, courts' review of executive compensation is not so stringent. To the plaintiff, it is far less effective to use only the reason of unreasonableness to challenge the amount of executive compensation than to use the reason of unfair transaction conditions to attack other affiliated transaction agreements. The relatively less strict position of courts in review of executive compensation implies the difficulty of constructing a series of reasonable and meaningful legal regulation systems. Many courts are undoubtedly under the influence of the following social ideas: In the most determination of executive compensations, the affiliated transactions involved are not serious. In the opinion of the US society, compared with many social issues that urge legislators to enforce price control in other areas, the issue of executive compensation that is generally considered excessive is not serious. Furthermore, for those who believe in free market competition, there exists a manager market of full competition in the US, and the market mechanism is sufficient to ensure that the compensation paid to executives is competitive rather than monopolistic. And there are also some economists who speak frankly and directly that executives are worth each and every nickel they get. (Murphy, 1986)

In this background, the company law of the US takes the middle path between intervening regulation and Laissez-faire. This path is of two aspects: Intensified market measures and judicial security safeguard means. Intensified market

measures focus on public information and due process of decisions. The SEC both strictly requires listed companies to disclose directors' compensation arrangements to shareholders, and tries hard to promote the reform of the board of directors. In most large public companies, outside directors have constituted the most majority of the board of directors, and they have obtained exclusive control on the audit committee, the compensation committee and the nomination committee under the board of directors (Burke, Birch, Higgins, 2001), thus the public exposure of the determination procedure of executive compensation is considered to have been drastically improved. (NACD, 2001) The significance of due process lies in that courts tend to strictly or leniently rule on the executive compensation according to the level of obviousness of the involvement of inside or outside persons. For example, CEO's presence at the meeting of the board of directors that determines his compensation and his participation in voting is considered unwise, especially when his vote is necessary for the amount of his compensation to be approved. While in another occasion, though the approval of shareholders does not essentially affect the substantive justice of the compensation, it is normally of certain factual or procedural influence in judicial review. In Saxe v. Byady, the Court of Delaware held that the approval of shareholders shifted the burden of proof on the reasonableness of the director's compensation to the plaintiff, where the plaintiff must prove to the court that the compensation was so high that it constituted waste.[5] Scholars acutely observed that "considering this point, as long as the contract has been approved by the board of directors and there is no evidence of conflict, malice or fraud among directors, it is fair or reasonable." (Clark, 1986)

Besides intensified market measures, law also provides a means of security safeguard to rectify the compensation that is unreasonable or that causes waste, i.e., for abnormal compensation that cannot be effectively regulated by the market competition mechanism provided by the intensified market measures or the procedure-oriented legal control, judicature must intervene. However, by summarizing the cases of the US' company law, we can see that the causes of this kind of cases examine whether executive compensation is reasonable mostly from the standpoint of income tax, and there are rare cases where the ruling of illegal executive compensation has been made in the principles of the company law, which reflect more or less the relatively lenient judicial position of the US courts with respect to the fairness review of executive compensation. This position can be seen from International Ins. Co. v. Johns (874F. 2d 1447, 11th Cir.

[5] 2nd Atlantic Report (V. 184), 1962. The Court of Chancery (Delaware), 602.

1989),[6] where the directors of Southwest Bank had actually designed a "golden parachute" plan for directors and senior staff through the "performance-based award plan". For this "golden parachute" plan, the academic circle in the US mostly thought that it should be void as it constituted directors' breach of their fiduciary obligations to the company, or violation of public policy. (Zhang, 1998) The trial court of the case thought that two factors must be taken into account when judging whether the clause was legal: Firstly, whether the board of directors of the company had the authority to devise the "golden parachute" clause, and secondly, if the board had such a right, whether such clause applied to the "principle of business judgment". According to Section 6.10 of the Corporation Law in Florida, the board is authorized to formulate such clause. In determining whether this clause was protected by the principle of business judgment, the court believed three factors must be considered: (1) Whether the company benefited from the service provided by directors; if not, the clause would constitute waste of corporate assets; (2) whether the executive compensation was appropriate for the benefit received by the company; if not, it would be categorized as a gift; and (3) whether such payment resulted from the service. The judgment of the case showed that the court favored successful business managers. The three important reasoning links of inference of the court included: The establishment of a performance award plan was within the authority of the board of directors; the examination and approval of the plan had

