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Articles

TAKING STOCK—SALARY AND OPTIONS TOO: THE LOOTING OF CORPORATE AMERICA

Kenneth R. Davis*

I. Introduction

Executive compensation has come to mean corporate greed. Too many managers appointed to protect the interests of shareholders are looting their companies. CEO pay has soared to incomprehensible levels.¹ Even in 2008, a year of shriveling corporate profits and

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* Professor and Area Chair of Law and Ethics, Fordham University Graduate School of Business; J.D., University of Toledo, School of Law, 1977; M.A., University of California, Long Beach, 1971; B.A., State University of New York at Binghamton, 1969. Without the research support of my wife, Jean, who worked tirelessly on many a sunny weekend, I would probably still be stuck on the first paragraph of the introduction. Jean is the Nastia Liukin of law librarians, a skillful and agile researcher who turns somersaults around all the others

1. See Matt Ericson & Alan McLean, The Pay at the Top, N.Y. Times, Apr. 5, 2009, at BU9 (reporting data compiled by Equilar, a research firm that tracks executive and director compensation, comparing 2007 and 2008 executive compensation figures for CEOs of prominent U.S. companies); Kathryn Jones, Who Moved My Bonus?, N.Y. Times, Apr. 5, 2009, at BU1 (reporting that, until 2008, executive compensation had risen almost every year since the burst of the tech bubble in 2001–2002); Matteo Tonello, The Role of the Board in Turbulent Times . . . Overseeing Risk Management and Executive Compensation: "Pressure Points" for Corporate Directors 5 (The Conference Bd., Executive Action Series No. 292, 2008), available at http://ssrn.com/abstract=1325028 (noting that "recent studies document that in the last two decades executive compensation has grown substantially faster than corporate earnings" and citing an analysis of the Wall Street Journal and ERI Economic Research Institute showing that in 2007, the median salary of the top executive of a Standard and Poor's 500 company rose 20.5%); cf. Nuno Fernandes et al., The Pay Divide: (Why) Are U.S. Top Executives Paid More? 24–25 (Eur. Corp. Governance Inst., Finance Working Paper No. 255/2009, 2009), available at http://ssrn.com/abstract=1341639 (summarizing evi-

plummeting stock prices, more CEOs saw pay increases than cuts.² Despite the ravages of the financial crisis, average CEO pay in 2008 declined only modestly.³ The recession did not stop struggling companies from handing bloated pay packages to top executives. One of the highest paid CEOs in the United States was Sanjay Jha.⁴ Mr. Jha, who runs Motorola, made \$104.4 million in 2008.⁵ A 71% decline in

dence that U.S. executives receive more pay than their European and Asian counterparts, even after controlling for a wide spectrum of firm, industry, governance, and CEO characteristics).

- 2. Kim Dixon, More "US" CEOs Got Pay Hikes than Cuts in '08, Reuters, Apr. 14, 2009, http://www.reuters.com/article/idUSTRE53D43N20090414 (reporting a study conducted by the AFL-CIO of 946 companies in the Russell 3000 index showing that 480 CEOs—more than half—received raises in 2008); see also Stephen Bernard, Citi Boosting Salaries to Offset Lower Bonuses, Wash. Times, June 24, 2009, available at http://www.washingtontimes.com/news/2009/jun/24/citi-boosting-salaries-offset-lower-bonuses (reporting that Citigroup, Inc., has raised the salaries of many of its employees to offset bonus reductions and to ensure that their compensation will not decline in 2009). But see Joann S. Lublin, CEO Pay Sinks Along with Profits, Wall St. J., Apr. 3, 2009, at A1 (noting that the median CEO compensation for 200 companies with over \$5 billion in annual revenue fell 3.4% in 2008, which was only the second annual decrease in executive pay since 1989).
- 3. See Allen Jackson & Ben Stradley, Towers Perrin, 2009 Proxy Statements High-LIGHT THE NEW REALITIES IN EXECUTIVE COMPENSATION 1-2 (2009), http://www.towersperrin.com/tp/getwebcachedoc?webc=USA/2009/200904/April_7_New_Realities_in_EC. pdf (describing a report by Towers Perrin showing that in 2008, despite the financial meltdown, the total direct compensation to CEOs of almost 200 of the Fortune 500 companies decreased only 2%). Data compiled by Equilar shows that for companies that filed their proxy statements by March 27 and had minimum revenues of \$6.3 billion, average executive pay fell 5.1% in 2008, which was not as steep of a decline as the fall in shareholder values. Jones, supra note 1. Even while the recession battered corporate profits and shareholder return, the average total compensation among CEOs at these companies in 2008 was \$10.9 million. AFL-CIO, 2008 Trends in CEO Pay, http://www.aflcio.org/ corporatewatch/paywatch/pay/index.cfm (last visited Mar. 31, 2010). Executives of some of the most financially troubled investment houses were impervious to the fury of the financial crisis. Merrill Lynch paid eleven of its top executives more than \$10 million in 2008, and it paid at least \$3 million to an additional 149 employees. Susanne Craig, Merrill's \$10 Million Men: Top 10 Earners Made \$209 Million in 2008 as Firm Foundered, Wall St. J., Mar. 4, 2009, at A1. The median compensation of directors at 300 of the Fortune 500 companies tilted upward during the financial crisis, increasing 4.7% from 2007 to 2008. Press Release, Equilar, Non-Employee Director Pay Climbs 4.7% to \$182K (May 5, 2009), available at http://equilar.com/press_20090505_1.php. Corporate counsel for major companies are also bathing in cash. For example, Jon Walton, counsel for Allegheny Technologies, Inc., reaped a total compensation package of \$8,133,733 in 2007. Law.com, Corporate Counsel's 2008 GC Compensation Survey, http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202423065928 (last visited Mar. 31, 2010). Gary Lynch, counsel for beleaguered Morgan Stanley, received a stunning discretionary bonus of more than \$6.3 million. Id. Mark Bobak of Anheuser-Busch Companies, Inc., raked in an option award of \$5,291,139. Id.
- 4. Ericson & McLean, *supra* note 1 (noting that Mr. Jha was the highest paid CEO out of 200 chief executives at 198 public companies that filed their annual proxies by March 27 and had revenue of at least \$6.3 billion in 2008).

^{5.} Id.

shareholder value did not deter the company from providing its CEO with this enormous sum.⁶ Walt Disney paid its CEO, Robert Iger, \$51.1 million in 2008, which is nearly double the \$27.7 million it paid him in 2007.⁷ This generous pay hike seemed particularly striking in a year when Disney's profits sank 5%.⁸ Kenneth Chenault, who heads American Express ("AMEX"), took a pay cut from \$50.1 million in 2007 to a mere \$42.8 million in 2008.⁹ This 14.6% reduction did not come close to matching the 29% plunge in AMEX's profits.¹⁰

Public resentment over multimillion dollar paychecks swelled to outrage when American International Group ("AIG") threw satchels of taxpayer bailout funds at its managers.¹¹ The rhetoric became inflammatory. An enraged Charles Grassley, the ranking Republican of the Senate Finance Committee, declared that AIG employees who took taxpayer money should "'follow the Japanese model and come before the American people and take that deep bow and say I'm sorry, and then either do one of two things—resign, or go commit suicide.'"¹² President Obama, who was more circumspect, called the bo-

Many Americans believe that any bonuses for top executives paid by rescued banks would constitute "excessive compensation," a phrase used by Mr. Obama. But no Wall Street CEO taking federal money received a bonus in 2008, and the same was true for most of their senior colleagues. Not only did those responsible receive no bonuses, the value of the stock in their companies paid to them as part of prior-year bonuses dropped by 70% or more, leaving them, collectively, with billions of dollars of unrealized losses.

^{6.} *Id.* Shareholder value, reported as "Total Return," assumes the reinvestment of dividends. Matt Ericson & Alan McLean, *How the Pay Figures Were Calculated*, N.Y. Times, Apr. 5, 2009, at BU9.

^{7.} Ericson & McLean, supra note 1.

^{8.} Id.

^{9.} Id.

^{10.} Id.

^{11.} See Greg Hitt & Aaron Lucchetti, House Passes Bonus Tax Bill: 90% Hit Would Affect Major Banks; Senate Mulls Similar Action Amid AIG Furor, Wall St. J., Mar. 20, 2009, at A1 (reporting the "popular outrage" over the AIG payouts); Dr. John E. Murray, Jr., The Applicability of Contract Law Theory to the AIG Executive Bonus Scandal, 2009 Emerging Issues 3485 (LexisNexis) ("The initial outrage over the millions in taxpayer dollars paid in bonuses to certain employees of American International Group (AIG) induced an almost frantic search to discover ways in which this putative injustice could be cured."). But see Roy C. Smith, Greed Is Good, Wall St. J., Feb. 7, 2009, at W1. Mr. Smith mounts a defense of Wall Street's use of bailout funds by arguing as follows:

Id.; see also Valerie Bauerlein & Paulo Prada, Curbs on Executive Pay: Among Bankers, Howls—and Cheers, Wall St. J., Feb. 5, 2009, at A10 (quoting Brady Adams, president of Evergreen Federal Bank, who protested in response to proposed federal "claw back" provisions for bonuses paid with Troubled Asset Relief Program funds that exceed \$100,000, saying that "[t]here ought to be consequences, but don't use a shotgun, use a rifle").

^{12.} Kenneth P. Thompson & Andrew S. Goodstadt, *In Defense of AIG Employees*, N.Y. L.J., Apr. 10, 2009, at 6. *But see id.* (contending that the payments were not bonuses but rather were previously negotiated retention agreements with "hard working, honest and dedi-

nuses an "'outrage'" and instructed the Treasury Department to use "'every legal avenue'" to recover the funds.¹³

When Representative Dennis Kucinich of Ohio learned that financially crippled Merrill Lynch planned to dispense \$3.62 billion of Troubled Asset Relief Program ("TARP") funds as executive bonuses, he asked the Securities and Exchange Commission ("SEC") to investigate. It was no wonder that he sarcastically described these bonuses as "little more than a farewell gift from senior management to themselves." More than twenty-two times larger than the AIG bonuses, Merrill Lynch's payouts represented 36.2% of its TARP allocation. If

Even companies that fired CEOs for having failed on the job bestowed unimaginable sums on them. After sustaining the largest loss in corporate history, Merrill Lynch fired Stanley O'Neal.¹⁷ A severance package of \$160 million must have salved his bruised ego.¹⁸ The same could be said of Robert Nardelli, the former CEO of Home Depot. Fired because of the company's dismal stock performance, Mr. Nardelli received severance pay estimated at \$210 million.¹⁹

These abuses have not merely enraged the public. They also shoved a hyperventilating economy toward financial panic. With the economy booming, companies became transfixed on short-term goals—surging profits, revenues, and stock prices.²⁰ Since executive compensation rose in tandem with profit margins, CEOs gambled on

cated professionals"). See generally Louise Story, Cuomo Says Merrill Deceived Congress on Bonuses, N.Y. Times, Mar. 12, 2009, at B2 (noting that New York Attorney General Andrew Cuomo is investigating the payment of these bonuses by Bank of America, which acquired Merrill Lynch).

^{13.} Editorial, *Bonuses for Bozos*, N.Y. Post, Mar. 17, 2009; *see also* Deborah Solomon & Laura Meckler, *Strict Executive-Pay Caps Planned—Latest Salvo from Obama Administration Aims to Rein in Firms Receiving Federal Aid*, Wall St. J., Feb. 4, 2009, at A3 (reporting that President Obama "called it 'shameful' that Wall Street firms awarded \$20 billion worth of bonuses as taxpayers were bailing them out").

^{14.} Yin Wilczek, Lawmakers Ask Regulators for Details on Merrill Bonuses, Use of TARP Funds, 41 Sec. Reg. & L. Rep. (BNA) 654 (Apr. 13, 2009).

^{15.} Id. (internal quotation marks omitted).

^{16.} Id.

^{17.} Gretchen Morgenson, How the Thundering Herd Faltered and Fell, N.Y. Times, Nov. 9, 2008, at BU1.

^{18.} See H.R. Rep. No. 111-236, at 7 (2009) (noting O'Neal's substantial exit package).

^{20.} See Christopher Keller & Michael Stocker, Eyeing Executive Compensation: Pay Structures Often Spur Chiefs To Focus on Short-Term Results Rather Than Long-Term Value, NAT'L L.J., Nov. 17, 2008 ("Years before the current [financial] crisis erupted, analysts suggested that the new generation of executives of publicly held companies were gambling long-term economic stability in order to achieve short-term financial goals."); Kara Scannell, Policy Makers Work to Give Shareholders More Boardroom Clout, Wall St. J., Mar. 26, 2009, at B4 (noting the argument that the incentives in executive compensation packages led to excessive risk-taking that caused the credit crunch).

high-risk strategies.²¹ CEOs of the major investment firms were particularly guilty of over-leveraging their portfolios until their debt to equity ratios were at unsustainable levels.²² Even worse, brokerage firms, hedge funds, and other investment companies, enticed by potential windfalls, speculated by selling credit default swaps.²³ They "insured" corporate bonds and collateralized debt obligations against default, although the companies acquiring the "insurance" did not own the underlying securities.²⁴ Massive debt led to financial collapse.

The objections to excessive executive compensation, both emotional and economic, are powerful. The solution to the problem, however, is not at all clear. Five broad strategies have emerged and all have failed. Moved by the public clamor to reduce executive pay, legislators and regulators have repackaged these worn out strategies in numerous proposals, but their efforts are unlikely to succeed. Before presenting a comprehensive proposal for reform, this Article will discuss and criticize the five strategies.

Part II of this Article will discuss the fiduciary approach, which relies on the directors to constrain the avarice of corporate executives. Referring to the seminal work of Lucian Bebchuk and Jesse Fried,²⁵ this Article will argue that directors, because of the influence of managerial power and because of their lack of commitment to shareholder and corporate interests, are unlikely to oppose the selfishness of CEOs.

Given the failure of directors to protect corporations and share-holders, Part III of this Article will explore the disclosure approach. Adopting the philosophy of federal statutory securities law, the SEC has imposed layer upon layer of compensation-related disclosure re-

^{21.} See Keller & Stocker, supra note 20 (quoting Bear Stearns's 2007 proxy statement, which explained that "[t]he Company's performance as measured by profit margins remained strong and earnings per share increased over the prior year" and "[t]he compensation paid to the Company's executive officers for fiscal 2006 reflects the strength of this performance" (first alteration in original) (internal quotation marks omitted)).

^{22.} See John C. Coffee, Jr., Analyzing the Credit Crisis: Was the SEC Missing in Action?, N.Y. L.J., Dec. 5, 2008 (arguing that the SEC facilitated over-leveraging, a primary cause of the credit crisis, by instituting the Consolidated Supervisory Entity program, which effectively removed the strictures of net capital requirements from the five major investment houses, Goldman Sachs, Merrill Lynch, Bear Stearns, Lehman Brothers, and Morgan Stanley, thereby permitting these companies to incur debilitating debt to equity ratios).

^{23.} See generally David W. Porteous & James G. Martignon, Credit Default Swaps: Regulatory Storm Clouds Brewing, 40 Sec. Reg. & L. Rep. (BNA) 2070 (Dec. 15, 2008) (defining credit default swaps and discussing their speculative risks).

^{24.} Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME, Mar. 17, 2008, http://www.time.com/time/business/article/0,8599,1723152,00.html.

^{25.} See infra Part II.A-C (discussing the thesis of Bebchuk and Fried and criticisms of their argument).

quirements on reporting companies. To comply with the most recent regulatory requirement—the Compensation Discussion and Analysis—companies need compensation consultants and lawyers with specialized expertise to help compile a report that few investors read and even fewer understand.

Even if disclosures succeeded in leading shareholders to discover corporate waste and director dereliction, shareholders would need a forum to seek a remedy. The courts, however, have been unreceptive to cases challenging excessive executive compensation. Part IV of this Article will concentrate primarily on the business judgment rule, which dooms many of these cases. In this discussion, Part IV will highlight a notorious case, *People v. Grasso.*²⁶ The verdict is clear: Litigation does not work for shareholders.

Since few of the participants in corporate governance are inclined or able to contain executive compensation, tax policy provides an alternative approach. Part V will discuss incentives in the federal tax code to cap executive pay and link it to performance. The most important tax provision, Section 162(m), provides a \$1 million cap on the deductibility of non-performance-based executive pay.²⁷ Rather than inducing companies to link pay to performance and cut the pay of low achievers, this approach has ironically resulted in higher executive pay and excessive risk-taking.

In response to these executive-pay abuses, legislators and regulators have proposed a spate of corporate governance solutions. Part VI will divide these solutions into four categories: (1) non-binding say-on-pay shareholder proxy votes; (2) shareholder rights to nominate directors; (3) Senator Schumer's comprehensive proposal, which incorporates say-on-pay, shareholder nomination rights, and numerous other governance provisions; and (4) direct government control of executive pay. In the course of the discussion of direct government control, Part VI will examine (1) the bill proposed by Senator Durbin, (2) a separate bill sponsored by Representative Frank and passed by the House, and (3) the provisions in place for recipients of TARP funds. This Part will criticize all these solutions as either undesirable or ineffective.

To curb executive compensation, a fair and workable framework must provide shareholders with a determinative voice. In Part VII, this Article will propose that Congress and the SEC establish a statu-

^{26. 893} N.E.2d 105 (N.Y. 2008); see infra Part IV.C (discussing and criticizing the judicial decisions disposing of the *Grasso* case).

