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, this Article suggests, may in fact overpay managers in order to maximize controllers' 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 unique approach to question conventional beliefs on executive pay by reviewing the ISS recommendations on say-on-pay votes, finding empirical indications that compensation packages in U.S. controlled companies appear to be a bigger problem than initially predicted. It, then, concludes by calling for a new regulatory approach: reconceptualize 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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INTRODUCTION

In 2010, Philippe Dauman, the Chief Executive Officer of a leading media company called Viacom, earned an important title. He was the highest-paid executive in corporate America with a compensation package totaling over $84.5 million for nine months of work,[1] while the median compensation for CEOs at two hundred large U.S. companies was $10.8 million in that entire year.[2] In fact, Dauman's total pay package represented approximately 10% of the company's reported net earnings during the equivalent period.[3]

The lucrative pay package of Viacom's CEO, however, seems uncorrelated with performance. A report by an independent executive-compensation advisory firm noted that "[b]lack marks are deserved" for his pay.[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]

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1. *See* Viacom Inc., Proxy Statement (Form DEF 14A) 48 (Jan. 21, 2011). Dauman earned an average of $312,963 a day for only nine months of work during 2010.

2. Steven M. Davidoff, *Efforts To Rein In Executive Pay Meet with Little Success*, N.Y. TIMES, Jul. 12, 2011, at B7.

3. *See* Viacom Inc., Annual Report (Form 10K) 75 (Nov. 10, 2011) (reporting that the net earnings attributable to Viacom during the nine months ended September 2010 were $854 million).

4. Robin Ferracone, *CEO Pay: When Highly Paid Is Not Overpaid*, FORBES.COM (Apr. 19, 2011, 9:24 AM), http://www.forbes.com/sites/robinferracone/2011/04/19/ceo-pay-when-highly-paid-is-not-overpaid/ (detailing a report by Farient Advisors LLC, an independent executive-compensation advisory firm, that shows that the pay of the Viacom CEO is not aligned with the company performance during the period 2008–2010).

5. ISS PROXY ADVISORY SERVICES, VIACOM INC. 15–16 (2011).

6. Meg James, *Viacom Executives Again Among America's Highest Paid*, L.A. TIMES (Jan.

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 contracting when determining the pay packages of professional managers?

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 policymakers,[8] 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[9] and developed by Jensen and Meckling.[10] 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 fail to provide more disciplined monitoring of management as they suffer from inadequate incentives, conflicts of interest, and regulatory constraints that impede their ability to act like real owners.[11] These

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27, 2012, 3:35 PM) (emphasis added), http://latimesblogs.latimes.com/entertainmentnewsbuzz/2012/01/viacom-executives-again-among-americas-highest-paid.html (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, 753 F.3d 416 (3d Cir. 2014).

7. *See* Viacom Inc., *supra* note 1, at 26–27.

8. *See, e.g.*, Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 753 (2002) (noting that "[e]xecutive compensation has long attracted a great deal of attention from academics, the media, Congress, and the public at large" and that the "rise of academic work on the subject . . . has outpaced even the growth rate of executive compensation"); Conrad de Aenlle, *More Scrutiny, Still Spectacular: C.E.O. Pay Remains Gigantic, Despite Growing Independence of Compensation Committees*, N.Y. TIMES, Jun. 8, 2014, at BU4 (noting that executive compensation in the United States in 2013 is still enormous); Luis A. Aguilar, *Providing Context for Executive Compensation Decisions*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Sept. 30, 2013, 8:22 AM), http://blogs.law.harvard.edu/corpgov/2013/09/30/providing-context-for-executive-compensation-decisions/ (criticizing the dramatic increase in executive pay in the United States and justifying the recent regulatory measures taken to curb it).

9. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 139–40 (1932) (observing that managers "while in office, have almost complete discretion in management").

10. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308, 315 (1976) (noting that "there is good reason to believe that the agent will not always act in the best interests of the principal").

11. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and*

constraints enable managers to exert influence in designing their compensation contracts and to divert value to themselves at the expense of shareholders.[12]

Corporate law theorists, however, have taught us that the presence of controlling shareholders 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.[13]

References to this conventional wisdom can be found in the works 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."[14] Andrei Shleifer and Robert Vishny argue that "[t]he more serious problem with high powered [managerial] incentive contracts" appears when "these contracts are negotiated with poorly motivated boards of directors rather than with large investors."[15] Additionally, Lucian Bebchuk and Assaf Hamdani explain that "[d]iversion of value through executive compensation . . . is a concern of lesser importance in CS [(controlling shareholder)] companies than in NCS [(widely held)] companies."[16]

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.[17] The Article uses a novel approach to question conventional beliefs about executive pay by reviewing the recommendations of Institutional Shareholder Services (ISS) on say-on-pay votes in the 2011 and 2012 proxy seasons, finding empirical indications that the

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Corporate Control, 155 U. PA. L. REV. 1021, 1048–57 (2007) (discussing the different monitoring constrains that institutional investors face).

12. *See* Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 71–72, 75–76 (2003) (showing how powerful managers are able to extract rent by exercising significant influence on the design of their compensation arrangements); Lucian A. Bebchuk & Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. PA. L. REV. 1263, 1309 (2008) ("Suboptimal compensation arrangements can be a main channel for insider opportunism at NCS [widely held] companies.").

13. *See infra* notes 14–16, 36 and accompanying text.

14. Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 791–92 (2003).

15. Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 745 (1997).

16. Bebchuk & Hamdani, *supra* note 12, at 1284 (also explaining that when a controlled company is managed by a professional manager, "the controller generally has an interest in setting executive compensation to maximize shareholder value" and noting that while a controller might use generous compensation arrangements to induce managers to facilitate controller's tunneling, managers usually have an incentive to cater to the controller preferences even without being paid for their cooperation).

17. *See infra* Part III.A.

compensation packages of professional managers in controlled companies are unlikely to be accurately calibrated to maximize shareholder value.

There are 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,[18] while providing professional managers with a premium for their "loyalty" and for colluding with tunneling activities.[19] This tendency, according to the second explanation, is aggravated by the use of control-enhancing mechanisms, such as dual-class share structures,[20] which further distort controllers' monitoring incentives.[21] The third explanation explores situations where controllers are "weak," 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.[22]

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 those managers. The proposed theory also advances the view that there is significant heterogeneity across U.S. controlling shareholders. Controllers vary in their identity, skills, and preferences, and such differences may impact their incentives and willingness to monitor executive pay.

The focus of this Article is on hired professional managers, 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 ("controller CEOs") has long been viewed as another mechanism for transferring private benefits to the controllers.[23] This mechanism for expropriating minority shareholders does not raise any new dilemma and is consistent with the existing theory on agency problems 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

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18. Alexander Dyck and Luigi Zingales define private benefits of control as "some value, whatever the source, [that] is not shared among all the shareholders in proportion of the shares owned, but it is enjoyed exclusively by the party in control. Hence, the name private benefits of control." Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537, 541 (2004).

19. *See infra* Part II.A.

20. For a definition of "dual-class share structure," see Paul A. Gompers, Joy Ishii & Andrew Metrick, *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1052 (2010) ("In the typical dual-class company, there is a publicly traded 'inferior' class of stock with one vote per share and a nonpublicly traded 'superior' class of stock with ten votes per share. The superior class is usually owned mostly by the insiders of the firm and causes a significant wedge between their voting and cash-flow rights. In many cases, this wedge is sufficient to provide insiders with a majority of the votes despite their claims to only a minority of the economic value.").

21. *See infra* Part II.B.

22. *See infra* Part II.C.

23. *See infra* note 33 and accompanying text.

is therefore already subject to special approval procedures.[24] The payment to hired professional managers, 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.[25] Even in the United States, where the model of large, widely held firms is dominant, there is a significant fraction of controlled companies.[26] Furthermore, the need to take executive pay in controlled companies more seriously has increased recently due to the global shift toward say-on-pay regulation.[27]

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.[28] This 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: reconceptualize 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 I lays out the background to the discussion on executive compensation in controlled companies and explains the limitations of the conventional view. Part II presents the agency-problem theory in designing executive compensation in controlled companies. Part III shows evidence from the ISS on executive pay patterns in U.S. controlled companies that are difficult

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24. *See generally* Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430 (2008) (surveying self-dealing rules around the world).

25. *See*, *e.g.*, Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 89–107 (2000); Mara Faccio & Larry H.P. Lang, *The Ultimate Ownership of Western European Corporations*, 65 J. FIN. ECON. 365, 378–83 (2002); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471, 491–97 (1999).

26. *See* Ronald C. Anderson, Augustine Duru & David M. Reeb, *Founders, Heirs, and Corporate Opacity in the United States*, 92 J. FIN. ECON. 205, 207 (2008) (showing that in 2000 of the 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"); Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 REV. FIN. STUD. 1377, 1382 (2009) (using a sample of 375 U.S. public corporations and finding that the average size of the largest block of ownership is 26%).

27. A typical say-on-pay rule requires that shareholders at public companies have a vote either approving or disapproving the pay of senior executives. This vote can be either binding or advisory. *See infra* notes 133–34 and accompanying text. For a discussion regarding the global shift toward say-on-pay regulation, see *infra* notes 180–87.

28. *See infra* notes 142, 188.

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 IV discusses the economic and regulatory impacts of the proposed theory, Part V proposes a new regulatory solution.