[6] Fact and ruling: the business Southwest Bank of Florida had been very successful in the 10 years from 1972 and 1982. In 1983 the board of directors of the bank approved a "performance-based award plan" to establish a fund with face value of four million US dollars with the purpose to attract important senior staff to work for the sustainable development of the bank in the coming five critical years. This award plan covered the bank's chairman Johns and other seven senior staff. The plan provided that the aforesaid amount will be paid after five years; and if the control of the bank changed, it should be paid immediately. In January 1984 Southwest Bank was acquired by another bank, and it implemented the "performance-based award plan" and paid four million US dollars to directors and senior staff. Shareholders initiated a derivative action to the 11th Federal Circuit Court by reason that the plan constituted waste of corporate assets. In 1985 the parties reached a settlement where the defendant returned 600 thousand US dollars, which was approved by the court, and the plaintiff withdrew the action. Later the directors and senior staff who had returned 600 thousand US dollars claimed their loss of such amount of 600 thousand US dollars due to the settlement from International Insurance Corporation according to the director responsibility insurance clause. The scope of director responsibility clause of International Insurance Corporation covered "all the losses (including liquidated damages and settlement) incurred by directors and senior staff due to their fault within their job responsibility." Two exceptional clauses in the insurance contract were: (1) Losses incurred due to the directors' and senior staff's receipt of illegal compensation not approved by the board of directors; and (2) losses incurred due to the illegal personal income of directors and senior staff. The US Federal District Court and the 11th Circuit Court ruled that the loss of 600 thousand US dollars of directors and senior staff was legal and was within the insurance coverage.

gone through due process; and if the plaintiff could not prove that this plan was obviously unreasonable, the plan would be protected by the "principle of business judgment".

In Hong Kong, managers can be paid handsomely when companies are in the red, which, though often triggering controversies, has incurred no obstacle in terms of legality. Compensation of directors may be explored by two parts: The position compensation of directors and the compensation received by directors for working for the company in other status. Hong Kong's Companies Ordinance does not provide for the procedure of determination of the former and normally the articles of association of companies provide that director compensation shall be decided by shareholders. For the latter, although early cases determined that "unless otherwise authorized by the official documents of the company or shareholders through meetings duly held, directors may neither receive compensation for service they provide, nor support themselves or each another, nor receive gifts".[7] However, the provisions of the Companies Ordinance and its actual implementation are that any director may provide professional service (except for audit service) to the company in his own name and have the authority to receive compensation for it.[8] The right for determination of compensation here is granted to the board of directors, which will be approved by the compensation committee comprised of independent directors. With respect to the protests by some people of excessive executive compensation, another response in law is mandatory disclosure. The Companies Ordinance provides that the financial reports of companies shall include the following information: (1) The total amount of director compensation; (2) the total amount of the pension of directors or former directors; and (3) the total amount of the compensation money paid to directors or former directors for loss of their positions. But the problem is that those legal measures are far from enough in controlling excessive executive compensation, because if there is the issue of excessive compensation, it will be an issue of excessive compensation for the senior management who are concurrently directors of excessive compensations based on their titles and of excessive charge for other professional services they provide to the company. If what law is concerned about is the legalization of executive compensation, the procedure approved by shareholders or the compensation committee is quite a good solution, but as a means of control it is meaningless since it treasures the proposed compensation according to the market. Meanwhile, the value of the mandatory disclosure procedure is not reflected. This is because "if disclosure is meant to control excessive compensation by making people feel shamed of making so much money, we can only be surprised by the simplicity of the

[7] Kerr v. Marine Products Ltd (1928) 44 TLR 292.
[8] Section 86(3) and (5) of the Companies Ordinance.

proponents". (He, 1997) In Hong Kong, at least observed from the standpoint of the public, the existing cases show that at least the mandatory disclosure has not lowered executive compensation. In other words, the disclosure procedure prescribed by law may not solve the crux of the problem, i.e., the problem of "excessive" compensation. In view of corporate governance, the excessiveness does not mean comparison with the compensation of ordinary people, but with what he deserves. This poses a question: What is the reasonable criterion for measuring the compensation of the senior management? Perhaps there is only one answer — performance. It is very obvious that the only way to solve the problem of excessive compensation of the senior management is to link the compensation mechanism to performance, but the exploration as to whether law is able to achieve it and how to achieve it is still limited to a theoretical level.