^{27.} See infra Part V.A (discussing and criticizing § 162(m)).

tory and regulatory framework to permit the amendment of corporate bylaws to create "Shareholder Compensation Committees." Part VII will discuss how such committees might be elected, what powers and obligations committee members might have, and what safeguards might be instituted to ensure the effective functioning of such committees. Part VII will then present and attempt to refute potential arguments against the adoption of this proposal.

The Article will conclude with Part VIII by asking Congress to enact legislation that would provide for the establishment and effective operation of Shareholder Compensation Committees.

II. APPROACH ONE: FIDUCIARY DUTIES

Shareholders entrust officers and directors with running corporations. Like anyone, corporate managers are inclined to promote their self-interests. This temptation is particularly acute in the corporate world where shareholders, as passive investors with tiny fractional equity interests, cannot affect the decisions of management. To ensure the fidelity of corporate officers and directors, the law has imposed fiduciary duties on them. Discussing these obligations, the Supreme Court of Delaware has observed:

While technically not trustees, [officers and directors] stand in a fiduciary relation to the corporation and its stockhold-

28. See, e.g., Del. Code Ann. tit. 8, § 141(a) (2007). The statute provides the following: The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

Id.

- 29. See Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 47, 63 (8th ed. 1940) (discussing the divergence between the needs of the corporation and the desires of the shareholders); David I. Walker, The Manager's Share, 47 Wm. & Mary L. Rev. 587, 616 (2005) (explaining that there is a "wedge between the manager's private incentives and the incentives of the shareholders generally").
- 30. See Walker, supra note 29, at 616 (noting that "outside shareholders cannot perfectly, or costlessly, observe the manager's effort or focus"); see also BERLE & MEANS, supra note 29, at 47 (discussing the infinitesimal equity interests that shareholders have in large publicly traded corporations).
- 31. See, e.g., McMullin v. Beran, 765 A.2d 910, 921–23 (Del. 2000) (reinstating share-holders' claims against directors for breach of fiduciary duties of care, loyalty, and good faith in recommending sale of chemical corporation); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 351 (Del. 1994) (remanding a case to the trial court where shareholders argued that the directors breached their duty of care and loyalty in approving a cash-out merger), modified on reargument, 636 A.2d 956 (Del. 1994).

ers. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty 32

The fiduciary duties of directors include the responsibility to set executive compensation at levels that optimally serve corporate interests rather than the greed of executives. The "optimal contracting" model posits that directors, as corporate fiduciaries, seek to negotiate executive compensation contracts that optimize shareholder value. An impressive body of scholarship, however, contradicts this model.³³ That scholarship supports the "managerial power" model, which holds that managers often manipulate directors into providing them with excessive levels of compensation, thereby diverting value from the very corporations that directors ostensibly serve.³⁴

A. Pitting Fiduciary Duties Against Managerial Power

In their seminal book, *Pay Without Performance*, Bebchuk and Fried argue that managers, most particularly CEOs, exert influence over directors to raise executive pay significantly beyond levels that would optimize shareholder value.³⁵ They note that nearly all directors of publicly traded corporations receive substantial compensation,

^{32.} Guth v. Loft, Inc., 5 A.2d 503, 510, 515 (Del. 1939) (holding that Guth, the president of Loft, misappropriated the business opportunity to acquire Pepsi-Cola from Loft).

^{33.} See generally Walker, supra note 29, at 592 ("The optimal contracting model . . . posits that the principal (the board of directors on behalf of the shareholders) can only imperfectly observe the effort, focus, and effectiveness of its agent (the manager) and negotiates a contract that minimizes the resulting agency costs").

^{34.} See id. at 633 (explaining that the managerial power model cautions that "we should not expect public companies to reach optimal contracts with managers"); see also Michael B. Dorff, Does One Hand Wash the Other? Testing the Managerial Power and Optimal Contracting Theories of Executive Compensation, 30 J. Corp. L. 255, 277 (2005) (providing experimental findings that directors agree to pay substantially higher compensation to executives who wield power over them than directors agree to pay to executives who do not wield power over them).

^{35.} Lucian Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation 30 (2004); see also Arthur Levitt, Jr., Corporate Culture and the Problem of Executive Compensation, 30 J. Corp. L. 749, 749 (2005) ("I believe that Lucian Bebchuk and Jesse Fried have brought to light one of the most important issues facing our society today. I agree enthusiastically and almost completely with their analysis of the problem." (footnote call number omitted)); Lucian Bebchuk et al., Lucky CEOs and Lucky Directors, J. Fin. (forthcoming), available at http://ssrn.com/abstract=1405316 (finding that the opportunistic timing of option grants to CEOs coincides with high CEO power).

which sometimes exceeds \$100,000 annually. ³⁶ CEOs, as company leaders and often as members of boards of directors, have considerable influence over the pay of directors. ³⁷ If pleased with the support they have received from directors, CEOs may use their power to raise the compensation of compliant directors, or CEOs may punish uncooperative ones. ³⁸ This problem, Bebchuk and Fried argue, is magnified where companies have interlocking directors, that is, where the CEO of company A is a director of company B, and the CEO of company B is a director of company A. ³⁹ When directors and CEOs have reciprocal power to affect each other's pay, all wallets, except those of shareholders, will tend to fatten.

Directors want to retain their positions, which bring pay, prestige, various perks, and valuable business contacts. 40 CEOs exert a powerful and sometimes decisive influence over the nomination process for directors. 41 Bebchuk and Fried contend that, if directors approve compensation agreements favorable to CEOs, CEOs will use their influence to include the names of those directors on proxy ballots. 42

Social forces, say Bebchuk and Fried, also erode director independence. CEOs, who may simultaneously serve as directors, will tend to develop personal relationships with other board members. Bebchuk and Fried believe that a sense of collegiality will discourage directors from opposing positions that CEOs support, including the compensation packages that CEOs desire.⁴³ Even directors who retain a sense of independence may not wish to stand out as contrarians. Sitting on the board for years, they want to be liked and respected as

^{36.} See Gary Strauss, Companies Pony Up to Keep Directors, USA TODAY, Nov. 21, 2002, at B1 (noting that, in 2002, compensation for outside directors on Fortune 1000 company boards averaged \$116,000 annually, and such compensation for the top 200 publicly traded corporations averaged more than \$152,000).

^{37.} Вевсник & Fried, *supra* note 35, at 30–31 (citing a study suggesting collusion between CEOs and directors in setting each other's pay).

^{38.} *Id.* (arguing that a CEO will use his "bully pulpit" to champion generous pay for directors who support his or her pay aspirations, and citing evidence that high CEO compensation correlates with high director compensation, despite a negative correlation between pay and performance).

^{39.} *Id.* at 29–30 (noting that stock exchange rules prohibit interlocking directors from sitting on compensation committees, but that any director, even if not on that committee, may still influence executive pay).

^{40.} *Id.* at 25–26 (pointing out that CEOs often sit on nominating committees, and even when they do not, directors often comply with the CEOs' wishes because angering them may lead to punitive reprisals).

^{41.} *Id.* at 26 (noting that CEOs are often on nominating committees and that, in any event, CEOs can sabotage the nomination of a perceived adversary).

^{42.} *Id*.

^{43.} Id. at 32 (arguing that directors are subject to the social pressures that affect human behavior).

members of the management team, and they want their leader, the CEO, to think well of them.⁴⁴

Bebchuk and Fried argue that even independent directors who maintain their impartiality probably will not represent the interests of shareholders effectively. Usually occupied with full-time careers outside of the corporation, such directors lack the time and knowledge to assess complex compensation packages. These directors generally rely on compensation consultants who ostensibly provide impartial advice to boards of directors and compensation committees, which are required for companies listed on the New York Stock Exchange ("NYSE"), and are, in any event, commonplace at large corporations. Although such a practice would seem to provide a circuit breaker to thwart inflated compensation proposals, Bebchuk and Fried suggest that compensation consultants often fail to provide unbiased advice because CEOs have influence over choosing and retaining them.

B. Camouflaging Excessive Executive Pay

A critical component of Bebchuk and Fried's thesis is camouflage. They argue that CEOs and other managers wish to maximize pay while minimizing the constraints that their corporations impose on them. Decoupling compensation from performance achieves both of these goals.⁴⁹ It enables managers to extract "rents," which are compensation benefits arising, not from arm's length negotiation, but rather from managerial power.⁵⁰ Even rents, according to Bebchuk

^{44.} *Id.* at 31–33 (discussing the social pressures that impel directors to acquiesce to the demands of CEOs).

^{45.} *Id.* at 36–37 (noting that independent directors do not spend sufficient time analyzing compensation packages to evaluate them adequately).

^{46.} NYSE, Inc., Listed Company Manual § 303A.05(a) (2009), available at http://nysemanual.nyse.com/lcm ("Listed companies must have a compensation committee composed entirely of independent directors."); see also NASDAQ, Inc., NASDAQ Stock Market Rule 5605(d)(2) (2009), available at http://nasdaq.cchwallstreet.com (requiring the compensation of executive officers of companies listed on NASDAQ to be determined or recommended by a majority of independent directors or a compensation committee comprised entirely of independent directors).

^{47.} Bebchuk & Fried, supra note 35, at 24.

^{48.} *Id.* at 37–38 (observing that the pay of compensation consultants is not linked to shareholder value, so compensation consultants have no incentive to protect the interests of shareholders when those interests are adverse to the interests of CEOs).

^{49.} *Id.* at 63 (noting that when pay is decoupled from performance, managers can pursue strategies such as empire building, which may serve the personal interests of the manager rather than the interests of the shareholders).

^{50.} *Id.* at 62 (defining "rents" as "the additional value that managers obtain beyond what they would get in arm's-length bargaining with a board that had both the inclination

and Fried, have upper limits. When pay reaches outlandish levels, the public in general and shareholders in particular may protest and exert pressure to reduce it.⁵¹ To divert attention from excessive pay levels, the architects of compensation arrangements, according to Bebchuk and Fried, camouflage rents in two principal ways. First, companies obscure the amounts of compensation.⁵² Second, companies disguise rents by falsely characterizing them as performance-related compensation.⁵³

Since the writing of *Pay Without Performance*, the SEC has sought to curtail these camouflaging practices by requiring publicly traded companies to include a Compensation Discussion and Analysis and expanded tabular disclosures in their proxy statements.⁵⁴ This expanded narrative and tabular regime promised to increase transparency, but after three years the strategy seems to have failed. Now companies camouflage questionable compensation provisions with self-serving platitudes folded into complex, incomplete, and seemingly interminable disclosures.⁵⁵ Though the designers of compensation packages portray executive compensation arrangements as primarily performance-based, such arrangements seem to result more from managerial power than from arm's length negotiations.

1. Bonuses

Boards of directors characterize bonuses as performance-based by tying them either to stock price or to financial results such as earnings.⁵⁶ Companies take the position that good management is the

to maximize shareholder value and the necessary time and information to perform that task properly").

^{51.} *Id.* at 64–65; *see also* Walker, *supra* note 29, at 634 (noting that outrage over excessive compensation may damage the reputations of officers and directors).

^{52.} Bebchuk & Fried, *supra* note 35, at 67 (discussing the "dressing, packaging, or hiding" of rent extraction).

^{53.} *Id.* at 145; *see also* Walker, *supra* note 29, at 637 (arguing that equity incentives provide cover for managers to hike their compensation even more than would otherwise be possible). Bebchuk and Fried criticize the pre-1992 and 1992 SEC disclosure requirements as inadequate to prevent camouflaging. *See* Bebchuk & Fried, *supra* note 35, at 67–68 (explaining that under the pre-1992 rules, firms "took full advantage of their discretion to obscure the amount and form of their pay" and continued to do so under the 1992 rules). As will be shown in Part III, the current SEC disclosure rules, adopted in 2006, have also failed to curtail the obfuscation of executive compensation arrangements.

^{54.} See infra Part III.C.

^{55.} See infra Part III.C.2.

^{56.} See, e.g., Intel Corp., Notice of 2009 Annual Stockholders' Meeting 26 (2009), available at http://www.intc.com/intelProxy2009/common/pdfs/Intel_2009_Proxy.pdf [hereinafter Intel Notice] (disclosing that executive compensation packages include "equity awards that reward stock price appreciation" and "[a]nnual and semiannual incentive cash payments [that] are determined primarily by Intel's annual financial results").

cause of rising stock prices and earnings increases and that managers should therefore be rewarded. Bebchuk and Fried point out that stock prices and financial metrics often benefit from bullish market conditions, which are unrelated to executive performance.⁵⁷ Furthermore, the drafters of compensation agreements sometimes manipulate targets that will trigger bonuses so that they are almost inevitable.⁵⁸ Bebchuk and Fried argue that an arm's length negotiation would not yield a contract that assures a bonus regardless of performance.⁵⁹

Presumably to establish a more sensitive measure of performance, a compensation committee or board of directors will ordinarily retain discretion to depart from objective measures of performance and to decide the magnitude of bonuses based on subjective assessments. ⁶⁰ Bebchuk and Fried observe that subjective determinations might fairly calibrate executive performance if the decisions were not left to directors inclined to support whatever package the CEO proposed. ⁶¹ Thus, regardless of whether market-driven objective measures or director-controlled subjective measures are used, compensation committees will award bonuses even when unsatisfactory executive performance would counsel otherwise. ⁶² This state of affairs, Bebchuk and Fried argue, suggests that managerial power, rather than the interests of shareholders, dictates the terms of executive bonuses. ⁶³

2. Options

Once comprising the bulk of executive compensation, base salary has receded in prominence.⁶⁴ Option grants, over recent years, have grown into a predominant component of executive pay.⁶⁵ The osten-

^{57.} Вевсник & Fried, *supra* note 35, at 123 (citing empirical evidence to show correlation between executive pay and general market conditions).

^{58.} *Id.* at 127 (noting that companies reset performance goals if executives fail to meet them).

^{59.} Id. at 126-27.

^{60.} *Id.* at 126; *see also* Time Warner, Inc., Notice of Annual Meeting of Stockholders (Form DEFA14A), at 56 (Apr. 8, 2009), *available at* http://ir.timewarner.com/phoenix. zhtml?c=70972&p=irol-sec&control_selectgroup=Proxy%20Filings [hereinafter Time Warner Notice] ("The Committee exercises discretion in determining the actual bonus amount paid (if any) to executive officers.").

^{61.} Bebchuk & Fried, supra note 35, at 126.

^{62.} *Id*.

^{63.} Id.

^{64.} See id. at 137 (describing the increased use of stock options as compensation during the 1990s).

^{65.} *Id.* ("Stock options became an increasingly important component of executive compensation during [the 1990s]."); *see also* Walker, *supra* note 29, at 641–42 ("Stock option compensation for CEOs and other senior corporate executives increased dramatically

sible reason for this trend is that option awards are performance-based. Bebchuk and Fried question the reliability of the linkage between options and performance because market conditions affect stock prices. 67

Bebchuk and Fried note that the effects of market-wide fluctuations could be eliminated by indexing the exercise price of options to discount for changes in the broader market. Indexing would not only eliminate the effects of rising economic tides, but it would also protect managers from the effects of market declines. In general, however, indexing would work to the disadvantage of managers because markets tend to rise in the long run. The managerial power model, according to Bebchuk and Fried, explains why few companies have paid their executives with indexed options.

If options expire worthless because the stock price has fallen, many companies will either reprice the options by lowering the strike price or, more commonly, will issue new options at lower strike prices.⁷¹ Bebchuk and Fried call this practice "backdoor repricing."⁷²

in the 1990s."). Companies listed on both the NASDAQ and NYSE must submit all equity compensation plans to a binding vote of the shareholders. NASDAQ, Inc., *supra* note 46, at Rule 5635(c) (requiring shareholder approval of all equity compensation plans); NYSE, Inc., *supra* note 46, § 303A.08 ("Shareholders must be given the opportunity to vote on all equity-compensation plans and material revisions thereto"). These provisions, however, do not afford shareholders meaningful input in the compensation process. Proposed equity compensation plans are highly complex and are phrased in general terms. Such plans provide shareholders with scant guidance as to specific equity awards that the company will grant to its executives.

- 66. See Bebchuk & Fried, supra note 35, at 137–38 (noting that "option compensation increases equity ownership and thereby helps link pay to performance").
- 67. *Id.* at 139 (conceding that managers may lose compensation when options fall, but arguing that gains from fortuitous stock fluctuations outstrip losses).
- 68. *Id.* at 141 (arguing that indexing options heightens the incentive for managers to achieve superior levels of performance because managers will not be able to rely on market or sector fluctuations to enhance the value of their options); *see also Compensation Structure and Systemic Risk: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 3–4 (2009) (statement of Professor Lucian A. Bebchuk) (advising that option grants to executives should be exercisable over five-year periods, but that an executive's right to sell options should not have to await the executive's departure from the company); Walker, *supra* note 29, at 652–53 (observing that the lack of indexing contradicts the optimal contracting model and supports the managerial power model).
 - 69. Вевсник & Fried, *supra* note 35, at 141-42.
 - 70. Id. at 143.
- 71. See, e.g., INTEL NOTICE, supra note 56, at 15 (showing that options awarded to certain directors were issued at lower exercise prices after the year 2000).
- 72. Bebchuk & Fried, *supra* note 35, at 165. Some companies allow the reloading of options by issuing new options at the price at which the option holder exercises existing options. This practice allows the option holder to profit from spikes in the stock price while retaining his option position. Should the stock spike a second time, the option holder will be able to reap the benefit. *Id.* at 169.

They argue that repricing is a camouflaged giveaway to managers because repriced options pay the recipient for failure rather than success. Such options will, if for no other reason than luck, bounce into the money sooner or later. What appears to be performance-based compensation is in reality a guaranteed paycheck. By assuring that executives will receive option-based compensation regardless of their performance, repriced options have a perverse effect: They provide a disincentive for managers to work hard for the company because repriced options decouple pay from performance.

