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Judge Posner Wrote What?

A leading free-market conservative concludes that CEO compensation practices are flawed.

By Eliot Spitzer

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Richard Posner, esteemed federal judge of the 7th Circuit, is one of the most respected and prolific conservative intellectuals. As a founder of the "Chicago School," he is both a creator and defender of the free-market theory that has guided deregulation for the past 30 years.

So when I read an opinion authored by Judge Posner saying that the market is arguably incapable of either setting CEO compensation or determining mutual-fund fees, my first reaction was to put the document down, rub my eyes, and check the authorship again. Then I read on, with increasing incredulity—and pleasure.

In an opinion dissenting from the "denial of rehearing *en banc*"—a sequence of words only a lawyer could love—Posner wrote that there are growing indications that CEO compensation "is excessive because of the feeble incentives of board of directors to police compensation. … Directors are often CEOs of other companies and naturally think that CEOs should be well paid. And often they are picked by the CEO." He then examined the conflicts inherent in the process of CEO compensation determination, concluding that "*[c]ompetition ... can't be counted on to solve the problem* because the same structure of incentives operates on all large corporations and similar entities, including mutual funds" [emphasis added].

Elsewhere in the opinion, Posner questioned the ability of the market to set mutual fund fees, saying that fees set through some comparability studies are bound to be too high: "The governance structure that enables mutual-fund advisers to charge exorbitant fees is industry-wide, so the panel's comparability approach would if widely followed allow those fees to be the industry floor. And in this case there was an alternative comparison, rejected by the panel on the basis of airy speculation—comparison of the fees that [the company] charges independent funds with the much higher fees that it charges the funds it controls."

The issues of CEO compensation and mutual-fund fees, though superficially different, are elements of the same problem: How much should management be paid for its services by shareholders?

Posner concluded that while judges shouldn't directly review corporate salaries, evidence of unreasonable compensation *could* be evidence of a breach of fiduciary duty. Yes, these are legal words, but they reveal a remarkable conclusion—courts should take a hard look at private-compensation issues—and demonstrate how far, and rapidly, the world has shifted. The two issues Judge Posner examined—setting CEO compensation at major companies and determining the fees

to be paid to mutual fund-management companies on the base of trillions of dollars of mutual-fund investments—are central to the governance of our financial system. It is remarkable that a leader in Chicago School thought would acknowledge that the market is so broken that it can't be properly trusted on those two critical issues. Yet that is exactly what Judge Posner has concluded.

CEO compensation cuts to the ability of our corporate governance system to function. In a genuine marketplace, nothing should be easier than a board, assisted by compensation consultants, a bevy of lawyers, and, of course, shareholders, setting the salary of one person. Yet this simple task is now deemed by one of the most articulate defenders of the free market to be beyond the competence of the market.

Even after the market cataclysm of the past year, mutual funds control trillions of dollars and generate extraordinary revenues just by pocketing 1 percent or 2 percent of their holdings. Setting fund fees not only has an enormous impact on the compounded return to investors but, as Judge Posner concluded, reflects whether the management companies are honoring their fiduciary duty to investors.

So where does Judge Posner's reasoning take us? Two remedies jump to mind. The first, although morally satisfying, is retrospective and clumsy: Shareholders can go to court—suing the enriched executives and board members who participated in the process—to reclaim compensation or fees that were so excessive as to violate fiduciary duty. Indeed, when I was attorney general of New York, we successfully reclaimed billions of dollars of mutual-fund fees for the shareholders of many mutual-fund companies on just this theory—yet were criticized by the intellectual allies of Judge Posner for doing so.

Among those who could and should go into court to recoup these funds are now the various government entities that are shareholders of companies with excessive compensation. These entities are in some cases recent investors as part of the bailouts or longtime investors through government pension funds. Government shareholders have rarely exercised their rights to be heard on critical management issues. Comptrollers and others around the nation who are stewards of the pension system have been hesitant to pursue these remedies—in large measure, I suspect, because courts have traditionally been so deferential to the "business judgment" of management. Judge Posner's frank admission of market and management failure may cause courts to rethink the wide berth given to laissez-faire capitalism.

The second and better remedy is not to rely on a few individual court cases that might succeed or fail—or for random regulations to be issued by government entities setting compensation standards. It is, rather, for boards, compensation consultants, and shareholders finally to awaken to their duties. If there is to be a revival in our corporate-management structure, it must begin with these stakeholders. They must insist on far greater transparency and far stricter evaluations of CEOs, eliminating the year-end congratulatory assessments that seem untethered to any economic reality.

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