I. 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 controlling shareholders ("CS companies") and those without controllers ("NCS companies"),[29] and that this difference, in 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."[30] 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."[31] 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 that 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.[32]

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.[33] In such situations, the common

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29. *See, e.g.*, Bebchuk & Hamdani, *supra* note 12.
30. Bebchuk & Fried, *supra* note 12, at 73.
31. For a general description of the optimal contracting view, see Bebchuk & Fried, *supra* note 12, at 71–73. For examples of scholars supporting this view, see generally Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q. J. ECON. 49 (2008); Steven N. Kaplan, *Executive Compensation and Corporate Governance in the U.S.: Perceptions, Facts, and Challenges* (Nat'l Bureau of Econ. Research, Working Paper No. 18395, 2012).
32. *See, e.g.*, Bebchuk & Fried, *supra* note 12, at 71–76.
33. As noted in the Introduction, this Article does not focus on the compensation to

perception has long been that controlling shareholders can monitor the compensation of professional managers effectively.[34]

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 through excessive executive compensation, while aligning their interests with those of minority shareholders.[35] If controlling shareholders do not closely monitor managerial rent extraction, then, the argument continues, any associated decrease in the firm's value will first and foremost be borne by the controllers. Second, the theory assumes that controlling shareholders also have the actual power to monitor professional managers and limit their ability to behave opportunistically.[36] In sum, the conventional theory 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.[37] For instance, not all controlling shareholders hold a large stake of the controlled-firm cash flow,[38] and the lack of substantial economic holdings may negatively affect their monitoring incentives.

Even if controlling shareholders maintain a large economic interest, setting the compensation of professional managers at an optimal level does not necessarily maximize the economic interests of the controllers. As further elaborated below, controllers may have a strong interest in maximizing their consumption of private benefits, even at the price of deviating from executive pay practices suggested by optimal contracting.[39]

Finally, not all controlling shareholders have the ability, power, or willingness to monitor managers closely. Some controllers may lack the relevant business

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controller CEOs as such pay has already been described in the economic literature as another mechanism for rent extraction. *See* Yan-Leung Cheung, Aris Stouraitis & Anita W.S. Wong, *Ownership Concentration and Executive Compensation in Closely Held Firms: Evidence from Hong Kong*, 12 J. EMPIRICAL FIN. 511, 521–28 (2005) (finding that the excess pay of owner-managers is not associated with better performance and interpreting it as a sign of a rent extraction); Harry DeAngelo & Linda DeAngelo, *Controlling Stockholders and the Disciplinary Role of Corporate Payout Policy: A Study of the Times Mirror Company*, 56 J. FIN. ECON. 153, 154–56 (2000) (providing evidence that family shareholders extract private rents through different ways, including excessive-compensation schemes).

34. *See supra* notes 14–16 and accompanying text.

35. *See supra* notes 14–16 and accompanying text.

36. *See, e.g.*, Shleifer & Vishny, *supra* note 15, at 754 (noting that a controlling shareholder "also has enough voting control to put pressure on the management in some cases"); Bebchuk & Hamdani, *supra* note 12, at 1281–82, 1284 (explaining that "controlling shareholders commonly have . . . the effective means to monitor management").

37. *See infra* notes 153, 169–71 and accompanying text.

38. *See infra* notes 90–91 and accompanying text.

39. *See infra* Part II.A.

experience and are more likely to develop strong dependencies on their professional managers. Others may have judgment biases because of their longstanding relationships with professional managers. Such dependencies or biases, in turn, impair the power or willingness of those controllers to monitor executive pay closely.[40]

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 CS companies, as the presence of a controlling shareholder practically renders the company immune to a hostile takeover.[41] The disciplinary effect of the market for capital is also more limited in the context of CS companies, as controllers can rely on their own financial resources instead of turning to the capital market to raise funds.[42] In addition, controllers' failure to tightly limit managerial pay is likely to only slightly raise a firm's cost of capital.[43]

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.[44] A 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 superstar CEOs is similar to the market competition among team owners for attracting talented NBA players.[45]

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40. See *infra* Part II.C.

41. Bebchuk & Hamdani, *supra* note 12, at 1270; *see also* Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CALIF. L. REV. 393, 421–23 (2003).

42. 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 J. ECON. LITERATURE 331, 338–39 (2007).

43. *See* Goshen, *supra* note 41, 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"). For general analyses of the limited effectiveness of the capital market in constraining managerial pay, see Bebchuk et al., *supra* note 8, at 778 (noting that excessive managerial pay will only slightly raise a firm's cost of capital); Zohar Goshen, *Controlling Corporate Agency Costs: A United States-Israeli Comparative View*, 6 CARDOZO J. INT'L & COMP. L. 99, 113 (1998) ("[M]ost companies do not need the capital markets. For most companies, undistributed profits and loans serve as a main source of finance, while raising money from shareholders is viewed as a last resort.").

44. For examples of literature supporting the market view in the context of NCS companies, see generally Gabaix & Landier, *supra* note 31; R. Glenn Hubbard, *Pay Without Performance: A Market Equilibrium Critique*, 30 J. CORP. L. 717 (2005). It is also possible that scarcity of talented outside CEOs in certain industries increases the relative bargaining power of incumbent CEOs. *See* K.J. Martijn Cremers & Yaniv Grinstein, *Does the Market for CEO Talent Explain Controversial CEO Pay Practices?*, 18 REV. FIN. 921, 923 (2014) ("Under the view that the CEO's bargaining power vis-à-vis [the board] is important, CEOs in industries with mostly insider CEOs are likely to have greater bargaining power.").

45. Bengt Holmstrom and Steven Kaplan best express this view, noting that "[CEO] wages[] are ultimately set by supply and demand . . . ." Bengt Holmstrom & Steven N. Kaplan, *The State*

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.[46]

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 control the nomination of professional managers, a strong competition between managers in order to influence controllers' hiring decisions could actually reduce professional managers' bargaining power vis-à-vis controllers and thereby negatively impact managers' pay level.[47] 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.[48] Empirical studies show, however, that managers of CS companies are not always paid for better performance.[49] 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 III. 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 of CS companies within the United States is negatively affected by problematic pay practices in NCS companies that do not necessarily align pay with performance.[50]

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of U.S. Corporate Governance: What's Right and What's Wrong?, 15 J. APPLIED CORP. FIN. 8, 19 (2003); *see also* Gabaix & Landier, *supra* note 31, at 64 (noting that "[t]he pay of a CEO depends not only on his own talent, but also on the aggregate demand for CEO talent").

46. Nuno Fernandes, Miguel A. Ferreira, Pedro Matos & Kevin J. Murphy, *The Pay Divide: (Why) Are U.S. Top Executives Paid More?* 3, 25–26 (European Corporate Governance Inst., Finance Working Paper No. 255, 2009) (showing that executive pay is "higher when foreign sales . . . are higher, and when foreign firms are cross-listed on U.S. exchanges").

47. This tendency is even more pronounced in countries with large business groups, as controlling shareholders control the nomination of executive positions in all of the companies that belong to the same business group. *See* Randall Morck, Daniel Wolfenzon & Bernard Yeung, *Corporate Governance, Economic Entrenchment, and Growth*, 43 J. ECON. LITERATURE 655, 665 (2005) (noting that control over pyramidal business groups frequently involves assigning controllers' preferred candidates to key executive and board positions throughout the pyramidal groups).

48. 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 160 and accompanying text.

49. *See, e.g.*, Francisco Gallego & Borja Larrain, *CEO Compensation and Large Shareholders: Evidence from Emerging Markets*, 40 J. COMP. ECON. 621, 621–23 (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); *infra* Part II.B.2 (showing that dual-class firms that pay higher salaries to their managers are not associated with better performance); *see also infra* note 77 (evidence on executive pay in Israel); *infra* note 78 (evidence on executive pay in Italy).

50. This argument is based on the corporate governance externalities theory. *Cf.* Viral V. Acharya & Paolo F. Volpin, *Corporate Governance Externalities*, 14 REV. FIN. 1, 28–30 (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

The international competition in the managerial labor market may also be 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.[51] This assumption is not always realistic. The "exit" threat of many managers, especially those who manage firms that have dominant positions in the domestic market and that operate in industries suffering from weak global competition, may be less reliable than initially assumed.[52] Such executives, who often reach the top managerial position at a relatively late age,[53] may face personal, cultural, and linguistic barriers and may lack the knowledge of the relevant foreign markets. Therefore, their intermarket transferability and bargaining power is limited.

In sum, this Part discussed the limitations of controllers' 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 minority shareholders can always trust controllers to effectively monitor the pay of professional managers.

II. TOWARDS AN AGENCY-PROBLEM THEORY

This Part turns to discuss the agency-problem theory in determining executive compensation in CS companies. This theory challenges the conventional wisdom that controlling shareholders generally have an interest in setting executive compensation to maximize shareholder value.[54] In particular, this Article proposes 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-problem theory assume a rational controller who chooses not to closely monitor executive pay of professional

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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.* at 29.

51. *Cf.* Charles M. Elson & Craig K. Ferrere, *Executive Superstars, Peer Groups, and Overcompensation: Cause, Effect, and Solution*, 38 J. CORP. L. 487, 504–05 (2013) (explaining that "[t]he notion of market driven executive compensation is derived from a . . . conception of executives possessing transferable management abilities").

52. Charles Elson and Craig Ferrere support this view, noting that "[t]he potential mobility of a CEO is of course influenced by the transferability of the CEO's human capital or skills. If an executive's productivity is mainly derived from firm-specific knowledge and skills, which have little value elsewhere, the executives themselves will have little value to outside firms." *Id.* at 505. They further review numerous empirical studies on CEO transferability and conclude that the existing empirical evidence does not support the proposition that "setting CEO compensation . . . is predicated on the notion of CEO transferability in competitive markets for talent." *Id.* at 511–16.

53. *See* Soojin Yim, *The Acquisitiveness of Youth: CEO Age and Acquisition Behavior*, 108 J. FIN. ECON. 250, 255 (2013) (researching S&P 1500 firms between the years 1992–2007 and finding that the average CEO age is 55.2 years).

54. *See supra* notes 14–16 and accompanying text.

managers since the private benefits such a controller derives and the costs he saves by not monitoring outweigh the benefits of monitoring. The third explanation deviates from the rationality framework. It assumes a controller who is not a profit maximizer but who derives nonpecuniary benefits from the maintenance of family control over the firm or from a 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 CS companies, some explanations may be more relevant to one type of CS company 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 of CS 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 in various forms of intercompany transactions such as selling (or buying) assets, goods, or services in terms that favor the company in which the controllers have the larger equity stake.[55] Controllers can also employ family members at the company,[56] use company resources for personal benefits,[57] receive financing on favorable terms using the controlled firm's assets as collateral,[58] or exploit business opportunities through another company they own.[59] Such transactions are referred to in the literature as "tunneling."[60] In order to engage in tunneling through any of the abovementioned channels, controlling shareholders need the cooperation of professional managers, who are usually in charge of initiating related-party transactions and bringing them to the approval of the board.[61]

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55. *See, e.g.*, Vladimir Atanasov, Bernard Black & Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1, 5–9 (2011); Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22, 22–24 (2000).