3. Restricted Stock

Bebchuk and Fried note that restricted stock is becoming a common means of providing executive compensation.⁷⁶ Like all equity, restricted stock will react to extrinsic market conditions and therefore may not reflect executive performance.⁷⁷ Nevertheless, some commentators prefer grants of restricted stock to grants of options because restricted stock, which must be held for substantial periods of time, discourages managers from engaging in high-risk strategies designed to drive stock prices higher over the short term.⁷⁸ This justifi-

^{73.} *Id.* at 165–66.

^{74.} See id. at 165 (explaining that current practices regarding options "do not leave executives empty-handed"). Executives may have an incentive to precipitate short-term declines in the value of the stock so that the company will grant them options at lower strike prices. Id. at 166. Once they have received bushels of cheap options, they will attempt to restore the stock to its previous high and sell their options. This strategy may be curtailed to some degree by having the options vest over a period of years, which is a practice that has been adopted by many public companies.

^{75.} See id. at 165 (explaining that "backdoor repricing" has "further weakened the link between option pay and managerial performance"). Defenders of option repricing argue that market conditions may drive options underwater and that executives should not be punished for circumstances beyond their control. Id. at 166. Indexed options, however, provide a more equitable solution to the problem because they do not guarantee compensation to executives who may be responsible for declines in the company's stock. See id. ("Using indexed options . . . will generally ensure that options remain valuable, and that managers continue to have incentives to perform, when markets decline.").

^{76.} *Id.* at 171 (noting that the increased use of restricted stock in executive compensation arrangements is a reaction to shareholder dissatisfaction with the use of conventional options); *see also* J. Mark Poerio, Executive Compensation Disclosure Update—2009 Proxy Season, Part 2 (2009) (noting that grants of restricted stock units have increased because, unlike options, restricted stock units are virtually never worthless).

^{77.} See generally Andrew C.W. Lund, What Was the Question? The NYSE and Nasdaq's Curious Listing Standards Requiring Shareholder Approval of Equity-Compensation Plans, 39 CONN. L. Rev. 119, 127–28 (2006) (explaining the value of restricted stock in comparison to other equity awards).

^{78.} See Sanjai Bhagat & Roberta Romano, Reforming Executive Compensation: Simplicity, Transparency and Committing to the Long-Term 11–13 (Yale Law & Econ. Research, Working Paper No. 393, 2009), available at http://ssrn.com/abstract=1506742 (arguing that delay-

cation is questionable since the vesting of option grants may be delayed.⁷⁹ An executive's preference for restricted stock over options, however, is understandable, according to Bebchuk and Fried, because the windfall derived from restricted stock exceeds the windfall derived from options: If the company's stock price falls, an option may be worthless, but restricted stock will retain value.⁸⁰

C. Criticisms of the Managerial Power Model

Despite its enormous influence, Bebchuk and Fried's work has encountered considerable criticism.⁸¹ Professor Jeffrey Gordon, for example, has cogently expressed many objections to their thesis.⁸² Though conceding that Bebchuk and Fried have identified and explained some executive pay abuses, Gordon argues that they have overstated the case for the managerial power model.⁸³

ing the vesting of equity awards for several years after executives have left companies would diminish perverse incentives to take ill-advised risks).

79. See id. at 12–13 (noting that option awards would not encourage excessively risky executive business decisions if vesting were delayed to coincide with the holding periods associated with restricted stock).

80. Bebchuk & Fried, *supra* note 35, at 171-72.

81. See, e.g., Kevin J. Murphy, Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options, 69 U. Chi. L. Rev. 847, 868 (2002) (arguing that the option practices that Bebchuk and Fried attribute to managerial power actually result from misperceptions of the cost and value of options); Franklin G. Snyder, More Pieces of the CEO Compensation Puzzle, 28 Del. J. Corp. L. 129, 135 (2003) (arguing that "the managerial power approach is, at best, only a partial picture of the CEO compensation puzzle and, at worst, entirely misguided"). James McConvill challenges the premise that the desire for high monetary compensation motivates corporate executives. James McConvill, Executive Compensation and Corporate Governance: Rising Above the "Pay-for-Performance" Principle, 43 Am. Bus. L.J. 413, 416 (2006). He argues that intangible factors motivate executive behavior. Id. at 423-25. These factors include ego-fulfillment, self-esteem, recognition, achievement, and self-actualization. Id. Psychological intangibles certainly provide powerful motivation for human behavior, but our society has exalted money to preeminent status. See BEBCHUK & Fried, supra note 35, at 61–64 (suggesting that executives and managers are primarily driven by the acquisition of money and other personal profits). People can seek to affirm their egos while simultaneously accruing as much cash as they can. It is ironic that wealth accumulation and feelings of personal fulfillment are not mutually exclusive. Steeped in materialism, our culture teaches us that making bundles of money is evidence of self-worth and competence. Nearly everyone is conditioned to seek material wealth.

82. Jeffrey N. Gordon, Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis," 30 J. Corp. L. 675, 688 (2005) (noting that some practices that Bebchuk and Fried characterize as abuses are sometimes benign and even salutary).

83. Id.

1. Competing Explanations

Gordon asserts that several factors, including arm's length negotiating, have a significant effect on executive pay.⁸⁴ He argues, for example, that attaining the coveted position of a company's CEO is the culmination of a "tournament."⁸⁵ The prize for winning the competition includes rewards for past performance.⁸⁶ Although this explanation for non-performance-based pay may have some validity, it is at least arguably consistent with the managerial power model: The winner of the prize gets to set the terms of his or her compensation.

According to Professor Gordon, the tendency to overpay CEOs also arises from their "superstar" status.⁸⁷ When a board anoints a new CEO, the board will shower him or her with favor.⁸⁸ This explanation, which carries intuitive appeal, seems altogether consistent with the managerial power model. If a board views a CEO as a superstar, the CEO will wield the power to extract rents.

Although not discussed by Gordon, an alternative explanation for high executive pay is the directors' inherent lack of commitment to shareholder interests. When directors authorize executive compensation packages, they are dispensing corporate assets, not their own. They may not feel a sense of loyalty to an enterprise owned by a nameless aggregation of individual shareholders and impersonal institutional investors. People get more excited about protecting their own property than about protecting the property of others. Small equity

Because boards of the large public corporations were now comprised of a number of outside individuals with little connection to the enterprise other than their relation with management, changes would have to be made in the corporation's relationship with them. This new breed of outside director often had little or no shareholding interest in the enterprise and, as such, no longer represented their own personal financial stakes or those of the other shareholders in rendering board service.

Charles M. Elson, *Director Compensation and the Management-Captured Board: The History of a Symptom and a Cure*, 50 SMU L. Rev. 127, 141 (1996). Professor Elson recognizes that providing outside directors with salaries or even relatively small blocks of shares does not align their interests with shareholders. To motivate directors to protect shareholder interests, he believes that they must own a substantial stake in the company. *Id.* at 165. Unfortunately, many directors have not reached the requisite level of equity ownership.

^{84.} See infra notes 85-88 and accompanying text.

^{85.} Gordon, supra note 82, at 680.

^{86.} *Id*.

^{87.} *Id.* at 684 (noting that directors are sometimes deluded into believing that a new CEO will deliver the impossible).

^{88.} See id. (suggesting that it is not surprising that a board will pay a promising new CEO generously).

^{89.} Professor Charles Elson has noted:

^{90.} Adam Smith recognized this aspect of the agency problem. He famously observed, "The directors of [a joint stock company], however, being the managers rather of other

stakes are not likely to overcome a director's human predisposition toward shirking. Designed to counteract this tendency, fiduciary duties have failed to sensitize directors to the interests of shareholders and corporations.

A diverse set of forces unquestionably affects the negotiating process, and it would be simplistic to believe that all companies operate in precisely the same manner. Nor is it sensible to contend that directors never satisfy their fiduciary duties. It should be noted, however, that although Bebchuk and Fried may overstate the explanatory force of the managerial power model, they do acknowledge that arm's length negotiating still operates in varying degrees in some corporate settings. As Professor Stephen Bainbridge has noted, "In sum, it seems plausible that the evidence does not exclusively support the managerial power model but rather supports multiple hypotheses that may prove complementary rather than competing." Thus, the question is not whether Bebchuk and Fried are right, but rather how right they are. One thing is certain: Regardless of the reason for its failure, the fiduciary model has not exerted the necessary discipline over directors to keep executive compensation at reasonable levels.

2. Conventional Versus Indexed Options

Having attempted to show that reasons other than managerial power contribute to high executive pay, Gordon challenges Bebchuk and Fried's arguments relating to specific types of compensation. Because Bebchuk and Fried concentrate much of their discussion on the

people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own." 2 Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations 264–65 (Edwin Cannan ed., Univ. of Chicago Press 1976) (1776); see also Claire A. Hill & Brett McDonnell, Executive Compensation and the Optimal Penumbra of Delaware Corporate Law, 4 Va. L. & Bus. Rev. 333, 349 (2009) ("An agent might take less care and attention as to her principal's business than she would as to her own business.").

- 91. Bebchuk & Fried, *supra* note 35, at 42–43 (acknowledging that "[a]lthough the pay-setting process has departed from arm's-length bargaining in most widely held public companies, this process has likely worked better in some companies than in others").
- 92. Stephen M. Bainbridge, *Executive Compensation: Who Decides*?, 83 Tex. L. Rev. 1615, 1631–32 (2005) (reviewing Lucian Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation (2004)) (summarizing evidence inconsistent with the managerial power model).
- 93. Professor Gordon acknowledges this point. See Gordon, supra note 82, at 688 (recognizing that "Bebchuk and Fried have generated a prima facie case that managerial power plays a significant role in the setting of executive compensation"). Gordon's point is, because factors other than managerial power hike up executive compensation, the means to remedy excessive pay often differ from the means of constraining managerial power. Id.

prevalence of conventional rather than indexed options, Gordon similarly focuses on that issue.

Gordon asserts that awards of conventional options may result from arm's length bargaining.⁹⁴ He suggests that some boards, in successive years, decrease or discontinue option grants to punish sub-par performance.⁹⁵ Though Gordon may be right in some cases, the common practice of issuing new options at lower strike prices seems to contradict his suggestion that boards commonly adjust option grants to reflect performance.

Defending option repricing, Gordon believes it helps companies retain key managers in sluggish economic environments. The "retention" argument, however, provides a dubious justification for any wasteful compensation arrangement. Falling stock prices and earnings might signal the failure of management as much as a foundering economy. The over-leveraging of financial institutions such as AIG and Merrill Lynch provides a stark example. Rather than receiving exorbitant bonuses, managers who exposed their companies to reckless investment strategies do not deserve their jobs.

The practice of not canceling out-of-the-money options further contradicts Gordon's argument.⁹⁸ If boards operated at arm's length, they would, when issuing new options, cancel those previously granted. Letting managers retain such options rewards failure.

There is, however, a persuasive alternative explanation to managerial power that explains why companies prefer awarding executives conventional rather than indexed options. As Gordon notes, federal tax law treats conventional options more favorably than it treats indexed options. Because conventional options are deemed to be performance-based, the cost of conventional options, regardless of the amount, is tax deductible under Section 162(m) of the Internal Revenue Code. Indexed options, however, are not per se performance-

^{94.} Id. at 682.

^{95.} *Id.* at 681 (noting that drafting indexed options entails a transaction cost, and to make conventional options performance-related, boards sometimes require the forfeiture of unvested conventional options).

^{96.} *Id.* at 686 (asserting that the repricing of options occurs most commonly in troubled growing companies).

^{97.} See supra notes 20-24 and accompanying text.

^{98.} See Bebchuk & Fried, supra note 35, at 165 ("When executives are left holding options that are out-of-the-money, firms often engage in backdoor repricing by replenishing the executive with additional options that have a lower exercise price.").

^{99.} Gordon, supra note 82, at 681.

^{100.} See infra notes 268–72 and accompanying text (discussing the tax deductibility of options under § 162(m)).

based, and therefore may not qualify for unlimited tax deductibility. 101

3. Outrage

Gordon faults Bebchuk and Fried for missing the obvious: Excessive compensation outrages the public, regardless of whether the pay is performance-based. Although Bebchuk and Fried defend any level of executive pay if it is performance-related, is not at all clear that they attribute public outrage solely to the decoupling of pay from performance. If they do, they are wrong. The sheer magnitude of many executive compensation arrangements has unquestionably enraged the public. Workers who live from paycheck to paycheck cannot fathom how Richard Grasso finagled a \$187 million seven-year compensation package working for a not-for-profit organization or why Michael Ovitz received \$130 million for failing at Disney.

D. A Possible Solution

No matter what the cause of astronomical executive pay, share-holders cannot trust boards of directors, compensation committees, or consultants to protect their interests. The problem is clear; the issue is how to resolve it. One approach would be to institute a disclosure system that would compel companies to lay bare all the facts, figures, and policies underlying their executive compensation practices. If shareholders knew all the material information, they could pressure officers and directors to arrive at more reasonable pay arrangements. The SEC has taken this approach for seventy years with disappointing results. After revamping disclosure requirements time after time, executive compensation has accelerated to greater and greater heights.

^{101.} See Treas. Reg. § 1.162-27(e)(2)(vi) (1996) ("Compensation attributable to a stock option or a stock appreciation right is deemed [fully tax deductible if] the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award.").

^{102.} Gordon, *supra* note 82, at 677 ("In particular, Bebchuk and Fried have only partially captured the reason why the public is concerned about executive compensation. It is not only the alleged disconnect between pay and performance, but the absolute level, especially in relation to other social frames of value.").

^{103.} ВЕВСНИК & FRIED, *supra* note 35, at 8 ("We would accept compensation at current or even higher levels as long as such compensation, through its incentive effects, actually serves shareholders.").

^{104.} See infra Part IV.C.

III. APPROACH TWO: DISCLOSURE

Over the years, the SEC has toughened the compensation-related disclosure rules. The current regulatory framework, which burdens corporations with extensive and often pointless requirements, has imposed more costs in money and manpower on corporations, while generating fees for corporate lawyers and compensation consultants. Even during the current financial crisis, executive compensation for most CEOs continues to rise. ¹⁰⁵

A. Origin of the Disclosure Model

The Great Depression rocked the capital markets and staggered the national economy for over a decade. At the onset of the Depression, some reformers supported the implementation of a new regulatory regime in which the federal government would have decided whether a business seeking entry into capital markets was worthy of admittance. Opposed to this view, Franklin Roosevelt endorsed the disclosure model of securities regulation. Shortly after his inauguration, he delivered a message to Congress, cautioning that the government should not guarantee to the public the soundness of newly issued securities. Rather, he advocated the adoption of a disclosure system:

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.¹⁰⁷

^{105.} See supra notes 1-19 and accompanying text.

^{106.} James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959) ("As the criticism mounted, doubts as to the value of the very system of private enterprise were generated, and a wide demand was prevalent for the institution of procedures of governmental control that would in essence have created a capital issues bureaucracy to control not only the manner in which securities could be issued but the very right of any enterprise to tap the capital market.").

^{107.} H.R. Rep. No. 73-85, vol. 2, at 2 (1933). Chaired by Sam Rayburn, the House Committee on Interstate and Foreign Commerce agreed with President Roosevelt's assessment. The Committee Report emphasized that a new federal law should provide "that there . . . be full disclosure of every essentially important element attending the issue of a new security," but that the disclosure requirements should "not . . . be capable of being construed as an approval or guarantee of a security issue." *Id.* at 3. Huston Thompson, a former member of the Federal Trade Commission, drafted a bill that was introduced into Congress but ultimately rejected. Landis, *supra* note 106, at 30–31. This bill sought to institute a merit system of securities regulation and would have vested the Federal Trade Commission with the authority to revoke the registration of any proposed securities offering if the issuer's affairs were in "unsound condition," if it was "insolvent," or if the issuer's business was "not based upon sound principles." H.R. 4314, 73d Cong. § 6(e)–(f) (1st Sess. 1933).

The Securities Act of 1933 ("Securities Act")¹⁰⁸ followed Roosevelt's view that the requirements of federal law "should be limited to full and fair disclosure of the nature of the security being offered and that there should be no authority to pass upon the investment quality of the security." This disclosure system has endured throughout the history of securities regulation in the United States. In Basic Inc. v. Levinson, the Supreme Court recognized that "[d]isclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress."

The disclosure approach of the Securities Act is generally sound. The government should not control access to capital markets by determining which companies are worthy of investment. Delegating such power to regulators would choke off speculative business ventures that might well founder but might, however, introduce innovative products or revolutionary technologies. Armed with full disclosure, every investor, whether institutional or private, must decide what is an acceptable level of risk.

Reluctant to exert direct pressure on issues of corporate governance, the SEC has reflexively applied the disclosure model to deal with most issues affecting securities and securities markets. Almost from its inception, the SEC has applied the disclosure model to the question of executive compensation. In November 2008, Christopher Cox, former Chairman of the SEC, reaffirmed the Commission's commitment to the disclosure approach:

^{108.} Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

^{109.} Landis, supra note 106, at 34.

^{110.} See SEC, 2008 Performance and Accountability Report 5 (2008), http://www.sec.gov/about/secpar/secpar2008.pdf (announcing the 21st Century Disclosure Initiative).

^{111. 485} U.S. 224 (1988).

^{112.} Id. at 234.