2 Standardization of remuneration for senior executives by law: Principle and method

2.1 Restriction of tax policy

In the countries and regions of the Anglo-American legal system, though the public and shareholders are both strongly resentful and critical of excessive executive compensation, their points of concerns are different. What the public resent and criticize is the excessive amount of executive compensation, while what most shareholders resent and criticize is the lack of the correlation between executive compensation incentive and their business performance, which leads to the situation where good CEOs are not motivated in a more meaningful way while bad CEOs are not punished. (Murphy, 1995) In the US, an important response of legislation to the strong voice of the public and shareholders regarding excessive executive compensation is the adjustment of taxation legislation. In 1993, the US Congress revised Section 162 of the Internal Revenue Code, prescribed that if the annual income of the CEO and the 4 highest compensated executives for the taxable year exceeds USD1,000,000, for the excess part, no deduction or exemption on tax shall be allowed as ordinary and necessary business expenses, with one exception that the remuneration of those executives that was related to the company's business performance was not bound by this provision, provided that the company's business performance targets must be set by the compensation committee comprised of non-executive directors and approved by shareholders, and should have been achieved as being proved by the compensation committee. In the years afterwards, empirical study showed that the revised provision failed to play its due role in restricting the growth of the amount of executive compensation but accelerated the increase of

the amount thereof.[9] Why? On the one hand, some companies disregard the revised restriction of the Internal Revenue Code and continue to pay executives huge remunerations, and on the other hand, more companies reduce the fixed compensation of executives but pay them more in stock options, and the value growth rate of stock options is far higher than that of fixed remunerations. This shows that restricting the absolute amount of executive compensation through legislation is hard to meet public requirements, and the result can even be the contrary. Furthermore, the revised provision of the Internal Revenue Code has actually increased the correlation between executive compensation and business performance, and hence has objectively satisfied the needs of shareholders to some extent. Thus it can be seen that it is difficult for legal reforms to meet the two requirements of reducing the amount of executive compensation and increasing the correlation between executive compensation and business operation at the same time. As there is a paradox here: Based on the consideration of executives' mental characteristic of risk aversion and the orientation of behavioral selection, the risk of compensation of stock options is far higher than that of fixed compensation, which determines it does not work at all to add 100 dollars of earnings of stock options and at the same time reduce 100 dollars of salary. This is because that the increase of the risk-to-income ratio in the composition of executive compensation will definitely prompt executives to request for more incomes of stock options. (Yu, 2005) There are two lessons we can learn from the experience of the US tax regulation policy for executive compensation: Firstly, the approach of restricting corporate executive compensation through taxation legislation is doomed to a failure and the reasonable executive compensation can only be determined by the market, beyond which there is no such an ideal criterion to be determined by the government. Secondly, taxation legislation can really play the role of tax leverage, leading companies to establish the principle of "performance-based compensation" in determining executive compensation and to try to improve the correlation between the amount of executive compensation and business performance. In a word, the scope and method of the regulation of executive compensation by tax law and policy are both highly specific.

2.2 Standardization of disclosure system

It is a generally accepted idea that disclosure system plays a positive role in regulating executive compensation and compared with other ways to regulate

[9] Investigation by the US tax authorities showed that, compared with the growth rate of the 14 years before Section 162 of the Internal Revenue Code was revised, executives compensation grew at a higher rate of 29%. See Yu Guanghua (2005).