56. *See infra* Part II.C.1.

57. *See* Atanasov et al., *supra* note 55, at 25–28.

58. *See* Johnson et al., *supra* note 55, at 24–26.

59. *See* Atanasov et al., *supra* note 55, at 7–8; Dyck & Zingales, *supra* note 18, at 540–41.

60. *See, e.g.*, Atanasov et al., *supra* note 55; Johnson et al., *supra* note 55.

61. *See* Guohua Jiang, Charles M.C. Lee & Heng Yue, *Tunneling Through Intercorporate Loans: The China Experience*, 98 J. FIN. ECON. 1, 18–19 (2010) (providing examples of top management that colluded with controllers' tunneling); Kun Wang & Xing Xiao, *Controlling Shareholders' Tunneling and Executive Compensation: Evidence from China*, 30 J. ACCT. PUB. POL'Y 89, 90 (2011) (explaining that "[t]unneling is usually achieved through collusion between controlling shareholders and executives").

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 the form of higher compensation.[62] 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 a controller derives from overpaying the manager outweigh the prorated costs such a controller incurs due to the payment of extra compensation and the decrease in firm value as a result of the enhanced transfer of private benefits (in case such decrease actually occurs). Suppose, for example, that a controller owns 30% of the outstanding shares of a company. Such a 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 the private benefit, the controller grants the professional manager additional compensation of $10 per year. As Table 1 shows, the controller would pay such extra compensation to the detriment of minority shareholders.

Table 1. Profits and costs for controlling and minority shareholders

	Additional profits	Extra costs
Controlling shareholder	$50*	$18†
Other shareholders	$0	$42‡

*Additional private benefit
†30% of $60 (the sum of the loss in the company value ($50) and the extra compensation to the CEO ($10))
‡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.[63]

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,[64] and they may even face legal

62. 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.

63. *See* Bebchuk & Hamdani, *supra* note 12, at 1284 n.68.

64. *See* Alexander Dyck, Natalya Volchkova & Luigi Zingales, *The Corporate Governance Role of the Media: Evidence from Russia*, 63 J. FIN. 1093, 1097 (2008) (studying the impact of media coverage on corporate governance violations in Russia and showing that

sanctions.[65] Therefore, it can be assumed that professional executives, who do not receive any direct benefit from colluding with controllers' tunneling activity, have weaker incentives to facilitate such activities.

Also, firing managers for not colluding with value-diversion activities may impose costs on controlling shareholders. A change in the company leadership (especially an unjustified one) may disrupt the company's operational activities and be associated with negative public coverage and a potential decline in the stock price. As a result, controlling shareholders are less likely to use their authority to terminate managers very often.

Suboptimal compensation to professional managers may also be triggered by controllers' willingness to pay generous salaries to themselves 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 funds from minority shareholders.[66] However, once controllers pay themselves (or their relatives) excess salaries, they set a high threshold and may have to pay professional managers compensation that is at least as high as the compensation awarded to themselves (or to their relatives).

3. Empirical Evidence on Rent Extraction and Excess Executive 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 a positive association.

For instance, one study on Chinese firms showed that "the pay-performance sensitivity of executive compensation is lower in firms where controlling shareholders tunnel resources for private benefits compared to other firms."[67] The authors of this study conclude that "executives may not care much about firm

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"in roughly half of the cases, media pressure leads a regulator . . . to intervene, while in the remaining half, it is the company itself that relents, realizing the reputational costs of continuing the battle"); Atanasov et al., *supra* note 55, at 37–38 (discussing the effect of egregious tunneling on controller's reputational concerns and noting that "shaming may impact tunneling behavior").

65. In the United States, for instance, tunneling is limited by corporate governance rules, which specify fiduciary duties of corporate officers and directors, and approval requirements for related-party transactions; securities rules that require disclosure of these transactions and bar insiders from extracting value by using their informational advantages and engaging in market manipulations; and creditor-protection rules that limit cash distributions and asset transfers from insolvent companies. Corporate insiders who breach any of these antitunneling rules may face legal sanctions. For a detailed analysis and specific examples, see Atanasov et al., *supra* note 55, at 9–36.

66. *See supra* note 33.

67. Wang & Xiao, *supra* note 61, at 94–99 (2011) (using data on Chinese companies between the years 1999–2005).

performance after all if controlling shareholders are able to provide non-pecuniary compensation to executives based on how they tunnel for the controlling shareholders."[68] Another study on Chinese public firms provided a similar result, showing that "increase[s] in CEO compensation are associated with more likelihood of controlling shareholders' tunneling."[69] 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."[70]

A recent study on Italian family firms shows that these firms 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."[71] The authors of the study interpreted this result as an evidence of rent extraction, arguing that families overcompensate their board members to "buy" their loyalty and allow them to expropriate minority shareholders.[72]

Finally, a study on institutional investors' voting patterns in Israel finds that institutional investors' support for proposals related to compensation of professional CEOs of CS companies tends to be low.[73] This tendency of institutional investors to oppose executive-compensation proposals even when they cannot influence the outcome shows, according to the authors, that the pay of professional managers is "an important source of concern even in firms with controlling shareholders."[74] Further, this can support the assertion that controllers provide professional managers with overly generous compensation arrangements to secure managerial cooperation with minority shareholder oppression.[75]

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.[76] Based on the rent extraction explanation, one would anticipate that executive compensation will be excessive and suboptimal in countries where controllers pay a high premium for acquiring a control block and thus are expected to enjoy a 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,[77]

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68. *Id.* at 97.

69. Yongli Luo & Dave O. Jackson, *CEO Compensation, Expropriation, and the Balance of Power Among Large Shareholders*, *in* 15 ADVANCES IN FIN. ECON. 195, 231 (Stephen P. Ferris, Kose John & Anil K. Makhija eds., 2012) (using data on public Chinese companies between the years 2001–2010).

70. *Id.* at 204.

71. Roberto Barontini & Stefano Bozzi, *Board Compensation and Ownership Structure: Empirical Evidence for Italian Listed Companies*, 15 J. MGMT. & GOVERNANCE 59, 84 (2011).

72. *Id.*

73. Assaf Hamdani & Yishay Yafeh, *Institutional Investors as Minority Shareholders*, 17 REV. FIN. 691 (2013) (researching institutional investors voting in 2006).

74. *Id.* at 704.

75. *Id.* at 704–05.

76. Dyck & Zingales, *supra* note 18, at 539, 543–44 (studying control premium in thirty-nine countries between the years 1990–2000).

77. Alexander Dyck and Luigi Zingales found a mean 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 Partial Control Transfers: Methodology and Evidence*, 2

Italy,[78] and Brazil.[79]

4. Tunneling in the United States

Finally, one may argue that while minority shareholder expropriation is relatively common in developing countries,[80] it barely exists in developed countries, such as the United States, which 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 tunneling and self-dealing transactions,[81] it should be recognized that no matter how effective these rules are, they cannot address all of 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.[82] Vladimir Atanasov, Bernard Black, and Conrad Ciccotello show that even in the United States, the existence of gaps in the overall system of antitunneling legal protections led to the exploitation of public shareholders by controllers.[83]

INT'L J. CORP. GOVERNANCE 183, 192 (2011) (studying control premium in Israeli companies between the years 1993–2005 and finding similar results for private benefits (32%) compared to those of Dyck and Zingales). Reports by the Israeli Securities Authority (ISA) discuss the suboptimal level of executive compensation in Israel and also show that while the average salary of all Israeli senior executives doubled between the years 2003–2009, the connection between firm performance and higher CEO salaries is not statistically significant. *See, e.g.*, ISA ECON. DEP'T, EXECUTIVE COMPENSATION IN PUBLIC COMPANIES 2003–2011, at 5, 16–17, 27 (2012), *available at* http://www.isa.gov.il/Download/IsaFile_7531.pdf (in Hebrew); ISA ECON. DEP'T, EXECUTIVE COMPENSATION 15 (2010) [hereinafter ISA ECON. DEP'T, 2010 REPORT], *available at* http://www.isa.gov.il/Download/IsaFile_5029.pdf (in Hebrew).

78. According to the Dyck and Zingales study, the control premium in Italy is 37%. Dyck & Zingales, *supra* note 18, 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. CONYON, NUNO FERNANDES, MIGUEL A. FERREIRA, PEDRO MATOS & KEVIN J. MURPHY, INST. FOR COMPENSATION STUDIES, THE EXECUTIVE COMPENSATION CONTROVERSY: A TRANSATLANTIC ANALYSIS 43–44, 47–53 (2011).

79. According to the Dyck and Zingales study, the control premium in Brazil is 65%. Dyck & Zingales, *supra* note 18, at 550. For a discussion on the suboptimal level of executive compensation of professional managers in Brazilian CS companies, see Gallego & Larrain, *supra* note 49, at 630–41.

80. *See, e.g.*, Atanasov et al., *supra* note 55, at 2 n.2 (providing examples of tunneling in developing markets). *See generally* Marianne Bertrand, Paras Mehta & Sendhil Mullainathan, *Ferreting Out Tunneling: An Application to Indian Business Groups*, 117 Q. J. ECON. 121 (2002) (discussing tunneling in India).

81. For a comprehensive analysis of the different rules that affect tunneling, see Atanasov et al., *supra* note 55, at 9–25.