^{113.} See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) (stating that a "fundamental purpose" of federal securities law "was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry"); Omari Scott Simmons, Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform, 62 SMU L. Rev. 299, 328 (2009) (recognizing "a federal reluctance to directly regulate the internal affairs of the corporation," and instead to use indirect means of regulation "such as disclosure"). Professor Simmons believes that Congress has used indirect forms of regulation to minimize "political backlash from powerful corporate constituencies." Id. He argues that, because of political self-interest, lawmakers, on both the federal and state levels, focus public attention on the inflammatory but relatively unimportant issue of executive compensation, while diverting attention from more urgent and controversial issues such as unemployment, plant closings, job outsourcing, and income inequality. Id. at 306.

^{114.} See Amended Proxy Rules, SEC Securities Exchange Act Release No. 34-1823, 3 Fed. Reg. 1991, 1991–92 (Aug. 13, 1938) (establishing the first disclosure rules).

During FY 2008 the SEC also launched the 21st Century Disclosure Initiative, a wide-ranging internal effort to fundamentally rethink public company disclosure. . . . The Initiative is focused on using new technology to gather information from registrants in new ways that can generate more dynamic, accessible, and easier to use disclosure for investors. 115

President Obama selected Mary Schapiro to serve as the new Chairman of the SEC.¹¹⁶ Under her leadership, the SEC has expressed a desire to increase shareholder rights to participate in the process of nominating directors.¹¹⁷ Although praiseworthy, this measure would not vest shareholders with sufficient power to control executive compensation in a meaningful way.¹¹⁸ In any event, the SEC, even under the present administration, has expressed its continuing commitment to the disclosure approach and has introduced a proposal to expand disclosure requirements.¹¹⁹ This effort will not work. All the SEC's past disclosure initiatives have failed to reduce rampant executive pay abuse. Rather, it appears that the disclosure requirements have had the perverse effect of adding to the problem.¹²⁰

^{115.} SEC, *supra* note 110, at 5; *see also* John W. White, Dir. of Corp. Fin., SEC, Speech by SEC Staff: Principles Matter: Related Person Transactions Disclosure and Disclosure Controls and Procedures (Oct. 12, 2006), *available at* http://www.sec.gov/news/speech/2006/spch101206jww.htm (extolling the virtues of "principles-based disclosure" in the "securities and disclosure arena" (internal quotation marks omitted)); John W. White, Dir. of Corp. Fin., SEC, Speech by SEC Staff: Where's the Analysis? (Oct. 9, 2007), *available at* http://www.sec.gov/news/speech/2007/spch100907jww.htm (stressing the SEC's commitment to "implementing the new disclosure requirements, gathering the new information, and crafting the new disclosures for investors," and concluding that "investors are well-served by the new disclosures"). Meredith Cross succeeded Mr. White as the new Director of the SEC Division of Corporation Finance on April 13, 2009. *See* Press Release, SEC, Meredith Cross Named New Director of SEC Division of Corporation Finance (Apr. 13, 2009), *available at* http://www.sec.gov/news/press/2009/2009-78.htm.

^{116.} Press Release, SEC, Mary Schapiro Sworn in as Chairman of SEC (Jan. 27, 2009), available at http://www.sec.gov/news/press/2009/2009-11.htm.

^{117.} See infra Part VI.B.1.

^{118.} See infra Part VI.B.3.

^{119.} See Mary L. Schapiro, Chairman, SEC, Testimony Before the Subcomm. on Fin. Servs. and Gen. Gov't of the S. Comm. on Appropriations 6 (June 2, 2009), available at http://appropriations.senate.gov/ht-financial.cfm?method=hearings.view&id=df601eee-c2 68-4afc-a483-3afd25f719a2 (commenting on the SEC's desire to expand disclosure requirements); see also Proxy Disclosure and Solicitation Enhancements, 74 Fed. Reg. 35,076 (proposed July 17, 2009) (to be codified at 17 C.F.R. pts. 229, 239, 240, 249, 270, 274). The proposed rule change would require the disclosure of (1) qualifications of candidates for boards, (2) company leadership structures, (3) company risk-management process, and (4) fees paid to compensation consultants and additional services that they provide to the issuer. Id. at 35,082, 35,085–87.

^{120.} See infra Part III.C.2.

B. Background of the SEC's Executive Compensation Disclosure Rules

Both the Securities Act and the Securities Exchange Act of 1934 ("Exchange Act") ¹²¹ provide broad requirements for disclosing executive and director compensation. ¹²² To implement these requirements, the SEC adopted its first compensation-related rules in 1938. ¹²³ Since then, the SEC has periodically tinkered with its requirements by vacillating between narrative disclosures, tabular disclosures, or a combination of both. In various incarnations, these requirements have sought to keep pace with changing strategies for compensating executives—and camouflaging their compensation. ¹²⁴ The efforts have been like a man chasing a moving train.

The SEC has taken a restrictive view of how disclosures should be used, frowning on the use of such disclosures to launch litigation: "If shareholders are not satisfied with the decisions reflected in the report, the proper response is the ballot, not resort to the courts . . ."¹²⁵ Even today, with stories of excessive executive pay flooding the media, the SEC does not wish its rules to influence corporate decisionmak-

^{121.} Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78nn (2006)).

^{122.} Item 14 of Schedule A to the Securities Act requires registrants to disclose "remuneration, paid or estimated to be paid, by the issuer or its predecessor, directly or indirectly, during the past year and ensuing year to (a) the directors or persons performing similar functions, and (b) its officers . . . naming them wherever such remuneration exceeded \$25,000 during any such year." 15 U.S.C. § 77aa (2006). A similar provision in the Exchange Act requires the disclosure of the remuneration of "directors, officers, and underwriters, and each security holder of record holding more than 10 per centum of any class of any equity security of the issuer." Id. § 78l(b)(1)(D).

^{123.} Amended Proxy Rules, SEC Securities Exchange Act Release No. 34-1823, 3 Fed. Reg. 1991 (Aug. 13, 1938).

^{124.} See, e.g., Executive Compensation Disclosure, 57 Fed. Reg. 48,126, 48,129 (Oct. 21, 1992) (codified at 17 C.F.R. pts. 228, 229, 240, 249) ("The Summary Compensation Table was praised by shareholder commenters Through this more objective, formatted presentation of compensation information, which in the past often has been furnished in widely dispersed and disjointed narrative, shareholders will be able to understand clearly compensation for the last completed fiscal year" (footnote call number omitted)); Disclosure of Executive Compensation, 48 Fed. Reg. 44,467, 44,469 (Sept. 29, 1983) (codified at 17 C.F.R. pts. 229, 230, 231, 239, 240, 241, 270, 274) (limiting tabular disclosure to cash compensation); Amendments to Disclosure Forms, 43 Fed. Reg. 58,181 (Dec. 13, 1978) (codified at 17 C.F.R. pt. 229.90) (expanding tabular disclosures to cover all forms of executive compensation); Solicitation of Proxies, 17 Fed. Reg. 11,431 (Dec. 18, 1952) (codified at 17 C.F.R. pt. 240) (requiring separate tables for pensions and deferred compensation). See generally MARK A. BORGES, SEC EXECUTIVE COMPENSATION DISCLOSURE RULES 4–8 (2008) (summarizing changes to the SEC's disclosure rules for executive compensation).

^{125.} Executive Compensation Disclosure, 57 Fed. Reg. 48,126, 48,138 (Oct. 21, 1992) (codified at 17 C.F.R. pts. 228, 229, 240, 249); *see also id.* at 48,127 (explaining that "changes have been made" in response to concern of potential litigation).

ing. In discussing the 2006 amendments to the disclosure rules, John W. White, former Director of the SEC's Division of Corporation Finance, stressed the SEC's refusal to become entangled in executive compensation arrangements:

I have already used the word "disclosure" a couple of times this evening, and I really want to emphasize that the Commission's new rules [adopted in 2006] are all about disclosure. I believe the Commission and its staff take very seriously the charge—as our Chairman, Chris Cox, has made clear—that the Commission is not in the business of setting executive compensation. Not even in subtle ways. Nor is the Commission in the business of judging companies or boards about the decisions they make in this area. . . . [S]hareholders and investors . . . [using the disclosed information] can react how ever they like. 126

Even when shareholders ferreted out suspected abuses, they would have to find a means of redress without the help of the SEC.

C. The Current Framework

Adopted in 2006, the extensive disclosure requirements of the current rules apply to Securities Act registration statements, Exchange Act registration statements, periodic reports, and proxy statements. ¹²⁷ These rules compel companies registered under the Exchange Act to bombard shareholders with information. After describing these onerous rules, this Article will argue that they are ineffective.

1. Summary of the Requirements of the Current Framework

Item 402 of Regulation S-K,¹²⁸ the primary source of the compensation disclosure requirements, begins benignly. It provides that all disclosures must be expressed in "clear, concise and understandable" language.¹²⁹ The rule goes on to designate the executive officers whose compensation must be disclosed. "Covered" executives include a company's CEO and the next four most highly paid executive officers.¹³⁰

^{126.} John W. White, Dir. of Corp. Fin., SEC, Speech by SEC Staff: Executive Compensation Disclosure and the Important Role of CFO's (Oct. 3, 2006), *available at* http://www.sec.gov/news/speech/2006/spch100306jww.htm.

^{127.} Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,158 (Sept. 8, 2006) (codified at 17 C.F.R. pts. 228, 229, 232, 239, 240, 245, 249, 274). 128. 17 C.F.R. § 229,402 (2006).

^{129.} Id. § 229.402(a)(2).

^{130.} Id. § 229.402(a)(3). Item 402 also provides that disclosure is mandated for up to two additional persons who, but for ending their service as executive officers before the

The Compensation Discussion and Analysis ("CD&A") is the centerpiece of the new disclosure requirements. The fundamental purpose of the CD&A is to provide all material information so that investors can understand a company's compensation policies and its decisions in compensating the covered executive officers. To achieve this end, the new regulation requires the CD&A to contain so-called "principles-based" rather than boilerplate disclosures. The purpose of the principles-based system is to compel more meaningful disclosures than the sometimes stilted disclosures made under previous regimes, although, as shown below, registrants have effectively evaded even the principles-based disclosure requirements.

The CD&A must "explain all material elements" of the reporting registrant's compensation to each covered executive. Understandably, the SEC will not delegate to registrants the unfettered power to determine materiality, so the SEC provides mandatory components of the CD&A including (1) objectives of the registrant's compensation program; (2) what the compensation program seeks to reward; (3) each element of compensation; (4) why the registrant chooses to pay each element of compensation; (5) how the registrant determines, for each element, the amount of pay and, where applicable, the formula; and (6) how the registrant's decisions under each element fit into the registrant's overall compensation objectives and affect compensation decisions under other elements. 135

In keeping with the principles-based disclosure philosophy, Item 402 recognizes that disclosures "will vary depending upon the facts and circumstances," and it provides examples of the types of disclosures that might be mandatory under various circumstances. These

end of the last fiscal year, would have been covered under paragraph (a)(3)(ii). *Id.* § 229.402(a)(3)(iii).

^{131.} See id. § 229.402(b) (requiring a "Summary Compensation Table"); see also Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158, 53,163–69 (Sept. 8, 2006) (codified at 17 C.F.R. pts. 228, 229, 232, 239, 240, 245, 249, 274) (explaining the requirements for the "Compensation Discussion and Analysis").

^{132. 17} C.F.R. § 229.402, Instructions to Item 402(b).

^{133.} *Id.* ("The Compensation Discussion and Analysis should focus on the material principles underlying the registrant's executive compensation policies and decisions and the most important factors relevant to analysis of those policies and decisions. The Compensation Discussion and Analysis shall reflect the individual circumstances of the registrant and shall avoid boilerplate language and repetition of the more detailed information set forth in the tables and narrative disclosures that follow.").

^{134.} Id. § 229.402(b)(1).

^{135.} *Id.* § 229.402(b)(1)(i)–(vi).

^{136.} Id. § 229.402(b)(2). Item 402 provides reduced disclosure requirements for "smaller reporting companies." Id. § 229.402, Instructions to Item 402.

^{137.} Id. § 229.402(b)(2).

disclosures include, but are not limited to (1) the policies for allocating between long-term and currently paid out compensation, (2) the policies for allocating between cash and non-cash compensation and allocating among different forms of non-cash compensation, and (3) the basis for allocating different forms of long-term compensation (such as the relationship of the award to the achievement of the registrant's long-term goals, and management exposure to downside equity risk). Other noteworthy disclosures include how the registrant has structured and implemented policies to reflect each covered executive's individual performance, the benchmarking of compensation by reference to peer-group practices, and "[t]he role of executive officers in determining executive compensation."

The SEC has retained from the prior regime an all-important qualification on disclosures, which guts their effectiveness. Confidential information such as target levels concerning specific quantitative performance-related factors need not be disclosed if the compensation committee or the board of directors can show that such disclosure might cause "competitive harm." This provision will be discussed below.

^{138.} *Id.* § 229.402(b)(2)(i)–(iii).

^{139.} Id. § 229.402(b)(2)(vii).

^{140.} Id. § 229.402(b)(2)(xiv).

^{141.} Id. § 229.402(b)(2)(xv). The SEC enumerates several other matters that might affect compensation and therefore might be subject to mandatory disclosure, including (1) "[h]ow the determination is made as to when awards are granted, including forms of compensation as options"; (2) "[w]hat specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions"; (3) "[h]ow specific forms of compensation are structured and implemented to reflect . . . the registrant's performance, [and how] discretion can be or has been exercised"; (4) "[registrant] policies and decisions [for recovering or adjusting] awards or payments if [the registrant's goals have been changed] in a manner that would reduce the size of an award or payment"; (5) "factors considered in decisions to increase or decrease compensation materially"; (6) how current or prior compensation is considered in setting the elements of compensation (for example, "how gains from prior option or stock awards are considered in setting retirement benefits"); (7) events that trigger payments regarding termination or change in control; (8) "[t]he impact of the accounting and tax treatments of the particular form of compensation"; and (9) "[t]he registrant's equity or other security ownership requirements." Id. § 229.402(b) (2) (iv)-(vi), (viii)-(xiii).

^{142.} Id. § 229.402, Instructions to Item 402(b) ("Registrants are not required to disclose target levels with respect to specific quantitative or qualitative performance-related factors considered by the compensation committee or the board of directors, or any other factors or criteria involving confidential trade secrets or confidential commercial or financial information, the disclosure of which would result in competitive harm for the registrant. The standard to use when determining whether disclosure would cause competitive harm for the registrant is the same standard that would apply when a registrant requests confidential treatment of confidential trade secrets or confidential commercial or financial information pursuant to Securities Act Rule 406 (17 CFR 230.406) and Exchange Act Rule 24b-2 (17 CFR 240.24b-2) A registrant is not required to seek confidential treatment

The CD&A narrative is only part of the disclosures that Item 402 mandates. Item 402 also requires a series of seven compensation tables. A Summary Compensation Table must disclose, for each of the prior three years, each covered executive's (1) salary, (2) bonus, (3) stock awards, (4) option awards, (5) non-equity incentive plan compensation, (6) change in pension value and nonqualified deferred compensation earnings, (7) all other compensation, and (8) total compensation. 143 Perquisites and other personal benefits aggregating to \$10,000 or more must be disclosed in the column for "All other compensation." 144 Also subject to mandatory reporting are "grossups," which are reimbursements to executives for taxes paid, 145 and amounts paid or accrued because of retirement, resignation, severance, or change in control. 146 In five additional tables for covered executives the company must report (1) grants of plan-based awards for equity and non-equity incentive plans, 147 (2) unvested stock awards, and outstanding, unexercised options, 148 (3) exercised options and vested stock, 149 (4) pension benefits, 150 and (5) nonqualified deferred compensation. 151 Registrants must include a summary table reporting director compensation. 152

2. Shortcomings of the Current Framework

After three years, the current framework has failed to bring executive compensation under control, even during the worst financial crisis since the Great Depression. Most shareholders have never heard of the Compensation Discussion and Analysis. They probably discard proxy statements without realizing that, if they had taken a look, they would have discovered a daunting volume of information. The cur-

under the procedures in Securities Act Rule 406 and Exchange Act Rule 24b-2 if it determines that the disclosure would cause competitive harm in reliance on this instruction ").

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143. Id. § 229.402(c).
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^{144.} *Id.* § 229.402(c)(2)(ix)(A).

^{145.} *Id.* § 229.402(c)(2)(ix)(B).

^{146.} *Id.* § 229.402(c)(2)(ix)(D)(1).

^{147.} Id. § 229.402(d).

^{148.} *Id.* § 229.402(f).

^{149.} Id. § 229.402(g).

^{150.} *Id.* § 229.402(h).

^{151.} Id. § 229.402(i).

^{152.} Id. § 229.402(k).

^{153.} Mark Borges, an author and law practitioner in the field of executive compensation, acknowledged that, despite the SEC's extensive disclosure requirements, shareholders tend "to skim" the CD&A. Mark A. Borges, Executive Compensation Disclosure Update—2009 Proxy Season, Part I (2009). Borges may have overestimated the attention that most shareholders pay to these disclosures.

rent framework is a bulked-up disclosure approach that requires companies to overload shareholders with repetitive and, from a layperson's perspective, opaque information.¹⁵⁴ For example, ConocoPhillips' compensation-related disclosures fill over fifty pages of its 2009 Proxy Statement.¹⁵⁵ Compensation-related disclosures in Advanced Micro Devices' 2009 Annual Proxy Statement spans forty pages.¹⁵⁶ The plain English requirement succumbs to vertiginous footnotes, arcane terminology, and incomprehensible tables and charts.¹⁵⁷ Challenging for lawyers, the matrix of disclosures bedevils those unfortunate shareholders who venture into the depths of the CD&A. Individual shareholders are more apt to toss a proxy statement into the trash than to read it.