executive compensation, disclosure system is more suitable to the law of market economy and conducive to the improvement of capital market. There is no problem with such an idea itself, but the fact that the US on the one hand adopts the most stringent disclosure system with the longest history in the world regarding executive compensation and on the other hand has the highest executive compensation level in the world prompts people to ponder more in depth on the relationship between disclosure system and the regulation of executive compensation. Empirical financial study in the countries and regions of the Anglo-American legal system including the US, Canada, the UK, Australia and Hong Kong shows that stringent disclosure system for executive compensation plays a positive role in promoting the correlation between executive compensation and business performance. According to the summary of the famous financial scholar Murphy, the reasons include: Disclosure system reduced the cost of shareholders' obtainment of company information, stimulated the desire of institutional investors of active participation in corporate governance for good reputation, facilitated shareholders' supervision of the board and its compensation committee to adopt more effective compensation policy, and enhanced the obligation and legal responsibility of the compensation committee for statement of the compensation policy of the company. (Murphy, 1995) Nonetheless, empirical study also shows that more stringent executive compensation disclosure system would increase the total amount of executive compensation, because in the condition that there is stronger correlation between executive compensation and business performance, companies will surely adopt the policy of linking executive compensation with business performance, usually more extensive adoption of stock options. Thus, as discussed above, while the predictable compensation at risk is increased, it is very difficult to lower accordingly the fixed executive compensation. As a result, the overall increase of executive compensation always corresponds with the increase of total wealth of the company. Of course, from the perspective of shareholders, since the total increase of executive compensation is also accompanied by the increase of the rights and interests of shareholders, it does not make sense to purely worry about the excessive executive compensation. This echoes the question of insightful people: "As long as the high executive compensation promotes more effectively the growth of net social wealth, what other more effective approaches of executive compensation do we need?"[6] (Yu, 2005)

In short, disclosure system can improve the correlation between executive compensation and business performance, and in this respect, it is even more suitable to the operational law of market economy than other legal means such as tax regulatory policy. Nevertheless, the attempt to restrict the excessive amount and growth of executive compensation through enhancing the compensation disclosure system will be in vain.

2.3 Position of judicial review

Courts admit that executive compensation in most cases belongs to a kind of self-dealing, to which the principles and methods of the transactions with conflicts of interest of directors in company law should apply, because when an officer of the company is at the same time a director, or there are various interest relationships between him and other members of the board, the determination of executive compensation involves the application of the law governing self dealing. Courts also agree that if litigation occurs regarding executive compensation, reviewing whether the executive compensation is excessive relating to the realization of substantive justice, which is of great significance as a duty of the court where the responsibility of the court cannot be shirked. However, experience proves that courts are reluctant to conduct stringent judicial review on such an affiliated transaction as executive compensation. The reasons can be summarized in the following aspects:

(1) Executive compensation is considered a result of the high competition of the market. The fully competitive manager market helps executive compensation be competitive rather than monopolistic; and even if this competitive manager market cannot result in a real equitable negotiation to determine compensation, it is not appropriate for courts to impose mandatory regulation.

(2) The approval of executive compensation has been gone through internal due process. Executive compensation mainly refers to the compensation of executive directors and executives, and the board is responsible for examining it, and since executive directors are members of the board and important position holders among executives such as CEO and CFO are usually members of the board and often act as chairman, most public companies have a compensation committee in place comprised of non-executive directors (most of which are independent directors) who examine the compensation of all the members of the senior management entitled to big amount of compensation. This way, executive compensation approved by non-executive directors has gone through sufficient due process in the company. Under this condition, courts on the one hand naturally consider executive compensation falls within the scope of the decisions of the board and regard this kind of disputes as the internal affairs of the company, hence unwilling to interfere proactively; and on the other hand, courts consider the fairness of procedures in approving executive compensation almost unquestionable, and though due process itself does not exempt judicial review, it is sufficient to cause courts inclined to believing that no stringent judicial review is necessary.

