When You Set Your Own Pay – A Study on Board Compensation

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Can legal frameworks address directors' self-dealing?

When Starbucks wooed the star CEO Brian Niccol from Chipotle for a **reported** US$113 million pay package (and the use of a private jet), the story predictably grabbed headlines. Recent years have seen plenty of attention over firms awarding their CEOs enormous payouts, especially when typical workers' salaries have struggled to keep pace with inflation.

However, despite public outrage over excessive executive salaries and economic inequality, there has been far less focus on the compensation awarded to board directors. This is surprising when you consider that board members are the ultimate stewards of companies. Not only do they appoint the CEO – they also approve the CEO's pay package. Moreover, in the United States at least, the board of directors has the authority to set their own pay, unless explicitly specified otherwise in the company's articles of incorporation.

Conflict of interest

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There is clearly a conflict of interest at play here, one that creates an opportunity for self-dealing – a situation where directors could award themselves generous pay packages at the expense of shareholders.

Our **new research**, which looks at directors' compensation over a 20-year period, certainly suggests that this might be taking place. We found that between 2000 and 2020, director's total compensation packages at US-listed firms rocketed from an average of US$189,000 to US$456,000.

To put it in perspective, this nearly 150-percent surge was more than double the 60-percent pay increase CEOs enjoyed during the same period. Our study also revealed a significant move away from cash towards equity-based compensation, including both stock grants and stock options.

Unlike director pay packages in the last century, over 70 percent of total director compensation today comes in the form of stock. This rise in stock-based compensation is driven in part by the theory that it aligns director incentives with shareholder interest. For example, Alphabet, the parent company of Google, requires its directors to **own at least US$1 million worth** of the company's shares. This, when tied with the bull market of the last two decades, has led to huge gains for investors in stock, including directors.

The problem is exacerbated by the unique structure of US corporate boards – the focus of our study – which typically combine both executive and non-executive directors into a single board. This differs from the two-tier board structure common in many European countries, where a supervisory board oversees the executive board. The US system lacks this built-in check on self-dealing, making it easier for directors to set their own compensation.

Self-dealing: Legal frameworks and interventions

This led us to ask a central governance question: Are the high levels of director pay potentially a result of self-dealing? Getting conclusive evidence of such economic outcomes is always a challenge. In medicine and natural sciences, randomised control trials are the gold standard, but such

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experiments are simply not possible in real life.

Our solution was to identify a “shock” to the system that impacted some firms but not others in a somewhat random fashion. The idea was to see if this resulted in different levels of director compensation between the “treated” companies that experienced the shock and the “control” companies that were unaffected.

We found such a shock in a landmark legal case in Delaware. As the second smallest state in the US, Delaware’s business-friendly legal environment means it punches way above its weight when it comes to corporate affairs. In 2023, it was the place of incorporation for **over 65 percent** of Fortune 500 companies. As a result, Delaware's Court of Chancery has long been influential in shaping US corporate law. Its rulings on director compensation therefore have significant implications for companies across the country.

Historically, decisions related to director compensation have been protected by the "**business judgment rule**". This gives boards wide latitude in making business decisions without fear of frivolous shareholder litigation. Under this standard, directors need only show that their decisions were made in good faith; if challenged, the burden of proof lies firmly with the plaintiff.

However, the court’s stance shifted dramatically with the surprise ruling in the Seinfeld v. Slager case in 2012. In this instance, the shareholder-approved director compensation plan (of Republic Services, Inc.) should have been protected by the “business judgement rule”. However, the presiding judge defied legal tradition and ruled that even though shareholders have approved the plan, the board of directors “will ultimately have to show that the transaction is entirely fair”. This subjected the board to a much more stringent “entire fairness” legal standard. Under “entire fairness”, when challenged, the burden of proof is placed on the defendant – the board – to show it has acted fairly.

This unexpected result led to a realisation by corporate boards that their director compensation packages would undergo greater scrutiny and be held to higher legal standards by the Delaware courts. Consistent with self-

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dealing, the impact of this was that packages for Delaware-incorporated firms fell after the 2012 Slager ruling when compared to firms not incorporated in Delaware. In other words, boards started paying themselves less to avoid being penalised by the Delaware courts.

Stock prices of Delaware-incorporated firms also grew relative to non-Delaware-incorporated firms, indicating that investors applauded the tougher legal stance and improved corporate governance.

Subsequent cases have reinforced that ruling and emphasised the need for stronger justification for director compensation plans. This shift mirrors the "**say-on-pay**" votes that are now required for executive compensation.

Increasing responsibilities

Clearly, there are other reasons for the increase in director compensation, aside from self-dealing. The workload, accountability and potential legal risks that come with serving on a board have all increased dramatically since the turn of the century.

A string of corporate fraud cases, such as **Enron** and **WorldCom**, led to the **Sarbanes–Oxley Act** in the US in 2002, which resulted in greater levels of responsibility on directors to ensure good governance. Although our results do not provide direct evidence for this theory, the increase in director pay we observed did indeed coincide with the post-Sarbanes–Oxley era.

An additional suggestion given for rising director pay is simply the “keeping up with the Joneses” effect. Directors’ salaries are benchmarked against the competition. So, if one firm starts paying its directors more, there’s undoubtedly a knock-on effect. This is especially true among leading firms that want to remain competitive and attract top talent.

Balancing incentives and oversight

As the debate over director compensation continues, policymakers, shareholders and boards must grapple with striking the right balance

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between attracting talented directors, aligning their interests with those of shareholders and preventing self-dealing.

Our research suggests that legal frameworks and the standard of proof can be effective and powerful tools to shape corporate governance policies and practices. Other potential solutions may include the creation of independent committees, perhaps featuring external advisors to set director compensation. An alternative could be to give shareholders greater power to nominate directors and to vote on compensation matters.

Caps could also be placed on equity compensation, limiting the proportion of director pay that can come in the form of equity to reduce short-term thinking. At the same time, extending the time frame for the release of equity awards could encourage a focus on long-term performance.

On a legal level, the US Securities and Exchange Commission has also implemented rules requiring more detailed disclosure of director compensation, including the philosophy behind compensation decisions and the metrics used to determine pay levels.

As corporate governance practices continue to evolve, addressing the issue of director self-dealing will be crucial to maintaining the integrity of US capital markets and ensuring that boards truly serve the interests of shareholders and other stakeholders. By implementing robust legal and regulatory frameworks, along with enhanced transparency and shareholder engagement, it may be possible to curb excessive director compensation, while still attracting the talent needed for effective corporate oversight.

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About the research

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About the series

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