The impulse to forego the multi-hour analysis needed to comprehend all this information becomes nearly irresistible when lay share-holders realize that the compensation decisions have already been made. Public outrage over ballooning executive compensation in corporate America has pressured some companies to include an advisory vote on executive compensation—a so-called "say-on-pay" resolution. Even in such cases, few shareholders will have the fortitude to plough through the disclosures merely to express a vote that the company will likely ignore unless shareholders mobilize and engage the media.

Short-term institutional investors such as hedge funds that control enormous blocks of stock in most major corporations have the expertise to understand proxy disclosures and the savvy to know an excessive pay package when they see it. The managers of such funds,

^{154.} But see Sean M. Donahue, Executive Compensation: The New Executive Compensation Disclosure Rules Do Not Result in Complete Disclosure, 13 FORDHAM J. CORP. & FIN. L. 59, 82–86 (2008) (arguing that the disclosure requirements of the CD&A should be broadened to include (1) all work performed by and all fees paid to compensation consultants; (2) detailed target performance levels, despite the potential for competitive harm, but only after the performance period has ended; (3) all earnings on deferred compensation; and (4) all perquisites). This proposal would accomplish little beyond padding proxy statements with more information that shareholders would either not read or not understand even if they tackled the narrative disclosures. Expanding disclosure requirements wastes companies' money and manpower.

^{155.} ConocoPhillips, Notice of 2009 Annual Stockholders Meeting May 13, 2009 and Proxy Statement 16–67 (2009) [hereinafter ConocoPhillips Notice].

^{156.} Advanced Micro Devices, Inc., Notice of Annual Meeting of Stockholders 13–52 (2009) [hereinafter Advanced Micro Devices Notice]; *see also* Intel Notice, *supra* note 56, at 18–46 (outlining compensation-related disclosures spanning twenty-nine pages).

^{157.} See, e.g., ConocoPhillips Notice, supra note 155, at 36 nn.1-7.

^{158.} See, e.g., INTEL NOTICE, supra note 56, at 64 ("Advisory Vote on Executive Compensation"); see also infra Part VI.A.

however, have an interest in encouraging improvident risk-taking in the companies they own. A reckless corporate strategy, in the short term, may increase the market price of a stock, which is what short-term institutional investors need to cash out with a profit. Once out, they have no concern if the risky strategy later backfires and the stock price collapses. Thus, short-term institutional investors will not object to the immediate vesting of stock options, a favorite compensation arrangement which encourages reckless corporate decisionmaking.

Ironically, the disclosures tend to increase executive compensation. Inflated executive egos demand inflated executive pay, especially when benchmarked to the compensation of rival executives. The CD&A encourages a "my-daddy-makes-more-than-your-daddy" mentality between peer companies. ¹⁶⁰ Nearly all major corporations target their executive compensation levels to exceed the mean compensation among their peer groups. Companies attempt to justify these policies by arguing that high pay attracts high quality managers. Since nearly every company sets its compensation goals above the mean, pay inevitably rises. For example, Time Warner, seeking "to attract and retain high-caliber executive[s]," generally targets direct compensation, which it defines as salary, bonus, and equity awards, at the seventy-fifth percentile of companies in its three peer groups. ¹⁶¹

Intel's policy is more complicated. To encourage and reward executives for producing strong financial and operational results, and to retain executives and to align their interests with those of stockholders, performance-based cash and equity compensation are targeted at the sixty-fifth percentile of its peer group. Base salaries, which are not performance-related, are targeted at only the twenty-fifth percen-

^{159.} See Posting of Martin Lipton to The Harvard Law School Forum on Corporate Governance and Financial Regulation, The Proposed "Shareholder Bill of Rights of 2009," http://blogs.law.harvard.edu/corpgov/2009/05/12/the-proposed-

[%]E2%80%9Cshareholder-bill-of-rights-act-of-2009%E2%80%9D (May 12, 2009, 16:56 EST) (describing how "short-termist pressure . . . contributed significantly to the financial and economic crises we face today").

^{160.} One commentator recognizes that, since executive compensation has no "spot market," CD&A disclosures may increase compensation by adding transparency and therefore facilitating the efforts of companies to provide top pay to their executives. Gordon, *supra* note 82, at 697–98. Similarly, greedy executives may demand what executives are making at other companies. *Id.* Yet, this commentator argues that the CD&A will have beneficial effects by providing explanations and justifications for compensation packages. *Id.* If such justifications are persuasive, the author argues, they will allay resentments of shareholders and the public. *Id.*

^{161.} Time Warner Notice, supra note 60, at 60-61.

^{162.} Intel Notice, supra note 56, at 19.

tile of its peers.¹⁶³ This policy may seem reasonable, but because the bulk of Intel's executive compensation packages are ostensibly performance-based, Intel's executive compensation is substantially above its peer-group average. In fiscal year 2008, so-called performance-based compensation accounted for 87% of Intel's total executive compensation.¹⁶⁴ Calculating the weighted average of salary and so-called performance-based compensation reveals that Intel targeted its level of executive compensation at the sixtieth percentile of its peer group, which includes, for example, Advanced Micro Devices, its chief competitor.¹⁶⁵ Benefiting from this target, Intel CEO Paul Otellini has seen his compensation rise dramatically from \$9.8 million in 2006, to \$11.54 million in 2007, to \$12.72 million in 2008.¹⁶⁶ The recession had no impact on Otellini's compensation despite a reduction in Intel's net income from \$6.98 billion in 2007 to \$5.29 billion in 2008.¹⁶⁷

Not to be outdone by rival Intel, Advanced Micro Devices has established a target level of executive compensation between the fiftieth percentile and the seventy-fifth percentile of its peer group, which of course includes Intel. Always exceeding the average compensation paid by their peers, companies compete in an executive-compensation ping-pong match.

Weighted most heavily with options, equity awards account for most executive compensation because tying compensation to a company's stock price supposedly creates an incentive to improve performance.¹⁷⁰ By delaying the vesting of such awards over a period of several years, some companies seek to discourage executives from launching risky strategies that may result in ephemeral surges in stock prices.¹⁷¹ When executive pay is linked to metrics such as stock price or operating income, however, executive compensation may depend

^{163.} Id.

^{164.} Id. at 26.

^{165.} Id. at 22.

^{166.} Id. at 34.

^{167.} See Intel Corp., Annual Statement (Form 10-K), at 56 (Feb. 23, 2009).

^{168.} See Advanced Micro Devices Notice, supra note 156, at 24.

^{169.} *Id.* at 23. Dell targets the seventy-fifth percentile of the compensation of its peer group, which includes both Advanced Micro Devices and Intel. Dell, Notice of Annual Meeting and Proxy Statement 20 (2009) [hereinafter Dell Notice]. Intel includes Dell in its peer group. *See* Intel Notice, *supra* note 56, at 22.

^{170.} See, e.g., INTEL NOTICE, supra note 56, at 19 (explaining that Intel's objective in awarding stock equity as compensation is to align the interests of Intel's executives with the interests of its shareholders).

^{171.} See id. ("Annual equity awards generally vest in 25% annual installments over four years. Long-term equity awards generally vest in full on the fifth anniversary of the grant date.").

on market forces that have little, if anything, to do with managerial performance. 172

To reflect executive performance more accurately, performance-based criteria for compensation must be qualitative. The compensation committee must assess the contributions of the executive, excluding external forces such as market conditions. The assessment of an executive's annual performance might take into account the executive's innovative ideas and initiatives, problem solving, crisis management, and consensus building. All these performance measures are subjective and hard to evaluate. Nevertheless, shareholders would want to know the reasons for judgments made by directors. They will not find them in the CD&A. Item 402 does not require the disclosure of subjective assessments. Furthermore, detailed performance metrics, whether qualitative or quantitative, likely fit under the Item 402 reporting exemption for confidential information that might cause "competitive harm." 173

By failing to disclose performance standards, companies camouflage the reasons for their compensation decisions, and shareholders find it difficult, if not impossible, to evaluate those decisions. Performance-based goals that do appear in the CD&A are easily manipulated to ensure robust pay raises. Directors may set performance goals at levels that executives are almost certain to attain. A company will declare self-righteously in its CD&A that it bases executive compensation primarily on performance-based measures because they align the interests of shareholders with executives.¹⁷⁴ Equity grants—options and particularly restricted stock—are supposedly performance-based, but companies turn them into guaranteed windfalls. If the value of the stock and options falls, new bundles of equity will be granted in succeeding years—restricted stock at lower market prices and options at lower strike prices.¹⁷⁵ Though vesting may be delayed, sooner or

^{172.} See supra note 57 and accompanying text.

^{173.} See 17 C.F.R. § 229.402 (2006), Instructions to Item 402(b) ("Registrants are not required to disclose target levels with respect to specific quantitative or qualitative performance-related factors . . . or any other factors or criteria involving confidential trade secrets or confidential commercial or financial information").

^{174.} See, e.g., Dell Notice, supra note 169, at 18 (expressing the goal of "[h]eavily weighting the compensation package towards long-term, performance-dependent incentives to better align the interests of executives with stockholders"); Intel Notice, supra note 56, at 19 (highlighting the objective of aligning executive officers' interests with those of stockholders).

^{175.} See, e.g., Dell Notice, supra note 169, at 32–33 tbls. (showing that the exercise prices of options granted in 2009 had substantially lower exercise prices than did unexercised options granted in prior years); INTEL NOTICE, supra note 56, at 34, 40–41 tbls. (same with respect to Intel options awarded in 2009); Time Warner Notice, supra note 60, at 83

later the stock will rise, and management will prosper despite its failures.

In the final analysis, the "principles-based" disclosure approach fails to provide the information that shareholders need to evaluate the propriety of compensation decisions. Despite the best intentions of the SEC, the system, in practice, has devolved into an intricate sham. Companies have defeated the aspirations of "principles-based" disclosure by reverting to a more sophisticated brand of boilerplate.

The mandatory disclosures have not tempered the brazenness of some companies to overpay their top executives. Bank of America is a startling example. Agencies of the U.S. government agreed to absorb 90% of losses exceeding \$10 billion resulting from a \$118 billion pool of Bank of America's troubled assets. The Department of the Treasury also committed \$20 billion in TARP funds to rescue the bank from the brink of financial ruin. The bank's earnings plummeted from about \$15 billion in 2007 to about \$4 billion in 2008, and its stock price plunged from \$41.26 at the end of 2007 to \$14.08 at the end of 2008. In response to this financial distress, the bank slashed the quarterly dividend on its common stock from a high of \$2.56¹⁷⁹ to a lonely penny per share. Nevertheless, Bank of America must have regarded its troubles as a minor setback: CEO Kenneth Lewis's total compensation in 2008 was nearly \$10 million, and Joe Price, the Chief Financial Officer ("CFO"), made over \$4 million.

Some would argue that, in a time of near financial collapse, Bank of America needed to maintain multimillion dollar compensation levels to retain experienced management. Cynical shareholders might complain, however, that the company would benefit from rid-

⁽explaining that the fair value of restricted stock and restricted stock units represents the average of the high and low prices of Time Warner common stock on the grant date).

^{176.} See Bank of America Corp., 2008 Annual Report 58 (2009) [hereinafter Bank of America 2008 Annual Report] (explaining that "the U.S. government has agreed in principle to provide protection against the possibility of unusually large losses on \$118.0 billion in selected capital markets exposure"); see also Peter Barnes & Joanna Ossinger, BofA to Get \$20B More from TARP, Plus Backstop on \$118B, Fox Bus., Jan. 16, 2009, http://www.foxbusiness.com/story/markets/industries/finance/bofa-shares-falter-reports-needs-new-tarpmoney/ (noting that 90% of Bank of America's eligible losses exceeding \$10 billion will be absorbed by the government).

^{177.} Barnes & Ossinger, supra note 176.

^{178.} Bank of America 2008 Annual Report, supra note 176, at 28.

^{179.} Kate Gibson, S&P 500 Investors Face Dismal Dividends in 2009, WALL St. J. MARKET WATCH, Jan. 16, 2009, http://www.marketwatch.com/story/bank-of-americas-dividend-cut-one-of-many-facing-investors.

^{180.} Bank of America 2008 Annual Report, supra note 176, at 59.

^{181.} Bank of America Corp., Notice of 2009 Annual Meeting of Stockholders 27 (2009).

ding itself of the very managers who led it to the event horizon of a financial black hole. Such shareholders might argue that managers responsible for the company's distress should receive a symbolic dollar for their trouble. A dollar would be one hundred times the dividend.

The SEC's disclosure system does not shield directors from the pressures, both financial and psychological, that affect their decision-making. They cloak their decisions in self-serving platitudes in the CD&A that purport to align management and shareholder interests, and they establish performance-based compensation arrangements that are supposed to be blind to undue influence. All the disclosures imaginable will not repair the broken fiduciary model.

Despite the inadequacies of the disclosure approach, a fastidious shareholder might defy the odds, analyze the proxy disclosures, and discover objectionable decisions. Such a shareholder might seek a judicial remedy. As shown below, however, the courts have been inhospitable to such claims. 182

IV. APPROACH THREE: LITIGATION

The litigation approach would initially seem promising. The judicial system is notorious for granting relief to those who press even the most inconsequential grievances. One would expect such a welcoming judiciary to provide a remedy for valid claims of corporate waste and breach of fiduciary duty. The courts, however, turn uncharacteristically conservative when shareholders, or government agencies acting on their behalf, challenge the conduct of corporate directors. Judges use procedural devices to rid themselves of such cases before plaintiffs have the opportunity to reveal director neglect or complicity in authorizing the payment of windfalls to executives. Even when courts pay attention, they usually find director misconduct not quite bad enough to justify judicial intervention. Once having condoned the directors' misconduct, the courts will not even consider

^{182.} See infra Part IV.

^{183.} In a recent class action, the California Superior Court for the County of Los Angeles approved a settlement agreement awarding *up to* \$22.50 to iPod purchasers who would certify the following under penalty of perjury: "I declare that I experienced scratching of my iPod nano that impaired my use or enjoyment of my iPod nano." Apple First Generation iPod nano Class Action Settlement Reminder: Claim Filing Deadline June 10, 2009, Claim Form Attached (April 2009) (on file with author). A judicial system generous enough to allow settlement of the claims of scratched iPod users should embrace claims of shareholders charging executives with plundering corporations for tens and even hundreds of millions of dollars.

dizzying numbers that stun ordinary people but not the judicial temperament.

A. Contours of the Business Judgment Rule

The primary culprit is the business judgment rule. Designed to protect officers and directors from shareholder meddling, this rule has stymied challenges to excessive executive compensation. A notable case applying the business judgment rule, Unocal Corp. v. Mesa Petroleum Co., 184 involved a hostile tender offer launched by Mesa for Unocal stock. The *Unocal* court characterized the business judgment rule as "a 'presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." 185 As long as directors do not act in their self-interests and have even a tenuous basis to support their decision, the rule prevents courts from evaluating the merits of that decision. The court emphasized that "[a] hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.' "186 Unocal makes clear how completely courts defer to corporate decisionmakers.

B. Justifications for the Rule

Courts have articulated several rationales for the business judgment rule. Some are more persuasive than others. One rather weak justification is that shareholders know or should know the risk-taking profiles of corporate directors before buying stock. Such shareholders, therefore, voluntarily accept the risk of faulty judgments the directors ultimately make. This justification, however, applies equally to anyone hired to perform a service, and yet no equivalent to the business judgment rule protects doctors, lawyers, shoemakers, or

^{184. 493} A.2d 946 (Del. 1985).

^{185.} Id. at 954 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

^{186.} Id. (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

^{187.} See generally D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation*, 81 Tul. L. Rev. 829, 839–63 (2007) (criticizing the rationales offered for the business judgment rule and concluding that "the Rule is a poorly understood piece of legal doctrine").

^{188.} See, e.g., Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982) (listing risk of bad business judgment voluntarily undertaken by shareholders as a rationale for the business judgment rule). The court also pointed out that judges should not second-guess directors who must often make decisions under pressure with imperfect information. *Id.* at 886. Many professionals, however, such as a surgeon encountering a crisis during an operation, also make decisions under pressure. Yet surgeons are held to a negligence standard of malpractice.

hairdressers. Judge Learned Hand has provided a response to this criticism by observing that "[d]irectors are not specialists, like lawyers or doctors. . . . They are the general advisors of the business, and if they faithfully give such ability as they have to their charge, it would not be lawful to hold them liable." ¹⁸⁹ Judge Hand's explanation goes only so far. Some inside directors hold themselves out as experts in running the affairs of the corporations they control. After years at the corporate helm, their experience and knowledge are analogous to the expertise of doctors or lawyers.

Ironically, another rationale, which clashes with the first, argues that judges and juries lack the knowledge to question the expert business judgments of directors. The court in *In re Caremark International Inc. Derivative Litigation*¹⁹⁰ reasoned that a more stringent rule "would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests." Judges and juries, however, evaluate conflicting expert testimony in complex professional malpractice actions. They analyze economic data in antitrust lawsuits and choose between rival statistical methodologies in discrimination cases. It is unclear why a judge or layperson can decide such cases more easily than those challenging business decisions. ¹⁹²

A more convincing justification for the business judgment rule is that exposing such decisions to a penetrating level of scrutiny would inhibit corporate risk-taking.¹⁹³ To maximize shareholder value, directors must take chances. This justification for the rule becomes

^{189.} Barnes v. Andrews, 298 F. 614, 618 (S.D.N.Y. 1924) (exonerating director from liability for failure of corporate enterprise).