82. For a discussion of tunneling in developed economies, see Atanasov et al., *supra* note 55, at 2 n.1.

83. *See, e.g.*, *id.* at 25–36. For empirical studies that documented tunneling in the United States, see Elizabeth A. Gordon, Elaine Henry & Darius Palia, *Related Party Transactions*

Part III presents data on CS companies whose compensation packages to their professional managers were subject to a negative ISS recommendation. A large number of these companies engage in various forms of self-dealing transactions or employ relatives of the controllers in managerial positions.[84] The example of Las Vegas Sands, Inc. (LVS) stands out in this respect, and the ISS, in its 2012 Report, expressed concern over LVS's continued provision of high levels of excessive perquisites to its controller without disclosed justification.[85] 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.[86] 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 . . . ."[87]

Interestingly, the provision of excessive perquisites to the controllers of the abovementioned 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's Chief Operating Officer (a professional manager not affiliated with the controller).[88] 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 performance, which, according to the ISS, "have fueled a pay-for-performance disconnect for the second year in a row."[89]

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and Corporate Governance, *in* 9 ADVANCES IN FINANCIAL ECONOMICS 1 (Mark Hirschey, Kose John & Anil K. Makhija eds., 2004) (researching related-party transactions in the United States and finding that weaker corporate-governance mechanisms are associated with more and higher dollar amounts of related-party transactions, and that industry-adjusted returns are negatively associated with those transactions); Conrad S. Ciccotello, C. Terry Grant & Gerry H. Grant, *Impact of Employee Stock Options on Cash Flow*, 60 FIN. ANALYSTS J. 39 (2004) (discussing the severe effects of "repricing" stock options on the company cash flow and its dilution impacts).

84. The New York Times Company, for instance, reports that seven family members of the controlling family work for the company. *See* New York Times Co., Proxy Statement (Form DEF 14A), at 15 (Mar. 17, 2014). Similarly, Marriott International Incorporated 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* Marriott International Inc., Proxy Statement (Form DEF 14A), at 76–77 (Apr. 4, 2014).

85. ISS PROXY ADVISORY SERVICES, LAS VEGAS SANDS CORP. 14–15 (2012). For instance, in 2011 alone, LVS paid $16.7 million to private companies controlled by LVS's controller for LVS's use of aircraft services, whereas LVS charged these private companies only $1 million with respect to their use of LVS's aircrafts. *See* Las Vegas Sands Corp., Proxy Statement (Form DEF 14A), at 52 (Apr. 27, 2012).

86. Ms. Stewart serves as Chief Editorial, Media and Content Officer, and as a Director of the company. *See* ISS PROXY ADVISORY SERVICES, MARTHA STEWART LIVING OMNIMEDIA, INC. 7–8 (2012).

87. *Id.* at 14.

88. *See* ISS PROXY ADVISORY SERVICES, *supra* note 85, at 10–15.

89. *See* ISS PROXY ADVISORY SERVICES, *supra* note 86, at 18.

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-enhancing devices, such as pyramids and dual-class shares, to maintain their control.[90] Control-enhancing devices are mechanisms that separate cash-flow rights and voting rights. When using such devices, controlling shareholders do not have to keep a large equity stake in order to exercise control over a majority of the firm's voting rights.[91]

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 benefits or to take excess risks, and such tendency, in turn, induces controllers' willingness to overpay professional managers. These two effects will be discussed in greater details in the rest of this Part.

As only a small fraction of the executive pay and the decrease in firm value is borne by minority controllers who use control-enhancing devices, such minority controllers have weaker incentives to monitor professional managers than controllers who hold 50% of the firm cash flow. Suppose, for example, that the cost of monitoring the CEO is $20 and that the enhanced monitoring would 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 minority controllers (who hold 10% of the firm cash flow) to closely monitor professional managers, as such controllers would incur all the monitoring costs ($20), but would receive only $10 of the additional profits (10% of $100). However, for controllers who hold 50% of the firm cash flow, it would be efficient to closely monitor the CEO pay as such controllers will bear the same costs ($20), but will receive $50 of the additional profits (50% of $100).

One may still argue that although only a small fraction of the extra compensation is borne by minority controllers (say 10% instead of 50%), such controllers still incur some of the losses caused by providing professional CEOs with excessive compensation.[92] Therefore, the argument continues, such controllers still have certain

90. *See* Claessens et al., *supra* note 25 (discussing the separation of voting rights from cash-flow rights via pyramid structures and cross holdings in East-Asian countries); Faccio & Lang, *supra* note 25, at 381–93 (showing that dual-class shares and pyramids are prevalent among Western European countries). *See generally* Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697 (2009) (discussing dual-class firms in the United States).

91. *See* Lucian Arye Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* NAT'L BUREAU OF ECON. RESEARCH, CONCENTRATED CORPORATE OWNERSHIP 295, 297–303 (Randall K. Morck ed., 2000) (presenting a theoretical analysis of the different control-enhancing mechanisms and the distortions created by them).

92. If the monitoring costs in the abovementioned example were $2 (instead of $20), it would be efficient even for minority controllers to exercise additional monitoring and to receive an additional profit of $10 while bearing costs of $2.

incentives to pursue optimal contracting schemes. True, the use of control enhancing mechanism does not fully eliminate the controllers' 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.[93]

The divergence between cash-flow rights and control rights has another negative effect on controllers' incentives. Such divergence leads to a certain misalignment of interests between the minority controllers and other shareholders, and to distortions in controllers' business decisions. For instance, the divergence increases the controllers' tendency to divert private benefits of control to their own pockets, or to engage in 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[94] 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 a business failure caused by excess risk taking.[95] Indeed, it is well established in the economic literature that the incentives to expropriate minority shareholders increase in the presence of control-enhancing devices[96] and that the separation between ownership and control leads to value-destroying investments.[97]

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93. Bebchuk et al., *supra* note 91, at 301–05 (showing that when two companies with separation of cash-flow rights and voting rights are identical except that the controller owns a smaller fraction of cash-flow rights in one company than in the other, the agency costs in the latter company are likely to be substantially more severe than the agency costs in the former).

94. For instance, if a risky strategy succeeds and the level of the firm cash flow increases, the controllers may be able to use some of the excess cash flow for empire building, to divert the additional profits to their pockets, or to gain other nonpecuniary interests such as increased political clout.

95. *See* LUCIAN BEBCHUK, CORPORATE PYRAMIDS IN THE ISRAELI ECONOMY: PROBLEMS AND POLICIES 7–11 (2012), *available at* http://www.financeisrael.mof.gov.il/FinanceIsrael/Docs/En/publications/opinion_2.pdf (analyzing and exemplifying this point in a report prepared for the Committee on Increasing Competitiveness in the Israeli Economy); *see also* Bebchuk et al., *supra* note 91.

96. *See, e.g.*, Bertrand et al., *supra* note 80 (presenting evidence about the significant volume of tunneling taking place in Indian firms using control-enhancing devices); Jiang et al., *supra* note 61 (finding evidence that tunneling through intercorporate loans is more severe when the controlling right is much larger than the ownership right); Minjung Kang, Ho-Young Lee, Myung-Gun Lee & Jong Chool Park, *The Association Between Related-Party Transactions and Control-Ownership Wedge: Evidence from Korea*, 29 PACIFIC-BASIN FIN. J. 272, 285–89 (2014) (providing evidence that a higher degree of separation between ownership and control correlates with greater related-party activities and tunneling); Chen Lin, Yue Ma, Paul Malatesta & Yuhai Xuan, *Ownership Structure and the Cost of Corporate Borrowing*, 100 J. FIN. ECON. 1, 4 (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 et al., *supra* note 91 (presenting a model that proves this argument).

97. *See, e.g.*, Masulis et al., *supra* note 90, at 1708–16 (reporting that as the divergence between cash-flow rights and voting rights widens, managers are more likely to make value-destroying acquisitions and capital expenditures contribute less to shareholder value); *see also* Stijn Claessens, Simeon Djankov, Joseph P.H. Fan & Larry H.P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741, 2764–69 (2002) (providing evidence that substantial separation of control and cash flow rights is associated with

As described in Part II.A, such enhanced tendency to divert private benefits may induce controlling shareholders to pay professional managers 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 Part II.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% of the company's voting rights through the use of control-enhancing devices. As shown in Table 2 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 2a. Controller with a large ownership stake

	Additional profits	Extra costs
Controller I (30% of the economic rights)	$50*	$18†
Other shareholders	$0	$42‡

*Additional private benefits
†30% of $60 (the sum of the loss in the company value and the extra CEO pay)
‡70% of $60

Table 2b. Minority controller

	Additional profits	Extra costs
Controller II (10% of the economic rights, 50% of the voting rights)	$50	$6*
Other shareholders	$0	$54†

*10% of $60
†90% of $60

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 found that the CEO compensation in dual-class firms (including those managed by professional CEOs) was higher than that in a matched sample of single-class firms and that such executive pay increased as the divergence between voting and cash-flow rights grew.[98] Another study on Canadian family firms presented a similar result.[99] According to the authors of that study, the result implies

worse performance for shareholders); Gompers et al., *supra* note 20 (evidencing that control-enhancing structures are associated with increased agency costs and reduced firm value).

98. Masulis et al., *supra* note 90, at 1703–05 (studying U.S. dual-class companies). The results were confirmed for both professional CEOs and controller CEOs, although Masulis, Wang, and Xie found that the excess control rights measure has a stronger effect, both statistically and economically, on compensation of the latter. *Id.* at 1707–08.

99. Ben Amoako-Adu, Vishaal Baulkaran & Brian F. Smith, *Executive Compensation in*

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."[100] A few additional empirical studies also support the finding that dual-class firms pay more to their professional CEOs.[101]

Another strand of studies examined the effect of control-enhancing mechanisms on the pay–performance sensitivity of executive pay (although without differentiating between professional managers and controller CEOs). For instance, two empirical studies, which researched executive compensation in China and Germany, showed that the link between CEO performance and pay was dramatically weaker in companies where cash-flow rights deviated from voting rights.[102]

In sum, the empirical evidence clearly shows that the agency problem created by the separation of cash-flow rights and voting rights drives the compensation of professional managers to levels that 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,[103] there are some exceptions where controllers are "weak" or lack the required business skills and thus may develop a dependency on hired professional managers. 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.