(3) The probability of both the plaintiff's initiation of litigation and its winning of the suit is very low. In this kind of cases, the litigation predicament of the plaintiff is that normally it is very difficult to prove the illegality and

impeachability of executives' salary, bonus, stock options and excessive on-job consumption. The criterion on reviewing whether executive compensation is excessive is to see whether the amount is so huge as to constitute "looting" and "waste".[10] In essence, such a criterion is still an equitable one which reviews whether the transaction is fair to the company. Thus, even if courts sympathize with the situation and the claim of the plaintiff, this factor makes it hard for courts to have sufficient reasons to rule in favor of the plaintiff, statistically resulting in a relatively small probability of wining of the case by the plaintiff. The low probability of wining is of implication for latecomers: Litigants would rather take the approach of self-adjustment and control and internal settlement than resort to judicature. As a result, the number of cases where the plaintiff takes legal actions is of a relatively small percentage compared with the actual number of such disputes. This also objectively leads to the limited power of intervention by judicial review in executive compensation.

(4) Both company legislation and judicature have not established a whole set of system for judicial judgment. Up till today, company legislation of countries and regions has not set up a whole set of legal criteria both fair and explicit in meaning to provide an adequate basis for judgment. Although judges in the countries and regions of the Anglo-American legal system have unique advantages and conditions for creating judgment rules, so far the overall accumulative judicial experience and rules are not sufficient to support judicial review in intervening in the determination of executive compensation in depth.

2.4 Further summary: Limited intervention of law

Then, how to describe the role of law in regulating executive compensation? Some scholars drew the following conclusion after investigating the process of the executive compensation determination and its institutional evolution of Australian public companies: In determining executive compensation, law plays a limited role only. (Ramsay, 2001) Specifically, the function of legal regulation is reflected in three aspects: Firstly, define who is authorized to decide executive compensation; secondly, define the relevant disclosure obligation; and thirdly, conduct judicial review. With regards to the first aspect, as a general rule, all

[10] In Rogers v. Hill [289, U.S. 582, 53 S. Ct. 731 (1993)], shareholders of the American Tobacco Company adopted the provisions of by-laws to determine bonus for executives of the company based on the company's profit percentage. At the beginning the budget was still reasonable, but when the company's profit skyrocketed, the amount of bonus became enormous. The Supreme Court ruled that the amount was too tremendous that it became waste. Similar cases include Adams v. Smith [275 Ala. 142, 153 So. 2d 221 (1963)], Wilderman v. See, Wilderman [315 A. 2d 610 (Del. 1974)].

countries provide the shareholders present at the Shareholders' Meeting shall decide executive compensation, and the compensation of executive directors (managers) shall be determined by other directors. But these "legal" principles are revisable, and in practice companies may formulate different provisions in the form of articles of association, and actually there are examples where the articles of association explicitly specifies that directors can decide their own compensation.[11] In terms of the second aspect, though the company law and securities law of countries have specified the relevant executive compensation disclosure rules for listed companies, they are generally considered not sufficient (Hou, Liu, 2002); and there are also practices of directors avoiding disclosure obligation by various methods. As far as the third aspect is concerned, it has been proved that judicial review plays an extremely limited role, and there are rare judicial precedents in this area. As a general rule, judges will not enquire whether the compensation paid is reasonable, which is considered a matter of internal management of the company; and it is also deemed inappropriate for judges to enquire whether the payment of compensation is in the interest of the company.

Then, on top of this, should law play a more significant intervention role? The answer is positive. Empirical study on public companies of the US shows that when there is no or weak connection between compensation and corporate business performance, the role of law urgently needs to be enhanced and only by this way can the effectiveness of the coordination between the interest of managers and that of shareholders be improved, because the "compensation scheme of the company controlled by managers may not be well devised for the maximization of economic efficiency and profitability" (Gomez–Mejia, Tosi, Hinldn, 1987), and such purpose cannot be achieved by relying only on market power. Nonetheless, besides this, can law play some other roles? Radical suggestions advocate that the most stringent form of legal regulation should be the approval by government regulators of compensation for the management. But this approach has been proved undesirable.[12]

Meanwhile, the claim for emphasis on more in-depth intervention of executive compensation by judicial review is also not appropriate. A similar situation is the

[11] This circumstance is very common in public companies in the countries of the Anglo-American legal system. See Liang Neng (2001), 313 et seq.