^{190. 698} A.2d 959, 971–72 (Del. Ch. 1996) (characterizing as "extremely weak" allegations that directors breached duty of due care by failing to institute corrective measures for regulatory violations and criminal conduct of drug company because the record did not support the conclusion that the directors lacked good faith in carrying out their supervisory responsibilities or that they knowingly acquiesced in a violation).

^{191.} Id. at 967; see also E. Norman Veasey & Julie M.S. Seitz, The Business Judgment Rule in the Revised Model Act, the Trans Union Case and the ALI Project—A Strange Porridge, 63 Tex. L. Rev. 1483, 1485 (1985) (noting that courts are not qualified to make corporate business decisions).

^{192.} See Telman, supra note 187, at 841–42 (observing that judges rely on expert testimony in resolving complex issues raised in non-business litigation).

^{193.} The court in In re Caremark observed:

It is doubtful that we want business men and women to be encouraged to make decisions as hypothetical persons of *ordinary* judgment and prudence might. The corporate form gets its utility in large part from its ability to allow diversified investors to accept greater investment risk. If those in charge of the corporation are to be adjudged personally liable for losses on the basis of a substantive judgment based upon what an [sic] persons of ordinary or average judgment and average risk assessment talent regard as "prudent" "sensible" or even "rational,"

even more persuasive when one recognizes the prominent role that guesswork plays in business decisionmaking. A doctor treats a condition with medications recommended in the *Physicians' Desk Reference*, a lawyer responds to a complaint with a motion to dismiss for failure to state a claim. In both circumstances, the approaches are established by professional standards. When a soft drink company decides to manufacture and market a new age beverage, it is not relying on a manual or code. Directors are paid to rely on their informed hunches. They are expected to outpace their competitors. Shareholders should not complain when a calculated gamble does not work out.

There is another sensible rationale for the business judgment rule. The stock of a publicly traded corporation may be dispersed among tens of thousands of shareholders. Any may commence a derivative suit. If the judiciary welcomed the claims of disgruntled shareholders, every corporate decision would be captive to their whims. 195

C. Abuse of the Rule

The business judgment rule applies to claims of excessive executive compensation. As a result, the business judgment rule has

such persons will have a strong incentive at the margin to authorize less risky investment projects.

698 A.2d at 967–68 n.16; see also Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors."). But see Telman, supra note 187, at 848 (noting that directors are protected from personal liability by doctrines apart from the business judgment rule, such as the right to indemnification). Alternative forms of legal cover for directors, however, do not invalidate the policy of encouraging corporate risk-taking. One might argue about the method, but the need is compelling to provide some effective protection for directors. Moreover, indemnification provides a circuitous and therefore inefficient route to protect directors. If directors should not be liable for certain business decisions, the law should absolve them of responsibility rather than hold them liable but permit the corporation to indemnify or insure them.

194. See Berle & Means, supra note 29, at 47–50 (discussing the inconsequential equity holdings of passive investors in major corporations).

195. But see Telman, supra note 187, at 849 (noting that at least fourteen states require shareholders with small equity interests to post bonds to cover corporate expenses and attorneys' fees when instituting derivative suits).

196. In addition to the justifications already discussed, a specific rationale for applying the rule to compensation claims is that the law should afford directors broad discretion so that corporations can attract top-level talent. See In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 75 (Del. 2006) ("The approval of the NFT [no-fault termination] provisions in the OEA [Ovitz Employment Agreement] had a rational business purpose: to induce Ovitz to leave CAA [Creative Artists Agency], at what would otherwise be a considerable cost to him, in order to join Disney."); Jennifer S. Martin, The House of Mouse and Beyond: Assessing the SEC's Efforts to Regulate Executive Compensation, 32 Del. J. Corp. L. 481, 499, 506–07

shielded directors from claims challenging even the most egregious compensation decisions. 197

People v. Grasso¹⁹⁸ is a striking example of how the courts use the business judgment rule to reject claims of excessive executive compensation. Richard Grasso was the CEO and Chairman of the Board of the NYSE, which was then a not-for-profit corporation.¹⁹⁹ During his tenure from 1995 until his resignation in September 2003, the Board of Directors lavished him with over \$200 million in compensation.²⁰⁰ Outrage over Grasso's exorbitant compensation forced him to resign.²⁰¹ After an internal investigation, the Interim Chairman of the NYSE requested, in writing, that the SEC and New York State Attorney

(2007) (criticizing the decision in *In re Walt Disney Co.* for concluding that "[w]here the payments at issue are related to rational business attempts to attract executive talent, there is no waste").

197. See, e.g., Cohen v. Ayers, 596 F.2d 733, 743 (7th Cir. 1979) (affirming dismissal of the complaint alleging that Sears directors wasted corporate assets by issuing repriced options to replace previously issued "underwater" options); In re Walt Disney Co., 906 A.2d at 39-41, 58 (upholding a \$130 million severance package to Michael Ovitz after only fourteen months of largely unsatisfactory service to Disney despite substantial evidence that Michael Eisner rammed the agreement containing the severance package through the compensation committee and board of directors); Grimes v. Donald, 673 A.2d 1207, 1214-15 (Del. 1996) (affirming dismissal of the claims that directors breached the duty of care and wasted corporate assets by entering into an employment agreement with a CEO entitling him to \$20 million in the event of constructive discharge); Mlinarcik v. E.E. Wehrung Parking, Inc., 620 N.E.2d 181, 183-84 (Ohio Ct. App. 1993) (rejecting shareholders' claim, despite expert witness's testimony, that two directors of the closely held corporation voted to pay themselves a total of \$18,000 annual compensation for services worth between \$576 and \$2000); Arthur R. Pinto & Douglas M. Branson, Understand-ING CORPORATE LAW 241 (2d ed. 2004) (concluding that "executive compensation cases in publicly traded corporations are rarely successful"); Telman, supra note 187, at 872 (noting that the courts rarely sustain shareholder claims alleging excessive executive compensation); Randall S. Thomas & Kenneth J. Martin, Litigating Challenges to Executive Pay: An Exercise in Futility?, 79 WASH. U. L.Q. 569, 605 (2001) (concluding that, although shareholder compensation cases, particularly those involving close corporations, are more successful than widely perceived, "derivative suits do not generally appear to be a strong check on executive pay," and that if shareholders "want to challenge executive pay more forcefully, we believe that they will need to find alternative methods of policing executive compensation practices"); see also infra notes 198-231 and accompanying text. But see Michelson v. Duncan, 407 A.2d 211, 216-17 (Del. 1979) (holding that shareholders' complaint met minimal pleading standards in alleging that option grants to key employees, including a number of directors, constituted corporate waste).

198. 893 N.E.2d 105 (N.Y. 2008).

199. Id. at 105-06.

200. *Id.*; Editorial, *Chasing Mr. Grasso's Millions*, N.Y. TIMES, May 26, 2004, at A22 ("The story of how Mr. Grasso earned more than \$200 million in less than a decade leading the nonprofit stock exchange seems to involve two of the more destructive trends of the recent Wall Street bubble: shameless C.E.O. greed and a total breakdown in corporate governance.").

201. Grasso, 893 N.E.2d at 107.

General pursue the matter further.²⁰² The New York State Attorney General at that time, Eliot Spitzer, embarked on a crusade to compel Grasso to disgorge some of those funds.²⁰³

The Attorney General commenced a lawsuit, alleging six causes of action against Grasso.²⁰⁴ All of the claims asserted that payments contemplated under a 2003 compensation agreement between Grasso and the NYSE were unreasonably excessive, and therefore contrary to provisions of the Not-For-Profit Corporation Law.²⁰⁵ Four of these claims arose from common law,²⁰⁶ and the remaining two claims were statutory.²⁰⁷

The complaint pointed out that beginning in 1995, Grasso received an annual salary of \$1.4 million plus annual bonuses that escalated from \$900,000 in 1995 to \$10.6 million in 2002. ²⁰⁸ Even more striking, Grasso's total compensation of \$130.3 million from 2000–2002, including salary, bonuses, and benefits, nearly equaled the NYSE's total profits of \$132.8 million for the same period. ²⁰⁹

Given this backdrop, the lawsuit challenged the 2003 compensation agreement between Grasso and the NYSE.²¹⁰ To compensate Grasso for future work and to reward him for past accomplishments for which he had already been handsomely compensated, this agreement provided Grasso with a lump sum payment of \$139.5 million supplemented by another \$48 million payable over four years.²¹¹

^{202.} Id.

^{203.} *Id.*; see also Chasing Mr. Grasso's Millions, supra note 200 ("When they were not being duped, the Wall Street notables on the exchange's board were being intimidated, according to Mr. Spitzer's allegations. Mr. Grasso regulated the trading firms many of his board members ran—a sordid conflict of interest, since resolved by the exchange's reforms.").

^{204.} Grasso, 893 N.E.2d at 107.

^{205.} *Id.* at 106–07. Numerous Sections of the Not-For-Profit Corporation Law empowered the Attorney General to commence actions to enforce shareholder rights including claims of corporate waste and breach of fiduciary duty. *Id.* at 108.

^{206.} *Id.* at 107. These claims alleged (1) a constructive trust, (2) payment had and received, (3) the right to restitution, and (4) a violation of the prohibition of loans to officers. *Id.*

^{207.} Id.

^{208.} *Id.* at 106; *see also* Joseph E. Bachelder III, *New York Courts Dismiss 'Grasso' Compensation Case*, N.Y. L.J., Aug. 27, 2008, at 3 (explaining that "the compensation and benefits for Mr. Grasso expensed over the period of 2000–2002 equaled slightly less than 100 percent of the New York Stock Exchange's (NYSE) net income over this same period" (citation omitted)). Bachelder suggests, "This case appeared to offer an ideal opportunity for New York courts to address the issue of what is reasonable compensation. It had all the earmarks of an egregious case of overpayment of compensation to an executive together with evidence of dubious corporate behavior in the setting of that compensation." *Id.*

^{209.} Bachelder, supra note 208, at 3.

^{210.} Grasso, 893 N.E.2d at 106.

^{211.} Id. Grasso never collected the \$48 million payout. Jenny Anderson, Stock Exchange's Former Chief Wins Court Battle to Keep Pay, N.Y. Times, July 2, 2008, at A1.

The complaint did not merely challenge the excessiveness of the 2003 compensation agreement. It also charged that the agreement resulted from overreaching and deception. Grasso had hand-picked members of the Compensation Committee, some of whom were subject to his regulatory authority. He even allegedly intimated to a Compensation Committee member that if the member supported the 2003 agreement, Grasso would assist him in his dealings with the NYSE. These members of the Compensation Committee approved Grasso's compensation package, although it violated NYSE benchmarks. In addition, the complaint alleged that the information provided to the NYSE's Compensation Committee and Board of Directors about the compensation package was "inaccurate, incomplete and misleading."

Grasso and his cronies also allegedly committed procedural improprieties. Several board members disapproved of the \$139.5 million lump sum payment. Because of these concerns, the proposal to approve that payment was excluded from the agenda of the August 7, 2003, meetings of the Compensation Committee and the Board of Directors. The complaint alleged that, as a result of the removal of this item from the agenda, neither corporate counsel nor opponents of the payment attended these meetings. Yet, approval of the compensation package was belatedly inserted into the agendas of the August 7 meetings, and the board approved the payment, though its members allegedly had no opportunity to review the details of the compensation package before voting to approve it. 220

Grasso moved to dismiss the four common-law claims alleged in the Attorney General's complaint. 221 New York Supreme Court Jus-

^{212.} Grasso, 893 N.E.2d at 106.

⁹¹³ *Id*

^{214.} People v. Grasso, 836 N.Y.S.2d 40, 55 (N.Y. App. Div. 2007) (Mazzarelli, J., dissenting), aff'd, 893 N.E.2d 105 (N.Y. 2008).

^{215.} Grasso, 893 N.E.2d at 106. In 1996, the Compensation Committee adopted a formal policy to align executive compensation with that paid to senior management of large, for-profit companies. *Id.* at 106 n.2. The purpose of this policy was to attract "world class talent." *Id.* (internal quotation marks omitted). Grasso's compensation package, however, exceeded the benchmark by 64% in 1999, by 141% in 2000, and by 65% in 2001. *Id.* at 106.

^{216.} Id. at 106.

^{217.} Id.

^{218.} Id.

^{219.} Id.

^{220.} Id.

^{221.} Id. at 107.

tice Ramos denied the motion.²²² He offered this thoughtful explanation for his decision:

The investing community relies on the integrity of the market as well as the NYSE's governance and regulatory structure which serves it. It is this regulatory power possessed by the NYSE which the Attorney General alleges Mr. Grasso used, or refrained from using, to the detriment of the independence of the NYSE Board and its Compensation Committee. . . . The interests of investors, individual or institutional, are the proper subjects of the Attorney General's responsibility. ²²³

The Appellate Division reversed the order of Justice Ramos, holding that the Attorney General's authority was limited to statutory claims, and therefore, that the Attorney General lacked authority to assert common-law claims.²²⁴

Affirming the Appellate Division's order dismissing the complaint, the New York State Court of Appeals relied on the business judgment rule. The court observed that the Not-For-Profit Corporation Law "provides that officers and directors must discharge 'the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." Officers and directors who meet these duties are immune from liability. The court concluded that the Attorney General did not allege bad faith or knowledge of wrongdoing sufficient to overcome the business judgment rule. Thus, the court found the common-law claims legally insufficient "however unreasonable [the] compensation may seem on its face."

^{222.} *Id.*; People v. Grasso, 816 N.Y.S.2d 863, 877 (N.Y. Sup. Ct. 2006), *rev'd*, 836 N.Y.S.2d 40 (N.Y. App. Div. 2007), *aff'd*, 893 N.E.2d 105 (N.Y. 2008).

^{223.} Grasso, 816 N.Y.S.2d at 871.

^{224.} *Grasso*, 836 N.Y.S.2d at 53. Justice Mazzarelli dissented. *Id.* (Mazzarelli, J., dissenting). She argued that the Attorney General had parens patriae authority to protect the public from a loss of confidence in the NYSE, which is vital to the national economy. *Id.* at 56.

^{225.} Grasso, 893 N.E.2d at 108.

^{226.} Id. (citation omitted).

^{227.} Id.

^{228.} Id. at 109-10.

^{229.} *Id.* at 110. The two remaining statutory claims did not survive for long. The Appellate Division dismissed them in a subsequent decision because the NYSE had merged into a for-profit corporation. People v. Grasso, 861 N.Y.S.2d 627, 636 (N.Y. App. Div. 2008). Derived from the not-for-profit status of the NYSE, the Attorney General's jurisdiction to prosecute these claims lapsed with the merger. *Id.* The court stressed that, after the merger, the public interest was no longer at stake in the lawsuit. *Id.* at 639–40.

The court was right to a point. The law should not provide a forum for quibbling shareholders. Decisions setting executive compensation, however, are not ordinary business judgments because the interests of shareholders and management clash. The misconduct alleged in Grasso was particularly egregious. The Attorney General, representing the public interest, alleged wrongdoing that the courts should have scrutinized and remedied. Instead the case was dismissed on pretrial motions.²³⁰ If the courts had condemned Grasso's tactics and compelled him to return the ransom he had extracted from the NYSE, other corporate executives might refrain from wringing every last million out of their corporations. They might settle for a paltry million or two. Instead the courts in Grasso seemed too squeamish to confront the alleged abuses. Although the case began with a public outcry, by the time Attorney General Andrew Cuomo announced his intention not to institute a futile appeal from the Appellate Division's order dismissing the statutory causes of action, the public's anger after five years of litigation—had faded to a grumble of discontent.²³¹

D. Pre-Suit Demands on the Board of Directors

To commence derivative suits, shareholders must either make demand on the board of directors to institute legal proceedings and be refused, or show that demand is excused. In *In re Citigroup Inc. Shareholder Derivative Litigation*, shareholders brought a derivative suit arising from massive losses sustained by Citigroup in the current financial crisis. Excusing demand in this case, the court articulated the relevant legal standard.

In *In re Citigroup Inc.*, shareholders charged certain officers and directors of the financial giant with wasting \$2.7 billion of its funds by authorizing the purchase of subprime loans.²³⁶ The suit also alleged

^{230.} Grasso, 893 N.E.2d at 107-08.

^{231.} See Anderson, supra note 211. New York State Attorney General Andrew Cuomo, the successor to Eliot Spitzer, issued a statement that he would not appeal the Appellate Division's decision to the New York Court of Appeals. *Id.* This statement effectively ended the *Grasso* litigation saga.

^{232.} See infra notes 235-58 and accompanying text.

^{233. 964} A.2d 106 (Del. Ch. 2009).

^{234.} Id. at 111.

^{235.} See id. at 120-21, 138 (articulating the requirement of either making a pre-suit demand or pleading facts showing that demand is futile).

^{236.} *Id.* at 111. The complaint also asserted claims of corporate waste against certain officers and directors for (1) authorizing Citigroup's stock repurchase program in the first quarter of 2007, which resulted in the repurchase of shares at inflated prices, and (2) allowing the company to invest in structured investment vehicles, which failed to pay off maturing debt. *Id.* at 111–12.

that a severance package provided to departing CEO Charles Prince wasted corporate funds.²³⁷ The severance package included \$68 million in bonus, salary, and accumulated stock holdings.²³⁸ It also provided Prince with an office, an administrative assistant, and a car and driver.²³⁹ In exchange, Prince agreed to standard provisions, including non-competition, non-solicitation, and non-disparagement clauses, and a release of claims against Citigroup.²⁴⁰ Shareholders argued that this compensation package was grossly excessive given that Prince allegedly shared blame for Citigroup's massive losses.²⁴¹

The court noted that the board of directors of a corporation is empowered to commence lawsuits on behalf of the corporation.²⁴² The right of shareholders to bring derivative suits arises when they plead facts showing that the board of directors wrongfully refused a demand to commence an action.²⁴³ Demand on the board is excused when there is a reasonable doubt that the directors are disinterested in the lawsuit or that the business judgment rule would shield them from liability.²⁴⁴

To overcome the business judgment rule, a claim of corporate waste must allege that the challenged compensation was unconscionably disproportionate. Expressing a "reasonable doubt" that the board could defeat the claim that Prince's severance package was unconscionable, the court excused pre-suit demand. This result did not mean that the shareholders would prevail. The shareholders merely survived the motion to dismiss.