Firms with Concentrated Control: The Impact of Dual Class Structure and Family Management, 17 J. CORP. FIN. 1580, 1585–90 (2011) (researching companies listed on the Toronto Stock Exchange between the years 1998–2006 and using a sample that also covers nonfamily professional executives).

100. *Id.* at 1590.

101. *See, e.g.*, Ettore Croci, Halit Gonenc & Neslihan Ozkan, *CEO Compensation, Family Control, and Institutional Investors in Continental Europe*, 36 J. BANKING & FIN. 3318, 3329 (2012) (researching CEO pay in Continental Europe and finding that dual-class firms pay more to their CEOs (including professional CEOs); Surjit Tinaikar, *Voluntary Disclosure and Ownership Structure: An Analysis of Dual Class Firms*, 18 J. MGMT. & GOVERNANCE 373, 394–99 (2014) (finding that CEOs in U.S. dual-class firms receive higher total compensation than CEOs in a matched sample of single class firms).

102. *See* Jerry Cao, Xiaofei Pan & Gary Tian, *Disproportional Ownership Structure and Pay-Performance Relationship: Evidence from China's Listed Firms*, 17 J. CORP. FIN. 541, 553 (2011) (using a sample of Chinese listed companies from 2002 to 2007); Alfred Haid & B. Burcin Yurtoglu, Ownership Structure and Executive Compensation in Germany 17 (2006) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=948926 (using a sample of German companies over the period 1987–2003).

103. *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) ("[T]he large shareholder is the most effective monitor of management in the corporate setting . . . ."); *see also supra* notes 14–16 and accompanying text.

1. Second-Generation Controllers

In firms where the founders are absent and replaced by heirs of the founders, such second-generation controllers sometimes lack the business expertise, talent, or motivation of the founders.[104] In order to maintain their lock on control, the second-generation controllers have to place in the top managerial position more capable, business-savvy, and talented outside professional managers. The "weak" controllers are then likely to develop a dependency on strong professional managers. This, in turn, may affect the controllers' 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).[105]

True, in such a 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.[106] Although it may not be economically efficient, a second-generation controller may resist such change in control and insist on keeping control within the family in order to preserve the psychic benefits of control and the family heritage, tradition, or a special set of values.[107]

It is well established in the economic literature that firms run by descendants of the founders underperform compared to other family firms managed by hired CEOs, and this result was confirmed in a wide range of studies.[108] Also, consistent with this

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104. *See infra* notes 108–09.

105. This explanation, in its broader formulation, may apply to controllers who lack the relevant business expertise or have time constraints and are therefore prone to becoming dependent on 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. This view is supported by empirical evidence that shows that CEOs who work for business groups (rather than for individual firms) receive higher compensation than CEOs of unaffiliated companies. *See* ISA ECON. DEP'T, 2010 REPORT, *supra* note 77, at 30.

106. *Cf.* Lucian Arye Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. ECON. 957, 957, 961–64 (1994) (developing "a framework for analyzing transactions that transfer a company's controlling block from an existing controller to a new controller").

107. *See* Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301, 1302–03 (2003) ("[F]ounding 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 . . . ." (citation omitted)); *see also* Alessio M. Pacces, *Control Matters: Law and Economics of Private Benefits of Control* 9 (European Corporate Governance Inst., Law Working Paper No. 131, 2009) (Rotterdam Inst. Law & Econ., Working Paper No. 4, 2009), *available 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).

108. *See, e.g.*, Anderson & Reeb, *supra* note 107, at 1316–17, 1321–22 (finding that the existence of founder descendants is unrelated to market performance, unlike the cases of hired CEOs and founder-CEOs); Morten Bennedsen, Kasper Meisner Nielsen, Francisco

evidence, another study showed that family firms run by second-generation controllers have relatively poor management practices.[109] Such mediocre performance, as evidenced in a large body of empirical literature,[110] suggests that second-generation controllers may lack the experience or the talent of the founders 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, who researched executive pay packages in Argentina, Brazil, and Chile, found a premium of around 30% for professional CEOs working in family firms.[111] The study showed that the premium comes mostly from family firms with absent founders, where heirs of the founders 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 professional CEOs.[112] 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 founders.[113]

2. Biased Controllers

Over the years, controllers may also develop 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 highlight 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

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Perez-Gonzalez & Daniel Wolfenzon, *Inside the Family Firm: The Role of Families in Succession Decisions and Performance*, 122 Q. J. ECON. 647, 647, 669–70, 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, 1574–78 (2006) (finding that 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. FIN. ECON. 385, 385, 388, 399–400 (2006) (showing that "[w]hen descendants serve as CEOs, firm value is destroyed" and that "minority shareholders in those firms are worse off than they would be in nonfamily firms").

109. Nicholas Bloom & John Van Reenen, *Why Do Management Practices Differ Across Firms and Countries?*, 24 J. ECON. PERSP. 203, 205, 217–19 (2010) (noting that family managed firms "have a large tail of badly managed firms").

110. *See supra* notes 108–09.

111. Gallego & Larrain, *supra* note 49, at 622.

112. *Id.* at 630–41.

113. *Id.* at 623. An alternative interpretation to this empirical finding is that professional CEOs "ask for compensation if they do not have access to the business expertise of the founder." Gallego & Larrain, *supra* note 49, at 623; *see also* Marianne Bertrand & Antoinette 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 of many family firms). 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 stages, they attribute high value to the lack of access to the business expertise of the founder.

independent.[114] It is expected that such ties will grow stronger the longer board members serve together.[115] There is also evidence that network ties between directors and CEOs weaken the intensity of board monitoring.[116]

Similarly, controllers and professional CEOs 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 at the company for twenty-eight years.[117] 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's peer group median.[118]

D. Putting the Pieces Together: Revisiting the Viacom Case

The theoretical explanations presented in this Part provide a useful tool for explaining the overly generous pay patterns in the Viacom example.[119] 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,[120] which may lead to severe distortions in his ability to effectively monitor the pay package of the company's CEO.

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114. *See*, *e.g.*, Bebchuk et al., *supra* note 8, at 768–69 (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); 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); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L. Q. 821, 858–60 (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).

115. *See generally* Yaron Nili, The "New Insiders"—Rethinking Independent Directors' Tenure 21–24 (Nov. 21, 2013) (unpublished manuscript) (on file with Harvard Law School) (discussing the effects of longer board tenure on directors' ability to remain independent and surveying related literature).

116. *See, e.g.*, Byoung-Hyoun Hwang & Seoyoung Kim, *It Pays To Have Friends*, 93 J. FIN. ECON. 138, 155 (2009).

117. Amy Chozick, *Times Chief Is To Retire at Year-End*, N.Y. TIMES, Dec. 16, 2011, at B1 (noting that Ms. Robinson worked at The New York Times Company for twenty-eight years).

118. ISS PROXY ADVISORY SERVICES, THE NEW YORK TIMES COMPANY 3, 11–12 (2012).

119. *See supra* notes 1–6 and accompanying text.

120. 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 provided therein

Second, there is evidence showing that the controller of Viacom is 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.[121] 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.[122] 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 the 2011 fiscal year amounted to approximately $30 million.[123] 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.[124]

Third, the CEO of Viacom has served in executive positions at the company for a very long period of time: he has been the company CEO since September 2006, and prior to that (from 1987 to 2000) he held several positions at the former Viacom, including deputy chairman and member of its executive committee.[125] It appears that during all of these years, the company's controller and its CEO developed a special relationship. As one executive close to the company puts it, the CEO of Viacom, Philippe Dauman, is "the son Sumner [(Viacom's controller)] wishes he had."[126] Although the daughter of the controller serves on the company's board,[127] Mr. Redstone already said, "I think[] that Philippe will be my successor."[128] 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,[129] the payment of overly generous salaries to the controller for serving as executive chair (over $20 million in 2011),[130] and a longstanding relationship between the controller and the CEO, who has served in executive positions with the company since 1995.[131] In light of these symptoms, it is not surprising that CBS also received a negative voting recommendation from the ISS in 2011, which criticized CBS's

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suggests that his combined ownership rights (as a percentage of both Class A and Class B common shares) is approximately 7%. *See* Viacom Inc., *supra* note 1, at 26–27.

121. *Id.*

122. Mr. Redstone is the controller of National Amusements, Inc. that directly and through its wholly-owned subsidiary, NAI Entertainment Holdings LLC, controls both Viacom and CBS Corporation. For a description of the related-party transactions that Viacom conducted through its subsidiaries, see Viacom Inc., Proxy Statement (Form DEF 14A) 23–24 (Jan. 23, 2015).

123. *See* Viacom Inc., Proxy Statement (Form DEF 14A) 29–30 (Jan. 27, 2012).

124. Atanasov et al., *supra* note 55, at 42.

125. Viacom Inc., *supra* note 122, at 7, 46.

126. Amy Chozick, *The Man Who Would Be Redstone*, N.Y. TIMES, Sept. 23, 2012, at BU1.

127. *Id.* at BU7.

128. *Id.* at BU6.

129. CBS Corp., Proxy Statement (Form DEF 14A) 14–16 (Apr. 13, 2012).

130. *Id.* at 57–58.

131. *Id.* at 24.

compensation practice 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."[132]

III. 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 executive pay. This Part, then, reexamines existing empirical evidence on executive compensation in companies with large share ownership and suggests 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).[133] All shareholders, including controlling shareholders, are allowed to participate in such say-on-pay votes.[134] Since many controllers exercise substantial influence over the voting rights of the companies they control, the results of say-on-pay votes held in CS 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,[135] are expected to be a useful indicator in determining whether compensation patterns in CS 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

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132. ISS PROXY ADVISORY, CBS CORPORATION 15 (2011).

133. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–1900 (2010). Section 14A of the Securities Exchange Act of 1934 and the rules thereunder subsequently adopted by the SEC, as part of the Dodd-Frank Act, implement the requirement to conduct a nonbinding vote on executive pay. Securities Exchange Act of 1934, Pub. L. No. 112-158, § 14A, 48 Stat. 881 (2012); 17 C.F.R. § 229.402 (2014).

