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Tuesday, November 13, 2007

Let boards, not taxes, decide exec pay

'Excessive' ceo compensation should be a corporate governance issue, not a tax issue

By Cary Ichter, Special To The Daily Report

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Bad news: Mike Trotter is at it again. After six months of considering our last exchange on the subject of "excessive executive compensation," Mr. Trotter has offered his reprise in the Oct. 18 Daily Report ["Higher marginal rates revisited"]. To provide context for those who did not witness February's point-counterpoint, Mr. Trotter opined many months ago that too many top executives are being compensated excessively.

As liberals do with most problems, real or imagined, Mr. Trotter suggested that government should intervene to rid us of the scourge of "excessive compensation" by raising the marginal tax rates on compensation over a certain unidentified amount to remove any incentive to pay above that amount.

I responded to Mr. Trotter's tome, suggesting, among other things, that defining terms might be in order. I proposed that any thoughtful proposal to raise taxes to end "excessive compensation" might start with a definition of the term "excessive compensation." In his second essay on the subject, Mr. Trotter has again successfully avoided offering any such definition. Apparently, such knotty details need not interfere with accomplishing the important goal of punitively taxing those we regard as undeserving. I do not propose to offer a definition of the term because an abstract definition is impossible. Whether compensation is excessive can only be determined when taking into account the performance, sacrifice and value the compensation is intended to reward. In short, one size does not fit all.

Rather than offer a definition of "excessive compensation," Mr. Trotter attempts to explain why it occurs, observing that executive compensation has risen in tandem with the emergence of compensation consultancy firms. This assertion ignores the facts cited in my response ["Market, not taxes, should dictate pay," Feb. 19] that "chief executive officer pay from the top 100 in Forbes ... fell 54 percent from 2000 to 2003," that "among the S&P 500 firms, average CEO pay fell 48 percent from 2000 to 2003," or that recent executive compensation increases have been a reaction to the relative decline in executive compensation over the decade between 1993 and 2003. One might surmise that compensation consultancy firms emerged in the market because executives were not doing a very good job of negotiating for themselves.

Indeed, as best I can tell, Mr. Trotter did not answer a single argument I made or accept a single request I made for explanation or elucidation of his position, other than to agree with the notion that sports figures, rock stars and artists of other types should, perhaps, not be subject to these suffocating tax rates. Apparently, oppressive tax rates should only apply to those working for corporate America.

This distinction between workers in corporate America and all other financially successful workers appears to be based upon Mr. Trotter's belief that CEOs and other executives within public companies, as a group, are overpaid and are soaking their shareholders for enormous and unjustified compensation packages. Whether this premise is right or wrong, the solution proposed by Mr. Trotter is completely wrong-headed and, on balance, destructive.

First, given that we have no idea what "excessive compensation" is, I submit that it is rather difficult to identify the members of the group who receive it. We do know this much, however: Public companies are a small percentage of all businesses in the United States, and the top wage earners within those companies are an even smaller percentage of the total number of tax paying workers. Hence, it is fair to assume that the vast majority of taxpayers who earn "excessive compensation"—even excluding sports figures, artists and the like—work for private companies and firms or for themselves. They are successful entrepreneurs, inventors, investors or even contingent-fee lawyers. Although in many cases these people invest many years of toil to generate a large return on their investment of time and effort, under the Trotter regime, their returns, at some undefined level, would be taxed into oblivion for the specific purpose of removing any incentive to earn such glutinous amounts.

For this audience, the example of the contingent-fee lawyer who works on the mega-case for many years presents the most typical real-world and oft-occurring example. Additionally, we all have probably known, or at least run across, the private business person who has invested years of hard work to enjoy some measure of financial success—what Mr. Trotter would call "excessive compensation." Increasing marginal tax rates to siphon off these small business people's return on investment would, no doubt, kill much of the incentives that drive the most efficient running engine that drives our economy. But, perhaps, this is a small price to pay to ensure that public CEOs aren't overpaid.

Alternatively, if we were to abandon our liberal instincts for a moment—those that demand enlarging government and feeding the beast with ever-higher taxes—and examine solutions that address causes (not results) and that are proportionate to the problem, other ideas might come to mind. For example, in my last column on this subject, I proposed that CEO compensation is a corporate governance issue, not a tax issue. Mr. Trotter further confirmed this notion in his latest column, insisting that board and management are too cozy for arm's length bargaining over executive compensation to occur.

Instead of a change in the tax code that reaches vastly beyond the scope of the problem identified, perhaps it would be better to promulgate rules that restrict the ability of public company executives to gouge their employers and, derivatively, their shareholders. It would make sense to limit CEO salaries to a percentage of revenues or earnings or to provide that CEO salaries can only rise in lock step with some kind of performance indicator in the absence of a shareholder vote permitting more. Such an approach would not only ensure that the solution is proportionate to the problem, it would also incentivize CEOs and other executives to deliver quality performance for their shareholders as their compensation would be more closely tied to corporate performance.

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So, here is a novel idea: Why not build a solution that adjusts to the contours of the problem? Perhaps the nature of the problem should define the nature of the solution; perhaps burning down the house to toast the marshmallows is a bad idea. Perhaps such proportional approaches could help government in being the solution rather than the problem.

CARY ICHTER is a partner in Thompson Hine's business litigation practice group. A trial lawyer with a wide-ranging commercial practice, he has tried more than 60 cases to verdict or award. His clients include national franchise companies, international software developers and licensors, international manufacturers of industrial products and professional service providers typically in disputes. He can be reached at cary.ichter@thompsonhine.com.

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