^{237.} Id. at 111-12.

^{238.} Id. at 138.

^{239.} *Id.* The right to a car and driver was for the lesser of five years or until he found new employment. *Id.*

^{240.} Id.

^{241.} Id.

^{242.} Id. at 120.

^{243.} Id.

^{244.} *Id.*; see Aronson v. Lewis, 473 A.2d 805, 814–15 (Del. 1984) (holding that demand is excused when there is a reasonable doubt that the directors are independent and disinterested and that the business judgment rule would protect them), overruled in part on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

^{245.} In re Citigroup Inc., 964 A.2d at 138 (citing Brehm, 746 A.2d at 262 n.56); see also Grimes v. Donald, 673 A.2d 1207, 1214–15 (Del. 1996) (dismissing claims that directors breached the duty of care and wasted corporate assets by entering into an employment agreement with the CEO entitling him to \$20 million in the event of constructive discharge), overruled by Brehm, 746 A.2d 244.

^{246.} In re Citigroup Inc., 964 A.2d at 138.

The pre-suit demand requirement scuttled a claim of corporate waste brought in *Zupnick v. Goizueta*.²⁴⁷ In that case, Coca-Cola's board of directors granted company CEO, Roberto Goizueta, options to purchase one million shares of Coca-Cola's common stock at the market price on the date the options were issued.²⁴⁸ The options were not exercisable for one year, after which they vested over the next three years.²⁴⁹

Plaintiff commenced a shareholder's derivative suit, alleging that the board awarded the options to Goizueta for past performance for which he had already been generously compensated.²⁵⁰ The complaint emphasized that Goizueta would receive the options even if he chose to retire immediately.²⁵¹ Conceding these points, the board responded that the option grant was a reasonable bonus for Goizueta's outstanding prior service to the company.²⁵² During his stewardship as CEO beginning in March 1981, the value of Coca-Cola stock had increased by nearly \$69 billion.²⁵³

The directors moved to dismiss the complaint because the plaintiff had not made a pre-suit demand on the board.²⁵⁴ The plaintiff argued that demand was excused because the board would not have sued itself.²⁵⁵ The court found this argument unpersuasive.²⁵⁶ It reasoned that a non-fraudulent transaction would rarely, if ever, meet the legal standard for a claim of corporate waste.²⁵⁷ Because the business

^{247. 698} A.2d 384, 385 (Del. Ch. 1997); see also Aronson, 473 A.2d at 808–09, 818 (granting defendants' motion to dismiss the complaint for failure to make demand on the board of directors where the board was charged with entering into a lucrative lifetime consulting agreement with a retiring controlling shareholder and providing him with \$225,000 of interest free loans, which he repaid after the suit was commenced).

^{248.} Zupnick, 698 A.2d at 385.

^{249.} Id.

^{250.} Id. at 386.

^{251.} *Id.* at 385. Goizueta elected to continue as CEO despite his right to retire and receive the options. *Id.* at 385–86.

^{252.} Id. at 386.

^{253.} *Id.* at 388. The court did not discuss how much of the increase in the value of Coca-Cola stock was attributable to Goizueta's leadership rather than to general market conditions, growth of the soft drink industry, or other factors. *See id.*

^{254.} Id. at 386.

^{255.} See id. ("[The plaintiff claimed] that the option grant itself was wasteful and not protected by the business judgment rule [and that he was excused from the demand requirement].").

^{256.} Id. at 387.

^{257.} See id. ("'But rarest of all—and indeed like Nessie, possibly non existent—would be the case of disinterested business people making non fraudulent deals . . . that meet the legal standard of waste!'" (quoting Steiner v. Meyerson, Civ. A. No. 13139, 1995 WL 441999, at *5 (Del. Ch. July 19, 1995))).

judgment rule would almost certainly shield the directors against such a claim, the court did not excuse pre-suit demand.²⁵⁸

V. APPROACH FOUR: TAX INCENTIVES

The absence of a judicial watchdog has emboldened the corporate wolves. Tax policy is a tool that the federal government uses to encourage behavior deemed socially desirable. The federal tax code therefore contains incentives to shape compensation practices.

A. Section 162(m)

Public outcries over skyrocketing executive compensation spurred Congress to enact Section 162(m) in 1993.²⁵⁹ The purpose of the Section was to discourage corporations from providing ever-increasing levels of executive pay, while encouraging them to link pay to performance.²⁶⁰ Unfortunately, Section 162(m) has failed to achieve either purpose.

1. Essential Provisions

Section 162(m) redefined eligibility for the federal tax deduction for executive pay. Before passage of this provision, the reasonable costs of compensation were deductible as business expenses.²⁶¹ The reasonableness standard had been used principally to disallow the deduction of dividends paid by closely held corporations.²⁶² Virtually all executive compensation was deemed reasonable and therefore deductible.

Section 162(m) introduced a cap of \$1 million on the deductibility of executive pay. 263 The Section provides an unlimited exception for performance-based compensation paid to the CEO and the next four most highly paid executives of publicly held companies. 264 To

^{258.} *Id.* at 389. The complaint was dismissed for two reasons—failing to allege a cognizable ground for corporate waste and failing to justify why a pre-suit demand was not made on the board. *Id.*

^{259.} I.R.C. § 162(m) (2006); see H.R. Rep. No. 103-111, at 646 (1993) ("Recently, the amount of compensation received by corporate executives has been the subject of scrutiny and criticism.").

^{260.} H.R. Rep. No. 103-111, at 646 (expecting that "excessive compensation will be reduced if the deduction for compensation (other than performance-based compensation) paid to the top executives of publicly held corporations is limited to \$1 million per year").

^{261.} *Id.* (observing that reasonableness "is determined on a case-by-case basis" but that the standard "has been used primarily to limit payments by closely-held companies where non-deductible dividends may be disguised as deductible compensation").

^{262.} Id.

^{263.} I.R.C. § 162(m)(1).

^{264.} Id. § 162(m)(3)-(4).

qualify as performance-based, compensation has to meet several conditions. The compensation has to be payable for the attainment of objective performance goals determined by a compensation committee composed of two or more outside directors. In addition, the material terms of the compensation arrangement must be disclosed to shareholders and approved by a majority vote of the shareholders. Before paying a covered executive the performance-based compensation, the compensation committee has to certify that the executive has met the performance goals. 267

Various forms of delayed equity compensation, including stock options, restricted stock, restricted stock units, and stock appreciation rights, are generally considered performance-linked under Section 162(m).²⁶⁸ Such awards qualify for the unlimited tax deduction because they presumably rise and fall with the financial success of the company and because the success of the company may be attributed, at least in part, to the performance of its principal officers. Neither in-the-money options nor options subject to repricing qualify for the unlimited deduction because they are only loosely tied to performance.²⁶⁹ At-the-money options, out-of-the-money options, and stock

265. Id. § 162(m)(4)(C). This Subsection provides:

The term "applicable employee remuneration" shall not include any remuneration payable solely on account of the attainment of one or more performance goals, but only if—(i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is composed solely of 2 or more outside directors, (ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration, and (iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and any other material terms were in fact satisfied.

Id.; see also Treas. Reg. § 1.162-27(e)(2) (1996) (providing that "[q]ualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals").

266. I.R.C. § 162(m)(4)(C)(ii).

267. Id. § 162(m)(4)(C)(iii). Certification was not required for out-of-the-money, at-the-money options or stock appreciation rights. H.R. Rep. No. 103-111, at 648–49.

268. See H.R. Rep. No. 103-111, at 648 (noting that stock options and stock appreciation rights generally qualify as performance-based compensation); David M. Schizer, Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility, 100 COLUM. L. Rev. 440, 468 n.101 (2000) ("The legislative history suggests that [the § 162(m)] performance-pay exception generally includes executive stock options." (citing H.R. Rep. No. 103-111, at 648)).

269. H.R. Rep. No. 103-111, at 649 (noting that if an executive is protected against a decrease in the value of the stock, the equity-based compensation is not covered by the performance-based exception); Murphy, *supra* note 81, at 863–64 (noting that "for option plans to qualify as performance-based compensation, the options must not be in the money when granted").

appreciation rights, all of which are presumptively tied to performance, qualify for deductibility even without committee certification.²⁷⁰ Bonuses paid under plans with objective performance-based criteria also qualify for the unlimited tax deduction.²⁷¹ Salaries and discretionary bonuses, however, are subject to the \$1 million deductibility limit.²⁷²

2. Backfire

Research has revealed that people are risk averse. They prefer the sure thing to speculation. Offered the choice between the guaranteed payment of a dollar and the 50% chance of the payment of two dollars, most people will take the guaranteed dollar.²⁷³ The two choices are equivalent in the value of the expected payout, but most people do not want to risk getting nothing. To induce an individual to accept the more risky alternative, the value of the uncertain payout must exceed the value of the guaranteed payout.²⁷⁴

Risk aversion affects the behavior of corporate managers. They will choose one dollar of salary to one dollar of stock options because the options may expire worthless. Even if the choice is between one dollar of salary and stock options worth somewhat more, some managers will still choose the salary.

Because of risk aversion, managers bargain for a higher value of options or other performance-based compensation than risk-free forms of compensation.²⁷⁶ Wishing to take advantage of the Section 162(m) performance-related tax deduction, companies award execu-

^{270.} H.R. Rep. No. 103-111, at 648 (noting that the requirements of director independence and shareholder approval must still be met).

^{271.} Treas. Reg. § 1.162-27(e)(2)(ii) (1996) (providing that a bonus is objective if it can be calculated by a third party based on specific performance results).

^{272.} Id. § 1.162-27(e)(2)(iii) (providing that compensation subject to upward discretionary adjustment does not qualify for the unlimited deductibility exception).

^{273.} See Bart De Langhe et al., The Emotional Information Processing System Is Risk Averse: Ego-Depletion and Investment Behavior 6 (2008), http://publishing.eur.nl/ir/repub/asset/13614/ERS-2008-064-MKT.pdf (noting that "most people irrationally reject a gamble with equal chances to win and lose, even when the expected value of gambling is larger than the expected value of the status quo").

^{274.} *Cf. id.* (describing the "long-standing rational, normative view on economic decision making in which consumers are described as economic actors that select alternative options with the highest expected utility or value").

^{275.} See Meredith R. Conway, Money for Nothing and the Stocks for Free: Taxing Executive Compensation, 17 Cornell J.L. & Pub. Pol'y 383, 408 (2008) (noting that corporate managers demand options worth more than they would have earned if paid a salary).

^{276.} Id.

tives a higher expected value of performance-based compensation than they would have awarded them in salary. 277

If the tax benefit exceeds the difference between the value of the performance-based compensation awarded instead of salary and the salary for which the performance-based compensation substituted, the company has a net savings. If, however, the tax benefit is less than that difference, the company has incurred a net loss. In the latter case, the company has a disincentive to opt for performance-based compensation. Should the company revert to salary to minimize its net cost, the purpose of Section 162(m)—to encourage performance-based pay—has been frustrated.²⁷⁸

Even though reverting to salary-based compensation would be the economically rational decision to avoid a loss, a company that did so might incur the disapproval of shareholders. They might feel that the company had betrayed their interests not only by failing to use an available tax benefit but also by declining to base executive pay on performance. To prevent shareholder discontent, a company might elect to incur a net loss and award the risk-averse executive the options or other performance-based compensation that he or she demands. In this case, the executive receives more compensation as a result of Section 162(m) than he or she otherwise would have received, and the Section fails in its other essential purpose—to lower executive compensation.²⁷⁹

Section 162(m) has backfired in other unexpected ways. Many directors view option grants as costless because such grants do not require a company to spend cash.²⁸⁰ Such directors are therefore overly generous when granting options to executives. Another problem is that the \$1 million cap has established a benchmark for CEO salaries.²⁸¹ Companies have therefore increased their CEOs' base pay

^{277.} See, e.g., Gregg D. Polsky, Controlling Executive Compensation Through the Tax Code, 64 Wash. & Lee L. Rev. 877, 898 (2007) (providing an example of the gross up of executive pay to offset the executive's risk aversion).

^{278.} See id. at 900-01 (analyzing the tax consequences of § 162(m) and providing an example of where using the § 162(m) tax deduction would impose a net loss on the company).

^{279.} See id. at 901 (observing that "the public might perceive deduction forfeiture as suggesting that boards are captured by management").

^{280.} See Ryan Miske, Note, Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Though the Tax Code, 88 Minn. L. Rev. 1673, 1690 (2004) (noting that many directors view options as being "costless" (internal quotation marks omitted)).

^{281.} See id. at 1687 (reporting that the \$1 million limit on the tax deductibility on non-performance-based executive pay has established "the government-sanctioned standard" for base salaries).

to meet that level. Third, unless vesting over a period of years, options and stock appreciation rights encourage executives to gamble on risky short-term strategies to raise the value of the stock and cause the options to spike. Such strategies are not likely to be in the long-term interests of a company. Yet, under the rules, grants of options and stock appreciation rights are presumptively performance-based. It is therefore both predictable and lamentable that public companies have gravitated toward option grants as their principal component of executive compensation.

The Section 162(m) standards for performance-based compensation are so permissive that they invite circumvention. The following is an example of a pay arrangement that meets the statutory criterion for objective performance-based pay:

This example provides a formula for the payment of undeserved bonuses.

The shareholder-approval requirement in Section 162(m) would seem to deter some of these abuses. The requirement, however, is largely ineffective. If a plan grants options or stock appreciation rights, the plan must merely disclose the maximum number of options or stock appreciation rights that an executive may receive. A company need not disclose the precise number of such grants contemplated for each executive. A company may even structure the

^{282.} See Conway, supra note 275, at 406 (observing that option grants lead to a decoupling of shareholder interests from management interests).

^{283.} See Treas. Reg. § 1.162-27(e)(2)(vi)(A) (1996). This provision states the following: Compensation attributable to a stock option or a stock appreciation right is deemed to satisfy the requirements [for deductibility] if . . . the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee

Id.

^{284.} *Id.* § 1.162-27(e)(2)(vii), ex. 3.

^{285.} Id. \S 1.162-27(e)(2)(vi)(A); see also Conway, supra note 275, at 402 (noting that the shareholder approval requirement of \S 162(m) has failed to help shareholders monitor or control executive compensation).

^{286.} See Treas. Reg. § 1.162-27(e)(2)(vi)(A) (requiring disclosure of the maximum but not the exact number of option grants an executive may receive).

plan so that shareholder reapproval is unnecessary when the company grants additional options or stock appreciation rights to an executive.

3. TARP Funds

The Emergency Economic Stabilization Act of 2008²⁸⁷ was Congress's initial response to the current financial crisis. The Act created the Troubled Assets Relief Program to provide relief to financially beleaguered financial institutions. TARP assistance came with conditions. One condition applies to public companies receiving at least \$300,000,000 in TARP funds. The tax deduction for the compensation of covered employees is limited to \$500,000. One must question whether billion-dollar public companies will observe this limit. In any event, the limitation applies only to TARP recipients.

4. Golden Parachutes and Severance Pay

Golden parachutes provide hefty payouts to executives who, because of mergers or sales of companies, are ousted from management. A rationale for golden parachutes is that they ensure the financial security of executives and therefore enable companies to recruit and to retain top-level management. Regardless of the efficacy of this rationale, the enormity of such payments aroused congressional action. To dissuade companies from entering into excessive golden parachute arrangements, Congress passed two tax provisions in 1984. Section 280G disallows companies from deducting excessive golden parachute payments made to highly compensated individuals, defined as (1) the highest paid 1% of employees, or (2) the most highly paid 250 individuals. Payments are deemed excessive if they are equal to or exceed three times the average salary of the recipient over the five-year period prior to the change in control. Section 4999 imposes a 20% excise tax on executives who receive golden

^{287.} Pub. L. No. 110-343, 122 Stat. 3765 (2008) (to be codified at 12 U.S.C. $\S 5201-5261).$

^{288. 12} U.S.C.A. § 5211(a)(1) (West 2001 & Supp. 2009).

^{289.} I.R.C. § 162(m)(5)(B)(i) (West 2002 & Supp. 2009).

^{290.} Id. § 162(m)(5)(A)(i).

^{291.} See id. § 162(m)(5) (setting forth "Special rule for application to employers participating in the Troubled Assets Relief Program").

^{292.} See id. § 280G(b)(2) (providing the statutory definition for golden parachutes).

^{293.} See Conway, supra note 275, at 414 (observing that many executives would not accept positions without inclusion of golden parachutes in their employment contracts).

^{294.} I.R.C. § 280G(a), (c) (LexisNexis 2009).

^{295.} Id. § 280G(b)(2)(A)(ii), (d)(2).

parachute payments exceeding the limits prescribed in Section $280G.^{296}$

Like Section 162(m), these provisions have failed to achieve their intended purpose. Many corporations persist in awarding excessive golden parachutes to executives.²⁹⁷ To counteract the effects of Section 4999, companies agree to pay the executives a "gross up," which is an additional payment to offset the 20% excise tax.²⁹⁸ The net effect of Sections 280G and 4999 is therefore to increase the cost of golden parachutes to corporations.