134. Section 14A(a)(1) of the Securities Exchange Act of 1934 and SEC Rule 14a-21(a) require that at least once every three years, at an annual meeting of shareholders, a public company afford its shareholders the right to a separate, nonbinding vote to approve the compensation of the company's named executive officers. Those rules do not prohibit controlling shareholders from participating in the vote. Securities Exchange Act of 1934 § 14A(a)(1); 17 C.F.R. § 240.14a-21 (2014).

135. *See* James K. Glassman, *Regulators Are a Proxy Adviser's Best Friend*, WALL ST. J. (Dec. 18, 2014, 12:14 AM), http://www.wsj.com/articles/SB22483005598294434483704580330903370477266 (noting that "ISS advises more than 60% of U.S. institutional investors, such as mutual funds and pension funds, on how to vote"). For a discussion on the influence of ISS recommendations on the results of say-on-pay votes, see *infra* notes 139–42 and accompanying text.

several matrices that are useful for determining whether the package is accurately calibrated to maximize shareholder value. For instance, the primary causes for issuing a negative voting recommendation, as reflected in the ISS guidelines, are pay-for-performance misalignment, problematic compensation practices, or poor responsiveness to shareholders.[136] The ISS pay-for-performance test examines the alignment of executive pay and total shareholder return, as well as how that alignment compares to that of the company's peer group over a one-year, three-year, and five-year period.[137] In determining company compensation practices, the ISS also assesses, among other things, problematic practices related to non-performance-based compensation elements (such as multiyear guaranteed payments), options backdating, completeness of disclosure, lack of rigorous goals, and other relevant special circumstances.[138] An ISS negative voting 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.[139] For instance, "of the S&P 500 companies that received a negative ISS recommendation in 2012, 21 percent experienced failed [say-on-pay] votes, as compared to the overall average of 2.7 percent."[140] 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 percent versus 95 percent for those with a positive ISS recommendation."[141] 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."[142]

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136. INSTITUTIONAL S'HOLDER SERVS. INC., 2013 U.S. PROXY VOTING SUMMARY GUIDELINES 38, 41 (2013), *available at* http://www.issgovernance.com/file/files/2013ISSUSSummaryGuidelines1312013.pdf.

137. *Id.* at 39.

138. *Id.* at 40–41.

139. *See* 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, 981–83, 1010–11 (2013) (showing that ISS has had a significant effect on shareholder say-on-pay voting and that its negative recommendations "are more explanatory than any other factor identified in say-on-pay voting . . . .").

140. David A. Katz, *"Say on Pay" in the 2012 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 21, 2012, 9:15 AM), http://blogs.law.harvard.edu/corpgov/2012/08/21/say-on-pay-in-the-2012-proxy-season/ (footnote omitted); *see also* Cotter et al., *supra* note 139 (showing similar effects of ISS recommendations during the 2012 proxy season).

141. Katz, *supra* note 140 (citing John D. England, *Say on Pay Soul Searching Required at Proxy Advisory Firms*, PAY GOVERNANCE (June 20, 2012)), http://paygovernance.com/say-on-pay-soul-searching-required-at-proxy-advisory-firms/); *see also* Cotter et al., *supra* note 139.

142. Randall S. Thomas & Christoph Van der Elst, *The International Scope of Say on Pay* 4 (Eur. Corp. Governance Inst., Law Working Paper No. 227, 2013) (Vanderbilt Law & Econ. Research Paper No. 22, 2013), *available at* http://ssrn.com/abstract_id=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 when it comes 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.[143] Then, I cross-referenced the data received from the Voting Analytics database with information obtained from FactSet[144] on the insider ownership and dual-class structure of these companies,[145] and I excluded from the list companies that FactSet did not provide the relevant ownership data. The final sample included 2566 observations for 2011 and 2290 observations for 2012. In total, there are 2820 companies in my sample, and 589 of them (20.9%) have concentrated ownership.[146] Finally, I also collected data from FactSet on the identity of the CEOs of the sampled CS companies in order to distinguish between CS companies with controller CEOs and those with hired-professional CEOs.[147] Out of the 589 CS companies in my sample, 392 companies (67%) have professional managers.[148] The results are summarized below:

Table 3. Ownership structure and ISS recommendations

	Say-on-pay votes			ISS negative recommendations		
	NCS	CS	CS with prof'l CEOs	NCS	CS	CS with prof'l CEOs
2011	2073	493	310	248 (12%)	89 (18.1%)	58 (18.7%)
2012	1994	296	208	262 (13.1%)	44 (14.9%)	32 (15.3%)

143. *Voting Analytics*, ISS GOVERNANCE, http://www.issgovernance.com/governance-solutions/investment-tools-data/voting-analytics/.

144. *Data and Delivery*, FACTSET, http://www.factset.com/data.

145. The data is as of December 31, 2010 and 2011.

146. Companies with concentrated ownership were defined as companies where at least 30% of the economic or voting interests were held by insiders and shareholders who owned at least 5% of the common stock (excluding institutional investors) or as companies with a dual-class structure. I used a relatively high cutoff of insider ownership to confirm that a controller indeed had the ability to monitor executive pay.

147. CS Companies with professional CEOs were defined as companies where the CEO was not the largest shareholder or an affiliate of such shareholder.

148. 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 107, at 1314. Considering that controllers of family firms tend to be more involved in the management of their companies than other types of controllers, the slightly lower percentage of professional managers in the Anderson and Reeb sample, which includes only family firms, is not surprising.

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.[149] This result is further corroborated by running a simple bivariate probit regression (Model 1) where the ISS recommendation is the dependent variable (1=Negative Recommendation; 0=Positive Recommendation) and ownership structure is the independent variable (1=CS; 0=NCS).[150] I found a positive and significant effect of the concentrated ownership dummy variable on the probability of a negative voting recommendation ($p<0.01$). The results show that, holding year constant, the predicted probability of a negative ISS 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 a negative 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 a negative recommendation is 11.7% for a NCS company and 15.7% 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 practices in a couple of specific industries.

I then rerun the regression on a sample that includes professional managers only (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 concentrated ownership dummy variable on the probability of a negative recommendation ($p=0.013$), showing that a CS company managed by a professional CEO still has a higher likelihood to receive a negative recommendation (15.9%) than a NCS company (11.6%). This result rebuts the possibility that controller 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 Tables 3, 4a, and 4b show 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.

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149. The total number of CS companies in the sample may be overestimated because of double counting block ownership (for instance, by attributing the same block to different family members) or due to the categorization of a dual-class firm where the controller holds less than 30% of the voting rights as a controlled one. To partially correct this problem, I read a large number of proxy statements, including all proxy statements of the companies that received negative recommendations and that fall into the definition set forth above. *See supra* note 146. Because the number of CS companies with negative recommendations should be accurate, an overestimation of the total number of CS companies included in my sample actually reduces the percentage of CS companies with negative recommendations.

150. 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.

Table 4a. Results of probit regressions

The Table reports results from bivariate probit regressions where the dependent variable is "ISS recommendation", a dummy variable equal to 1 if a firm received a negative ISS recommendation in connection with a say-on-pay vote. All regressions include yearly dummies. Model 1 adopts the regular probit regression without controlling for market cap and the industry-fixed effects, and Models 2 and 3 adopt a probit regression with a control for "ln(Market Cap)," defined as the logarithm of a firm's market capitalization at the fiscal year end prior to the applicable proxy season, and industry-fixed effects. Model 3 includes hired, professional CEOs only. Robust standard errors in parentheses below the coefficients. All standard errors adjust for clustering at the firm level. Finally, *, **, and *** indicate statistical significance of the coefficients at the 90%, 95%, and 99% levels, respectively.

	Model 1	Model 2	Model 3 (prof'l CEOs)
CS company	.1917***	.1855***	.1998**
	(.0643)	(.0696)	(.0808)
Log market cap	–	-.0011	.0002
		(.0176)	(.0180)
Constant	-51.2515	-153.651	-178.325
	(83.2102)	(86.9292)	(89.9256)
Year fixed effect	Yes	Yes	Yes
Industry fixed effect	–	Yes	Yes
Observations	4856	4634	4399
Pseudo R^2	0.0027	0.0166	0.0170
Log pseudolikelihood	-1893.2319	-1728.0193	-1619.8291

Table 4b. Predicted probabilities

The table reports the predicated probabilities of a negative ISS recommendation for a NCS company and a CS company for Models 1–3. Delta-method standard errors in parentheses below the margins. *, **, and *** indicate statistical significance of the coefficients at the 90%, 95%, and 99% levels, respectively.

Ownership variable	Model 1	Model 2	Model 3 (prof'l CEOs)
NCS company	.1253***	.1166***	.1156**
	(.0057)	(.0057)	(.0054)
CS company	.1692***	.1570***	.1593**
	(.0147)	(.0153)	(.0184)

In addition, I collected data from the SharkRepellent database on the existence of dual-class capital structure at the sampled companies in order to examine whether such capital structure indeed increases the likelihood of receiving a negative ISS recommendation.[151] Indeed, the data presented in Table 5 shows that the tendency to

151. *See* Factset Research Systems, Inc., SHARKREPELLENT.NET, https://www.sharkrepellent.net. The data is as of December 31, 2010 and 2011.

overpay professional managers is further aggravated by the use of dual-class capital structure. The percentage of companies with dual-class structure receiving negative ISS recommendations is higher than the percentage of CS companies with single-class capital structure receiving such recommendations in both 2011 and 2012, and this result holds even when the sample is limited to companies managed by professional CEOs.[152]

Table 5. Capital structure and ISS recommendations

	Say-on-pay votes			ISS negative recommendations		
	CS with single class	Dual class	Dual class (prof'l CEOs)	CS with single class	Dual class	Dual class (prof'l CEOs)
2011	346	136	71	59 (17.1%)	30 (22.0%)	17 (23.9%)
2012	211	71	45	31 (14.7%)	13 (18.3%)	8 (17.8%)

I also hand-collected additional information on the controllers of the sampled CS companies that yields a result consistent with the view that significant heterogeneity exists across controlling shareholders in the United States.[153] Firms managed by their founders and family firms consist of 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 retained 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.[154] Others are controlled by another large public entity or a foreign entity, and only 1% of the sampled CS companies are controlled by the U.S. government. I also examined whether companies controlled by private equity firms and venture capital investors have a lower likelihood of

152. When running a bivariate probit regression to identify the impact of a dual-class capital structure on the probability of a company to receive a negative recommendation, the results are not significant, probably due to the sample size, which only includes single-class CS companies and dual-class companies. When running a bivariate probit regression on the entire sample (including all widely held companies), I did find a positive and significant effect of the dual-class dummy variable on the probability of a negative recommendation ($p<0.01$). For a company with a dual-class structure, the predicted probability of a negative recommendation is 21.9%, whereas for all other single-class companies (including both controlled and widely-held companies) the predicted probability is 12.2%.