[12] In this regard, Ian Ramsay commented that because of certain factors that need to be considered, "this is an unnecessary form of regulation" for the following reasons: Firstly, as far as the main issue of executive compensation is concerned, it seems neither fair nor popular to impose the will of government regulations on shareholders; secondly, there is no reason to believe that a government regulator has the necessary expertise regarding compensation; thirdly, large amount of cost will be involved for government regulators to approve executive compensation; and fourthly, public pressure will lead to the equalization of compensation among companies and industries. And all those will drive the realization of the basic principle and target of compensation based on performance to its opposite. See Ramsay I M (2001), 438.

application by the court of the position of "business judgment rule". Reporter of the 1967 revision of the Delaware General Corporation Law, Professor Folk (E. L. Folk) pointed out that when courts applied this rule, the effect was as follows: Unless there was sufficient evidence to prove that the decision of directors violated the duty of loyalty, courts would not comment on the business decision of directors based on their own judgment. (Zhang, 1998) The Supreme Court of Delaware considered that in a sense the business judgment rule was only a logical result of the general legal provision that directors should manage the company.[13] Professor Clark held that "the rule means only that the judgment of directors is not to be questioned or overruled by courts or shareholders, and directors are not responsible for the consequences of the exercise of their business judgment power — even for judgment that appeared to be obvious decision-making — unless certain exceptions apply." (Clark, 1986) Those comments jointly summarize the principle and standing of courts when applying "business judgment rule". The professional nature of the management determines that they must make quick decisions when faced with complicated and volatile business environment. "They like neither judges who have the capability and willingness to keep arguing on specific cases to seek for the correct answer, nor scholars who seek for the truth conscientiously and meticulously, nor scientists who try to be perfect in the pursuit of better solutions in highly professional areas." (Manning, 1984) From the perspective of courts, judges do not have businessmen's skills and business judgment capability necessary for business activities and thus, for a long period, courts have been reluctant to give smart hindsight on those decisions that appear to have been made in good faith and due care. (Zhang, 1998) Indeed, there is no convincing reason to support the deep intervention by law, the proactive judicial review or judges' hindsight in replacement of the business judgment of executives, or to prove that the former is definitely more justified, reasonable and efficient than the latter.[14] "Respect in judicature of directors' business judgment may mean not only that courts are not willing to verify the prudence of directors, but also that they are reluctant to evaluate the advantages and shortcomings between director resolutions and other alternative purposes and policies." (Clark, 1986) Hence, to stick to the conservativeness and prudence of law under such circumstances and strictly restrict the applicable scope of legal intervention become a rational choice. This logic also applies to the judicial review of executive compensation.

However, the second role of law needs to be further expanded. Some scholars suggest that there is no need for government regulators to approve compensation

[13] Smith v. Van Gorkom [488 A. 2d 858, DEL. 1985]; Solomon Corporations: Law and Policy, 3rd. ed., West Publishing Co, 1994, pp.698–711.
[14] See Folk on the Delaware General Corporation Law, p. 101.

scheme of executives and a more desirable approach is to request more complete disclosure of the conditions and term of these compensation schemes in combination with improved internal negotiation procedure for compensation disclosure. The author believes such suggestion is to the point. Considering the situation of the securities market in China, it should be admitted that the requirements for executive compensation disclosure are not adequate, and such disclosure requirements are not well implemented. There are many reasons to show that the means is appropriate that is dedicated to more stringent disclosure for law to play a more important role in regulating executive compensation. For example, disclosure is very important to the effective operation of market powers, disclosure is very necessary to fill in the shortfall and rectify the deficiency of market powers, and disclosure is conducive to the execution of shareholder supervision and so on.

As for the promotion of establishing positive correlating relationship between executive compensation and corporate business performance, if the market can provide sufficient allocation power, the intervention by law is dispensable. However, the contract arrangement for coordinating the interests of the management and shareholders of the company and its execution provided by market powers are not adequate and thus it is inevitable for law to play the regulation role. The problem is that the existing regulation function of law is still a far cry from the ideal status and there is a room for law to play a big role. However, the purpose of the regulatory role of law is to ensure and enhance the positive correlation between executive compensation and business performance, or the realization of the principle of "performance-based compensation", which determines the reasonable scope of the regulatory role of law. Moreover, law only works in the area where market powers are not effective, which further limits the reasonable scope of the regulatory role of law. Finally, the principle and method of legal regulation are very important. For example, the positioning of the active and prudential standing of judicial review is very critical.