153. S*ee* Henrik Cronqvist & Rüdiger Fahlenbrach, *Large Shareholders and Corporate Policies*, 22 REV. FIN. STUD. 3941, 3942 (2009) (discussing the significant heterogeneity across blockholders and its influence on investment, financial, and executive compensation policies).

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

receiving a negative recommendation compared to other controlled firms, but the results were not significant.

Finally, I hand-collected additional information on the sampled CS companies with professional managers that received negative ISS recommendations. 63.4% of those companies were involved in related-party transactions with their controllers.[155] And, on average, the employment term of a professional CEO of such a CS company is ten years (the median is eight years).[156] Indeed, a CEO who works with a controller for such a long period of time is expected to develop close social and business ties with the controller.[157]

Before proceeding, 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.[158] 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[159] 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 point, not an ending point, for an extensive empirical analysis of executive compensation in U.S.

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155. Not every single, related-party transaction necessarily extracts resources from the CS companies to controllers' hands as such transactions can be, and sometimes 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 et al., *supra* note 55, at 42 (providing examples for tunneling activities in the United States).

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

157. It is difficult to compare this data to other studies on CEO turnover because this data does not include information on the full tenure of a CEO, and it also counts for the number of years such a 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 31, at 12 (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." INVESTOR RESPONSIBILITY RESEARCH CTR. INST., COMPENSATION PEER GROUPS AT COMPANIES WITH HIGH PAY 10 (2010), *available at* http://www.irrcinstitute.org/pdf/Final-Compensation-Peer-Groups-at-Companies-with-High-Pay_June2010.pdf.

158. Proxy advisory firms are often criticized for employing a "one-size-fits-all" approach as a means to avoid the cost of firm-specific analyses and for using a mechanical formula that frequently produces odd results. *See, e.g.*, Charles M. Nathan, *Corporate Governance Activism: Here To Stay?*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (July 5, 2012, 9:42 AM), http://blogs.law.harvard.edu/corpgov/2012/07/05/corporate-governance-activism-here-to-stay/. For an empirical study that discusses this criticism and rebuts it, see Yonca Ertimur, Fabrizio Ferri & David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 51 J. ACCT. RES. 951, 956–69 (2013).

159. INSTITUTIONAL S'HOLDER SERVS. INC., *supra* note 136, at 38–55.

companies with a controlling shareholder and the agency problem that may be associated with such compensation.

Second, while the analysis presented in this Part provides preliminary evidence that compensation packages in CS companies are a bigger problem than initially predicted (an interesting result in and of itself given the longstanding 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.[160] 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.[161]

B. Reexamining 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 have found that CEO compensation is lower when there is an external blockholder,[162] and that there is a negative correlation between the equity ownership of the largest shareholder and the amount of executive pay,[163] a closer examination of this empirical evidence suggests that it is unlikely to undermine the agency-problem theory presented in this Article.

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160. *See generally* Gallego & Larrain, *supra* note 49, at 624–25, 637–38 (empirically examining and rejecting these two explanations). Note that the financial literature surveyed by Gallego and 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.

161. *See, e.g.*, Gallego & Larrain, *supra* note 49.

162. John E. Core, Robert W. Holthausen & David F. Larcker, *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 388–89 (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 AM. ECON. REV. 203, 207 (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).

163. *See, e.g.*, Richard M. Cyert, Sok-Hyon Kang & Praveen Kumar, *Corporate Governance, Takeovers, and Top-Management Compensation: Theory and Evidence*, 48 MGMT. SCI. 453, 464–66 (2002) (finding that doubling the percentage ownership of a large outside shareholder is associated with a 12% to 14% reduction in a CEO's nonsalary compensation); Julie Ann Elston & Lawrence G. Goldberg, *Executive Compensation and Agency Costs in Germany*, 27 J. BANKING & FIN. 1391, 1407 (2003) (finding that "the greater the ownership concentration the less the ability of executives to extract higher levels of compensation"); Feng Li & Suraj Srinivasan, *Corporate Governance When Founders Are Directors*, 102 J. FIN. ECON. 454, 460–61 (2011) (finding that CEOs in companies where founders serve as directors of the company have higher pay-for-performance sensitivity than CEOs in nonfounder firms).

To begin with, some of the abovementioned 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.[164] 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 noncontrolling blocks are generally more aligned with those of other public shareholders.[165] 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.[166] As noted, such distinction is consequential for prompting the understanding of pay patterns and managerial incentives in CS companies. Because the majority of the empirical studies support the hypothesis that controller CEOs receive lower compensation compared to professional CEOs,[167] a nonnuanced empirical study, which treats controller CEOs and professional CEOs as members of the same group, may underestimate 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 nonfamily firms.[168]

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164. For empirical studies using a threshold of at least 5% to identify an external blockholder, see, for example, Bertrand & Mullainathan, *supra* note 162, at 204; Core et al., *supra* note 162, at 372; Fernandes et al., *supra* note 46, at 7.

165. *See* Jay C. Hartzell & Laura T. Starks, *Institutional Investors and Executive Compensation*, 58 J. FIN. 2351, 2372 (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); Henry L. Tosi, Jr. & 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).

166. *See, e.g.*, CONYON ET AL., *supra* note 78; Elston & Goldberg, *supra* note 163; Haid & Yurtoglu, *supra* note 102.

167. 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 101, at 3319–21; Luis R. Gomez-Mejia, Martin Larraza-Kintana & Marianna Makri, *The Determinants of Executive Compensation in Family-Controlled Public Corporations*, 46 ACAD. MGMT. J. 226, 232–36 (2003); 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, 126–29 (2000). Note, however, that there are also a handful of studies supporting the opposite view by showing that controller CEOs actually tend to extract rent through the payment of excessive compensation to themselves. *See, e.g.*, Shmuel Cohen & Beni Lauterbach, *Differences in Pay Between Owner and Non-Owner CEOs: Evidence from Israel*, 18 J. MULTINATIONAL FIN. MGMT. 4, 13–14 (2008).

168. Zhi Li, Harley E. Ryan, Jr. & Lingling Wang, Family Firms and Top Management Compensation Incentives (Nov. 18, 2011) (unpublished manuscript) (on file with the Midwest

In addition, there is significant heterogeneity across controlled firms that should not be ignored.[169] Controlling shareholders vary in many aspects: their 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[170] and may have an impact on controllers' incentives to effectively monitor executive pay.[171] 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 CS 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 or dual-class firms, where the agency problem between controllers and minority holders is expected to be more severe, with those found in companies controlled by private equity shops or with CS companies that have 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 CEOs' characteristics (such as age and experience) and controllers' value-diversion activities.

Finance Association).

169. Cronqvist & Fahlenbrach, *supra* note 153.

170. *Id.*; *see also* Villalonga & Amit, *supra* note 108, at 385–86 (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 destroys value when descendants serve as CEOs or the founder uses control-enhancing mechanisms).

171. Cronqvist & Fahlenbrach, *supra* note 153 (finding that "executive compensation policies are systematically related to the presence of particular large shareholder").

IV. ECONOMIC AND REGULATORY IMPLICATIONS

This Part discusses the economic and regulatory implications of the agency-cost theory in determining executive pay. Subpart A shows that controllers' absolute influence over managerial pay might distort managers' and controllers' incentives. Subpart B explains how the elimination of controllers' absolute influence over managerial pay can enhance managerial independence. Finally, Subpart C addresses the regulatory implications of the theory and suggests that it could help explain 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,[172] capital preservation,[173] massive distribution of dividends,[174] or the entry into new businesses about which the controllers know little but which are alluring personally.[175] 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,

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172. *See supra* note 107 and accompanying text.

173. Federico Munari, Raffaele Oriani & Maurizio Sobrero, *The Effects of Owner Identity and External Governance Systems on R&D Investments: A Study of Western European Firms*, 39 RES. POL'Y 1093, 1096 (2010) ("[F]amily owners are very sensitive to issues such as stability and capital preservation.").

174. Ami Ginsburg, *How IDB Group Learned To Get Behind in Business*, HAARETZ (Aug. 2, 2012, 7:36 AM), http://www.haaretz.com/business/how-idb-group-learned-to-get-behind-in-business-1.455393 (criticizing the controlling shareholder's aggressive dividend payout policies while the profits at the group's subsidiaries plunged).

175. Controlling shareholders' decisions to acquire a media or entertainment company may be motivated by their desire to increase their consumption of nonpecuniary private benefits rather than firm value. *See* Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641, 1667 (2006) (using as an example 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, 5:42 AM), http://www.haaretz.com/business/ngo-demands-probe-of-alleged-misconduct-at-maariv-under-nochi-dankner.premium-1.491348 (describing a minority holder in a newspaper who claims it was mismanaged in order to suit the needs of the controlling shareholder).

the theory presented in this Article suggests that such determination of executive 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 over the design of professional managers' pay packages. However, providing controllers with 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 controllers and minority shareholders. Providing minority shareholders or independent directors that are not affiliated with the controllers 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 companies need less incentive-based compensation just because controllers can effectively monitor them,[176] Sharon Hannes recommended that the use of equity-based compensation in CS companies be increased in order to better align the interests of professional managers with those of minority shareholders and to overcome managers' tendency to cater to controllers' preferences.[177] As he noted, "[E]xecutive 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."[178]

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 advisable to take Sharon Hannes' approach one step further and provide minority shareholders, or independent directors, with some additional power over the approval process of executive pay.

A comprehensive analysis of the suggested regulatory solution is presented in Part V. The goal of this Part, 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.

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176. Thomas & Van der Elst, *supra* note 142, at 65–66 (referring to studies supporting this view).

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

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

C. Regulatory Implications

The need to reexamine existing theories of 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, "[T]he historical U.S. monopoly on the controversy surrounding CEO compensation has also disappeared . . . ."[179] 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 "groundbreaking legislation."[180] Switzerland is not alone. Binding or advisory say-on-pay rules have already been introduced in other European countries, including Belgium,[181] France,[182] Germany,[183] the Netherlands,[184] and Sweden.[185] The European Commission is also considering a proposal to regulate executive pay across the Union members.[186] This rule is expected to trigger pressure for changes in other EU countries that are still considering the issue.[187]

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.[188] This Article contributes to the discourse on the relationship between

179. Fernandes et al., *supra* note 46, at 26.

180. Helena Bachmann, *On Executive Comp, the Swiss Aren't Neutral—Will the U.S. Be Persuaded?*, TIME (Mar. 7, 2013), http://business.time.com/2013/03/07/on-executive-comp-the-swiss-arent-neutral-will-the-u-s-be-persuaded/. The adopted proposals will go to the federal government, which will draw up appropriate legislation.

181. Thomas & Van der Elst, *supra* note 142, at 26–31. 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 nonbinding 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. *Id.* at 27–29.

182. In June 2013 the French Corporate Governance Code introduced a "say-on-pay" rule, giving companies the choice either to comply by providing an advisory vote on executive remuneration or to explain why they did not do so. *Id.* at 34–35.

183. Currently, Germany has a voluntary, although widely employed, shareholder vote on executive pay. *Id.* at 42–46. 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. *Id.* at 46.

184. The Netherlands already adopted a binding say-on-pay vote. *Id.* at 52–60.

185. Sweden already adopted a binding say-on-pay vote. *Id.* at 46–52.

186. *Id.* at 87.

187. *Id.* 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* 2009 O.J. (L 120) 28–31.

188. Thomas & Van der Elst, *supra* note 142 at 3–4. 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

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 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.

V. TOWARDS A NEW REGULATORY SOLUTION

This Part puts forward a proposal for a new regulatory approach to executive pay in CS companies. The suggested proposal is straightforward: conceptualize the pay of professional managers in CS companies as an indirect form of a related-party transaction and subject it to the rules regulating conflicted transactions, which usually stipulate special approval procedures. Subpart A explains why existing say-on-pay rules are less effective in mitigating the agency problem presented in this Article. Subpart B describes in greater details the recommended regulatory solution and addresses possible concerns. Subpart C presents more moderate applications of the regulatory solution, and Subpart D proposes 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.[189] 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.[190] This, in turn, makes a say-on-pay arrangement, which 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

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the movements at larger public companies toward increased dispersion of ownership in several European countries. *Id.* at 3.

189. *See supra* notes 133–34 and accompanying text (discussing the U.S. say-on-pay rule); *see also supra* notes 180–87 and accompanying text (discussing say-on-pay arrangements around the world, with most of those arrangements not requiring the approval by the majority of minority shareholders).

190. *See infra* note 192 and accompanying text.

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' concerns and does not take appropriate corrective actions, may face a potential withhold vote recommendation for some or all of the company's directors.[191] Such a disciplinary tool is significantly less powerful when it comes to CS companies. Since controlling shareholders exercise significant control over directors' election processes, receiving a withhold vote recommendation from a proxy advisory firm may have limited effect, if any, on the election of the directors nominated by controllers and, consequently, on controllers' 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.[192] The results of the say-on-pay votes presented in Part III support this view. Say-on-pay votes in only 4 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.[193]

B. Reconceptualizing Executive Pay as a Related-Party Transaction

The agency problem theory presented in this Article suggests that controllers cannot always be trusted to effectively monitor executive pay because they may be

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191. 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 136, at 38.

192. Evidence shows, however, that when controllers (or board members) are forced to be more attentive to shareholder concerns, executive pay decreases. The Australian Parliament was uncomfortable with a nonbinding vote that imposed no penalty on nonresponsive boards, and it decided to adopt a two-strike rule. The rule gives shareholders "an opportunity to 'spill the board' if the company remuneration report receives negative reception" for two consecutive years, and some evidence shows that its adoption led to a decrease in executive pay. Thomas & Van der Elst, *supra* note 142, 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, 3:03 AM), http://www.haaretz.com/business/.premium-1.528343.

193. *See generally* Kobi Kastiel, Against All Odds: Shareholder Activism in Controlled Companies (Apr. 6, 2015) (unpublished manuscript) (on file with Harvard Law School) (discussing and exemplifying controllers' lack of responsiveness to minority shareholders' demands in situations where minority shareholders have no legal bargaining mechanisms, such as the ability to nominate minority director or to veto controllers' decision).

biased and are likely to use their exclusive discretion over the determination of executive pay to maximize their consumption of private benefits. If the payment to professional managers departs from optimal contracting and there is a high likelihood that controllers will use executive 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 the 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 when they serve in managerial roles. 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.[194] This reconceptualization, of course, will have different regulatory implications, depending on the anti-self-dealing rules of the applicable jurisdiction.[195]

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 additional information, and hire proxy solicitors and legal advisors.[196] 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, have already adopted say-on-pay rules which require public companies to conduct an advisory vote on executive compensation proposals.[197] Therefore, a proposed rule, which requires a binding majority of minority 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.

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194. According to New York Stock Exchange 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 implementation of the proposed solution may require certain changes to such companies' board compositions. *See Section 3 Corporate Responsibility*, NYSE, http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F.

195. 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 fair dealing and reflects a "fair price." *See, e.g.*, Weinberger v. UOP, Inc., 426 A.2d 1333, (Del. Ch. 1981), *rev'd*, 457 A.2d 701 (Del. 1983). In other jurisdictions, certain self-dealing transactions may only be performed with the approval of a majority of disinterested shareholders. *See, e.g.*, Israeli Companies Law, 5759–1999 44 LSI 119 (1999) (Isr.).

196. Jill E. Fisch, *Leave It to Delaware: Why Congress Should Stay Out of Corporate Governance*, 37 DEL. J. CORP. L. 731, 754–58 (2013) (discussing the costs associated with providing shareholders a vote on executive pay).

197. *See supra* notes 179–87 and accompanying text.

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 executive 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 managers will become more difficult.[198]

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 still exercise significant influence over the formulation of executive pay. They will make 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 facto, enabling shareholders to express their opinions 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 United States, where institutional investors, which are more informed and sophisticated than most dispersed shareholders, often hold a large fraction of the companies' shares.[199] 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."[200] Additionally, it is often the case that U.S. institutional investors base their voting decisions on recommendations of prominent proxy advisory firms.[201] 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 shareholders that may create in reality an indirect conflict of

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198. 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 controlling shareholders can use their dominant position to consume private benefits in various forms, which are not covered by existing anti-self-dealing rules. *See supra* notes 83, 172–75 and accompanying text.

199. *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) (stating that in 2011 U.S. "institutional investors owned over 70% of the outstanding stock of the thousand largest U.S. public corporations").

200. Thomas & Van der Elst, *supra* note 142, at 3.

201. *See supra* notes 139–42 and accompanying text.

interests between the controllers and other public shareholders (such as the decision to expand into a different industry), the determination of executive pay has broad impacts and is not limited to a one-time event. As noted in Part IV.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 raises 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 a dual-class company, where a controller's ownership interest is below a certain threshold or when the number of years an executive is employed by a controller exceeds a 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 features high divergence between controller's ownership rights and voting rights, a majority vote of disinterested shareholders should be binding and not advisory.[202] 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 executive pay less frequently. For instance, the proposed rule could be applied when a compensatory arrangement with a professional manager 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 by shareholders unaffiliated with the controller. It is likely that this two-step process would further encourage companies to be more responsive to the concerns of their shareholders.[203]

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202. *See* Avi Licht, Ronnie Talmore & Haim Sachs, *Israel's Executive Compensation Reform*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 7, 2013, 9:09 AM), http://blogs.law.harvard.edu/corpgov/2013/01/07/israels-executive-compensation-reform/#3b (describing the Israeli say-on-pay model).

203. *Cf.* Robert C. Pozen, *The (Advisory) Ties That Bind Executive Pay*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Nov 4, 2013, 9:30 AM), http://blogs.law.harvard.edu

D. Enhanced Disclosure

Finally, it is also advisable to amend existing disclosure rules to require controllers to disclose in clearer and more uniform ways additional information regarding the scope of their relationships with professional managers, such as the exact number of years that the professional managers have worked for the controllers and prior business or personal acquaintance 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, 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.[204] 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 nonvoting shares, and the proxy statement does not clearly indicate the *combined ownership interests* of its controller in *all* of the company shares.[205] 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 the dual-class structure and the overall effectiveness of controllers' monitoring power.

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.[206] 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 pay in CS companies. At the end of the day, these different theoretical explanations have one thing in common: they all

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/corpgov/2013/11/04/the-advisory-ties-that-bind-executive-pay/ (suggesting to hold a binding vote only after a nonbinding vote fails).

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

205. *See supra* note 120. Assuming the two classes of shares have the same par value, the combined *ownership* interest reflects the controller's number of shares as a percentage of the total number of shares of the company, including both the voting and nonvoting shares. This information is not explicitly mentioned in the proxy statement and therefore has to be manually calculated.

206. Bebchuk & Fried, *supra* note 12.

subscribe to the view that minority shareholders cannot always trust controllers to effectively monitor the compensation of professional managers. This 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.