2.5 Something to add

What needs to be added is that the above-mentioned discussion is deployed by using public companies as the subjects. To public companies, in the background of effective competition of manager market, it is desirable to focus on building a procedure-oriented rule system for regulation of executive compensation. This is because managers and shareholders are independent, and it is a valuable procedure where outside directors who are not stakeholders determine and implement compensation for executive directors and executives. Nonetheless, this way of thinking does not necessarily apply to closed companies (in China, roughly including limited liability companies and joint-stock companies

established by promotion). In the most majority of closed companies, shareholders overlap with executives, and the determination of executive compensation is in a sense the allocation of dividends among shareholders, which may be realized through internal consultation among shareholders. But the problem of closed companies lies in that, as there is strong shareholder control (Davies, 2002), the board of directors is only a decision making body in name, and it is totally unnecessary to have outsiders as director to intervene in the disputes over interest among shareholders. Furthermore, as the most majority of closed companies are small, and to look for suitable people to act as outside directors is difficult and expensive for them. As a result, the ideal choice for closed companies should be to allow all shareholders to act as executives. This way, executive compensation is internalized as the allocation of dividends among shareholders.

However, the realistic choice of closed companies is that the controlling shareholders and their family members hold the positions of executives, and minority shareholders are excluded. The controlling shareholders then implement the "no-dividend distribution policy" and use it as a strategic means to squeeze out minority shareholders. On the one hand, the controlling shareholders transfer huge amount of company profits in the names of themselves or their families by ways of salary, bonus and luxury on-job consumption, hence zeroing out company profits; and on the other hand, the controlling shareholders refuse to hire minority shareholders to participate in the management of enterprises, leading to no-dividend distribution for minority shareholders. (Shi, 2006) The controlling shareholders use such "no-dividend policy" to soften up minority shareholders and force them to sell their shares to the company or to themselves at low prices. Such measure is called "squeeze out" strategy. Squeeze-out strategy may lead to litigation, where minority shareholders can request the company and the controlling shareholders to pay dividends or to obtain other remedies. But such litigation of forcing dividend distribution is seldom supported by courts, since courts often consider this kind of disputes as internal affair of the company and consequently they are reluctant to proactively intervene. Besides, since the power to decide whether dividends should be distributed is vested with the Shareholders' Meeting or the board and falls within their scope of decisions, it is normally not subject to judicial review. In individual cases, when the court orders dividend distribution, the plaintiff must prove in a hard way that the company's operation does not need so much cash accumulation and the management is of malicious intention.[15]

[15] See Dodge v. Ford Co., 170 N. Y. 668 (Mich. 1919); Keough v. St. Paul Milk Co., 285N. W. 809 (Minn. 1939); Miller v. Magline Inc., 256 N. W. 2d 761 (Mich. App 1977).

3 Conclusion and revelations

The conclusion of this paper can be expressed in one sentence: For standardization of executive compensation, legal regulation is indispensable; the role of law is very important but obviously not almighty — the scope and mode of its role are both specific.

The above-mentioned discussion gives us multi-facet lessons. In China the regulation of executive compensation has not attracted due attention from the legal circle including legislation and judicature, which, however, does not means that China's corporate executive compensation is not a legal issue. According to the provisions of Chinese Company Law, directors' compensation is determined by the Shareholders' Meeting and the compensation of managers is decided by the board of directors. On surface, executive compensation does not seem to be related to the conflicts of interest, and naturally there is no room for applying legal regulation to self dealing. However, it is another picture in practice. Two situations are rather common: One is for managers who are concurrently directors, and if their compensation is not determined by the Shareholders' Meeting, self dealing will be constituted with potential conflicts of interest; and the other is that though the compensation of directors is decided by the Shareholders' Meeting, in procedure it is directors who formulate compensation proposal and then submit it to the Shareholders' Meeting for review. If directors can in fact manipulate the Shareholders' Meeting, self dealing may be constituted, especially for closed companies. In many state-owned companies, there are serious flaws in the determination of executive compensation. On the one hand the expressly defined and legal compensation is seriously inadequate, and on the other hand the illegal income and abnormal on-job consumption stay high, where insufficient motivation and restriction coexist. While in the companies of centralized equity structure, it is very common that controlling shareholders exploit minority shareholders through holding executive positions by themselves or by their representatives so as to decide on excessive compensation. All those indicate that the construction of a legal system to regulate executive compensation should be put on agenda in China. The limitation of the role of law in regulating executive compensation does not mean there is nothing that law can do. The experience of company legislation and judicature of the Anglo-American legal system tells us that the following relationships should be handled well in legal regulation of executive compensation:

(1) Pay attention to the basic role of resource allocation that a fully competitive manager market plays in forming the competitive executive compensation, and improve the contractual arrangement between shareholders and executives and the market mechanism for its implementation. For this

purpose, efforts shall be made in building up an effective manager market. In essence, the amount and the growth rate of executive compensation are determined by the market pricing mechanism, and neither legislation nor judicature should intervene by ex ante restrictions or ex post reviews. The starting point and the purpose of legal regulation of executive compensation are not for the government to replace the market mechanism so as to formulate a compensation policy and its execution plan, but to give fully play of the guiding roles of law and policy and to make efforts to improve the correlation between corporate business performance and executive compensation. Therefore, it is pointless to discuss the amount of executive compensation from the standpoint of law. The makers of the relevant law, regulation and rule of China shall follow such principles and ideas, and the same is true for courts to handle such kind of judicial cases.

(2) Departmental laws such as securities law shall attach attention to the improvement of executive compensation disclosure system, as sufficient information disclosure system itself is both powerful restriction on unreasonable executive compensation and an effective measure for protection of the rights and interests of shareholders. The requirement for companies to disclose executive compensation is an important means for regulating executive compensation by law, which is normally prescribed by securities law and regulation and implemented by securities regulatory authorities. China's executive compensation disclosure system for listed companies that commenced in 1996 is being gradually perfected over the development more than a decade. As the direction for the perfection of the relevant system, the board of directors and its compensation committee of the company shall through information disclosure, explain to shareholders and the public the basis and reasonableness of the compensation packages to be adopted and their correlation with the business performance of the company.

(3) Departmental laws like the company law shall focus on the construction of the due process for determining executive compensation, particularly for public companies such as listed companies, and the function of the compensation committee mainly comprised of independent directors must be utilized; meanwhile, shareholders' decision-making rights and supervision rights in material compensation matters must be granted and safeguarded. The determination of executive compensation into many cases is reflected as an affiliated transaction and therefore company legislation shall incorporate the perfection of due process of executive compensation in the perfection of the system of affiliated transactions. (Li, 2007)

(4) Courts must hold an active and prudential position in the disputes involving the determination of executive compensation. Judicial review is indispensable, and courts should hold an active position in the acceptance and

trial of cases relating to executive compensation, where justice shall always be sought by courts as an ultimate goal for legal value, while judicial review must also adhere to the ideas of moderate intervention in the autonomous business operation of the company. Besides the general provisions of the Company Law,[16] the legal basis for courts in China to try disputes relating to the determination of corporate executive compensation also includes the judicial interpretations of affiliated transactions including the determination of executive compensation urgently remaining to introduce by the Supreme Court.

(5) Uniformly regulate the executive compensation and dividend distribution policy of limited liability companies. As mentioned above, controlling shareholders of limited liability companies adopt "no-dividend distribution policy" to exploit and squeeze out minority shareholders. Compared with that in executive compensation, the intervention of law in dividend distribution is even more limited. By designing the "no-dividend distribution policy", controlling shareholders confuse dividend distribution and determination of compensation, adding the complexity and difficulty of the intervention by law in executive compensation of limited liability companies. For this reason, law must closely combine the regulation of executive compensation of limited liability companies and the regulation of their dividend distribution policies for overall consideration.

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[16] Such as the provisions of Article 21 of the Company Law on prohibiting the use of affiliated relationship by executives to the detriment of the interest of the company.

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