The Emergency Economic Stabilization Act has extended the golden parachute restrictions in Section 280G to severance pay provided to covered individuals working for corporations that have received TARP funds.²⁹⁹ The Act, however, will have limited impact because it applies only to TARP recipients.

In sum, tax incentives have failed to control executive compensation. As shown in Part VI, many reformers believe that tinkering with the rules of corporate governance would be more effective.

VI. APPROACH FIVE: CORPORATE GOVERNANCE

All the strategies previously discussed in this Article have failed to control executive compensation. There is a commonality to each of these approaches that explains, at least partly, why none has even remotely succeeded. Approaches that require third parties to protect shareholder interests—whether the third parties are directors, the SEC, the courts, or the framers of the tax code—are destined to fail. The most effective strategy to control executive compensation is to empower shareholders to protect themselves and the corporations they own. 300

^{296.} I.R.C. § 4999(a)-(b) (West 2009).

^{297.} See Conway, supra note 275, at 418–19 (noting that, despite § 280G, golden parachute arrangements are still part of executive compensation packages).

^{298.} Susan Lorde Martin, Executive Compensation: Reining in Runaway Abuses—Again, 41 U.S.F. L. Rev. 147, 148 (2006).

^{299.} I.R.C. \S 280G(e)(2)(B) (West 2002 & Supp. 2009). The restrictions apply to severance pay resulting from involuntary termination, bankruptcy, liquidation, or receivership. *Id.*

^{300.} See Lawton W. Hawkins, Compensation Representatives: A Prudent Solution to Excessive CEO Pay, 72 BROOK. L. REV. 449, 473–75 (2007) (suggesting ways shareholders can address excessive executive compensation). Recognizing that many corporate boards make compensation-related decisions that are not in the best interests of shareholders, Professor Hawkins proposes that shareholders objecting to their companies' excessive compensation practices amend company bylaws to authorize the three largest shareholders to appoint a "compensation representative." Id. at 473. The compensation representative would be entitled to attend compensation committee meetings and board of directors meetings where

This Article organizes corporate governance initiatives to control executive compensation into four broadening tiers. The first and least empowering is "say-on-pay." Appearing in some proxy statements, say-on-pay resolutions merely provide shareholders with an advisory vote on executive compensation. The American Recovery and Reinvestment Act of 2009³⁰² requires recipients of TARP funds to provide shareholders with annual say-on-pay votes, and the United Kingdom has adopted a say-on-pay law. Source initiatives to control executive compensation and shareholders with annual say-on-pay votes, and the United Kingdom has adopted a say-on-pay law.

The second tier of initiatives would enhance shareholder power by allowing them to nominate directors, who presumably would be more responsive to shareholder interests than adverse interests of management. This approach has gained support on several fronts. Delaware has enacted legislation to permit shareholders to participate in the nominating process, and the SEC has proposed new proxy rules that would achieve the same result.³⁰⁴

Illustrated by Senator Schumer's ambitious bill, the third tier incorporates a wide range of corporate governance provisions, including both say-on-pay and shareholder nomination provisions.³⁰⁵

The fourth and most radical tier would empower the federal government to regulate executive pay arrangements. Sponsored by Representative Barney Frank, the House has passed a bill that would grant federal regulators veto power over compensation arrangements that encourage excessive risk-taking.³⁰⁶ Senator Durbin has proposed another bill, which would cap executive pay at 100 times the average salary of company employees, unless shareholders voted for higher

he or she could offer opinions and advice on compensation-related issues and objections to board decisions. *Id.* at 474. All compensation-related information presented to the board, the compensation committee, and any compensation consultant would be available to the compensation representative. *Id.* If the compensation representation reached an impasse with the directors, the compensation representative could report his or her objections to the appointing shareholders. *Id.* After attempting to resolve the impasse, a shareholder could force the company to include an alternative to the contested board proposal, but shareholders would have only an advisory vote. *Id.* at 474–75. The shareholder proposal, Professor Hawkins notes, would be limited to 500 words under SEC Rule 14a-8. *Id.* at 477. Professor Hawkins's proposal, though intriguing, does not go far enough. Advisory votes would not shift meaningful power to shareholders, and 500-word statements would not afford protesting shareholders the opportunity to express fully their objections to the wide-ranging executive compensation packages proposed by directors. Nor would such short statements enable protesting shareholders to present and defend their counterproposals.

- 301. See infra Part VI.A.
- 302. Pub. L. No. 111-5, 123 Stat. 115 (to be codified in scattered sections of 26 U.S.C.).
- 303. See infra notes 313, 316-18 and accompanying text.
- 304. See infra Part VI.B.
- 305. See infra Part VI.C.
- 306. See infra Part VI.D.1.

pay arrangements.³⁰⁷ The statutory and regulatory scheme applied to recipients of TARP funds also includes limits on executive pay. In addition, this framework adopts numerous other corporate governance strategies such as mandatory say-on-pay and the enhancement of the independence and role of compensation committees.³⁰⁸

A. Say-on-Pay

Because of the public clamor over excessive executive pay, a growing number of public companies have elected to include say-on-pay resolutions in their proxy statements. In some cases, activist shareholders have compelled companies such as Time Warner and ConocoPhillips to include say-on-pay resolutions in their proxy statements, despite the opposition of these companies. While still in the Senate, President Obama, along with Representative Frank, sponsored say-on-pay legislation.

^{307.} See infra Part VI.D.2.

^{308.} See infra Part VI.D.3.

^{309.} Verizon, MBIA, H&R Block, Ingersoll Rand, Blockbuster, Tech Data, and TIAA-CREF have all agreed to include say-on-pay resolutions in their proxy statements. *See* Time Warner Notice, *supra* note 60, at 131 (listing companies that agreed to an executive compensation advisory vote); *see also* INTEL NOTICE, *supra* note 56, at 64 (recommending that shareholders vote "yes" on the following question: "Do you approve of the Compensation Committee's compensation philosophy, policies, and procedures as described in the 'Compensation Discussion and Analysis' section of this proxy statement?"). This question does not solicit shareholder opinions of actual amounts of compensation awarded to company executives.

^{310.} See Time Warner Notice, supra note 60, at 131-33 (outlining shareholders' request that Time Warner "adopt a policy that provides shareholders the opportunity at each annual shareholder meeting to vote on an advisory resolution . . . to ratify the compensation of . . . executive officers"). Time Warner opposed adoption of the resolution primarily on the ground that a regulatory framework, if adopted by the SEC or the stock exchanges, would be a better approach to provide shareholders with an advisory vote on executive compensation. Id. at 132. Time Warner argued that shareholders lack the information needed to make well-considered decisions on executive pay. Id. at 133. This objection seems difficult to defend. First, shareholders receive a wealth of compensation-related disclosures. Ironically, ConocoPhillips, in opposing say-on-pay, raised this very point. See Co-NOCOPHILLIPS NOTICE, supra note 155, at 80–82 (urging shareholders to vote against say-onpay resolution because, among other things, other channels of corporate governance provide shareholders with adequate input into the compensation process). Second, the proposed resolution would merely give the shareholders a nonbinding vote. See Time Warner Notice, *supra* note 60, at 131 ("The proposal submitted to shareholders should make clear that the vote is non-binding and would not affect any compensation paid or awarded to any [named executive officer].").

^{311.} Introduced by former Senator Obama in the Senate on April 20, 2007, and Representative Frank of Massachusetts in the House on March 1, 2007, the Shareholder Vote on Executive Compensation Act would provide shareholders with say-on-pay and a nonbinding vote on golden parachutes. S. 1181, 110th Cong. (2007); H.R. 1257, 110th Cong. (2007). Both bills were referred to the Committee on Banking, Housing, and Urban Af-

Concerned with the misuse of federal bailout funds, the public protested against enriching already affluent corporate executives. This public antipathy applied most keenly to officers and directors whose mismanagement had edged their companies to the brink of financial collapse. As President Obama declared, "We don't disparage wealth. We don't begrudge anybody for achieving success. And we believe success should be rewarded. But what gets people upset—and rightfully so—are executives being rewarded for failure, especially when those rewards are subsidized by U.S. taxpayers." Spurred by public protest, Congress included a say-on-pay provision in the TARP legislation. Under the new law, recipients of TARP funds are required to provide shareholders with a nonbinding vote to approve or disapprove the executive compensation arrangements disclosed in their CD&A, compensation tables, and related materials. 313

Although affording shareholders some input over executive compensation, the say-on-pay approach is a half-measure, which is inadequate to protect the interests of shareholders and their companies. Corporations may heed or ignore such advisory votes; their preference is to ignore. Disregarding shareholder sentiments expressed in such votes may arouse public anger, but such votes may not receive enough attention to incite the public mind. It must be remembered that many shareholders barely glance at tedious annual reports and proxy statements. Many may not know that a say-on-pay resolution is buried in the materials, and others, who are more informed, may recognize the futility of casting a vote. In addition, despite providing voluminous disclosures, companies withhold from shareholders the performance criteria applied to compensation decisions and the per-

fairs. See S. 1181 (noting that the bill was "referred to the Committee on Banking, Housing, and Urban Affairs"); H.R. 1257 (same).

^{312.} Jonathan Weisman & Joann S. Lublin, *Obama Lays Out Limits on Executive Pay*, Wall St. J., Feb. 5, 2009, at A1 (internal quotation marks omitted).

^{313. 12} U.S.C.S. \S 5221(e)(1)–(2) (LexisNexis 2009). Section 5221(e)(2) provides as follows:

A shareholder vote [requiring that TARP recipients permit shareholders to vote on executive compensation] shall not be binding on the board of directors of a TARP recipient, and may not be construed as overruling a decision by such board, nor to create or imply any additional fiduciary duty by such board, nor shall such vote be construed to restrict or limit the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation.

¹² U.S.C.S. § 5221(e)(2); see also TARP Standard for Compensation and Corporate Governance, 74 Fed. Reg. 28,394, 28,402 (June 15, 2009) (to be codified at 31 C.F.R. pt. 30) [hereinafter Interim Final Rule] (establishing a say-on-pay requirement for TARP recipients).

^{314.} See supra notes 153-59 and accompanying text.

formance results of executives.³¹⁵ This lack of information impedes shareholders' ability to make informed decisions. Furthermore, sayon-pay resolutions do not afford shareholders any alternatives for executive compensation. Much like a contract of adhesion, the pay arrangements are presented on a take-it-or-leave-it basis, and they are disclosed only after the company has bestowed its generosity on management.

Measures are tested by results. Say-on-pay does not appear to have slowed the rise of executive compensation in the United States. Nor has it worked in the United Kingdom. In 2002, the United Kingdom adopted executive compensation disclosure requirements similar to the CD&A. As part of this regulatory framework, the United Kingdom required "quoted" companies Patricia Hewitt, former Trade and Industry Secretary, has lauded these regulations for achieving "improved disclosure of directors' pay and rewards and better engagement with shareholders. Hewitt may have been right in asserting that these regulations have enhanced corporate disclosures of executive compensation. Empirical research has shown, however, that the United Kingdom's approach has failed to moderate the levels and even the growth rate of the executive compensation dis-

^{315.} See supra Part III.C.2.

^{316.} Directors' Remuneration Report Regulations, 2002, S.I. 2002/1986 (U.K.); *see also* Small Companies and Groups (Accounts and Directors' Report) Regulations, 2008, S.I. 2008/409, sched. 3, pts. 1–12 (U.K.) (setting forth remuneration disclosure requirements for small companies).

^{317.} The regulations provide as follows: "A quoted company is defined . . . as a company whose equity share capital has been included in the official list in accordance with the provisions of Part VI of the Financial Services and Markets Act 2000, is officially listed in an EEA State or is admitted to dealing on either the New York Stock Exchange or the exchange known as Nasdaq." Directors' Remuneration Report Regulations, 2002, S.I. 2002/1986, Explanatory Note (U.K.).

^{318.} The regulations provide for an advisory shareholder vote on executive compensation: "The company must, prior to the meeting, give to the members of the company entitled to be sent notice of the meeting notice of the intention to move at the meeting, as an ordinary resolution, a resolution approving the directors' remuneration report for the financial year." $Id. \S 7(3)$. The regulations further state that "[n]o entitlement of a person to remuneration is made conditional on the resolution being passed by reason only of the provision made by this section." $Id. \S 7(8)$. To ensure compliance, the regulations provide that "[i]f the resolution is not put to the vote of the meeting, each existing director is guilty of an offence and liable to a fine." $Id. \S 7(10)$.

^{319.} Directors' Pay Rules Work, So No Need for Legislation-Hewitt, Company Law. 2005, 26(5), 146; see also M. Harrison, Ms. Hewitt Can Bark but Her Pay Law Won't Bite, Independent, Oct. 20, 2001, available at http://www.independent.co.uk/news/business/comment/ms-hewitt-can-bark-but-her-pay-law-wont-bite-632017.html (criticizing Hewitt's attempt to improve disclosure of director pay).

pensed by regulated companies.³²⁰ Some evidence indicates that the regulations have increased corporate sensitivity to linking CEO pay to performance,³²¹ but substituting excessive grants of options and restricted stock for excessive salaries does not fix the problem.

Though say-on-pay is a timid approach to controlling executive compensation, some commentators have criticized say-on-pay for going too far. They argue that say-on-pay resolutions overburden companies, encroach on the province of directors, and encourage shareholder interference with other controversial issues that may arise. Others observe that shareholders lack the knowledge of compensation packages to make informed decisions when voting on say-on-pay resolutions. Still others question the effectiveness of say-on-pay resolutions because a "no" vote registers disapproval without explaining what alternative arrangement would satisfy shareholders. These challenges to the desirability and effectiveness of say-on-pay apply equally to the proposal made in this Article to empower shareholders to decide between alternative recommendations for executive compensation. Accordingly, after setting forth the proposal, this Article will discuss and attempt to refute these criticisms. First, however,

320. See Fabrizio Ferri & David Maber, Say on Pay and CEO Compensation: Evidence from the UK 2 (March 2009) (unpublished manuscript, on file with author) (concluding that the United Kingdom's say-on-pay regulation has not affected the level and growth rate of corporate executives, though it has prompted management to tie pay to performance). But see Sandeep Gopalan, Say on Pay and the SEC Disclosure Rules: Expressive Law and CEO Compensation, 35 Pepp. L. Rev. 207, 241–42 (2008) (arguing that say-on-pay legislation may be working). Gopalan argues that law has an "expressive" function, which socializes prosocial behavior and leads to the internalization of socially desirable norms. Id. at 241. He believes that legislation and regulations making say-on-pay mandatory may succeed in controlling executive compensation if corporate management internalizes norms refuting the idea that "greed is good." Id. at 241–42 (internal quotation marks omitted). Such socialization, Gopalan suggests, may be achieved if institutional shareholders shame greedy executives into changing their behavior. Id. at 246.

321. See Ferri & Maber, supra note 320.

322. See Tresa Baldas, "Say on Pay" May Be Here to Stay, NAT'L L.J., May 19, 2008, at 4. The article quotes J. Mark Poerio, a practitioner in the field of executive compensation:

It's a nuisance Governmental regulators and the courts have long drawn a line between the appropriate role of shareholders, which is to elect those who will govern a company as its directors The say-on-pay initiative . . . places us on a slippery slope that opens the door for mandating future nonbinding votes on any issue that becomes front-page news.

Id. (internal quotation marks omitted).

323. See id. (referring to the comments of Paul Ritter, a law practitioner in the field of executive compensation).

324. *Id.* (referring to the comments of Johanna O'Loughlin, a law practitioner in the field, who suggested that companies should focus on linking pay to performance, which is the primary concern of shareholders).

this Article will discuss other corporate governance measures that seek to control executive compensation.

B. The Nomination of Directors

Some believe that providing shareholders with the power to nominate candidates for the board of directors will help shareholders control executive pay. The theory holds that directors nominated and elected by shareholders will be more sensitive to shareholder interests than directors nominated by management.³²⁵

1. SEC Proxy Regulation

The SEC's concerns over corporate risk-taking and compensation structures prompted it to reconsider a contentious issue—whether SEC proxy rules should permit shareholders to nominate candidates for the board of directors.³²⁶ This issue has long been controversial. In October 2003, the SEC proposed Rule 14a-11, which would, "under certain circumstances, [have] require[d] companies to include in their proxy materials security holder nominees for election as director."³²⁷ Under intense opposition spearheaded by corporate lobbyists, the proposal languished for years.³²⁸ Rededicated to providing share-

325. Most elections for directors are uncontested. Directors, under NYSE Rule 452, may cast votes for shares held in street name in uncontested elections in place of shareholders who neglected to vote themselves. See NYSE, Inc., Rule 452 (2009), available at http://rules.nyse.com/nysetools/PlatformViewer.asp?SelectedNode=chp_1_2&manual=/nyse/rules/nyse-rules. Since brokers tend to vote for the slate of nominated directors, brokers wield substantial power in elections. See NYSE, Inc., Report and Recommendations of the Proxy Working Group to the New York Stock Exchange 9 (2006), http://www.nyse.com/pdfs/proxy_working_group062006.pdf (explaining the impact of broker votes on "just vote no" campaigns (internal quotation marks omitted)). The NYSE has proposed to change Rule 452 to eliminate broker discretionary voting in uncontested elections for directors. See id. at 8–9 (explaining the problems associated with "Broker Discretionary Voting"). As expected, boards oppose this rule change, while shareholders support it. See Yin Wilczek, Proxies: Fight Over Shareholder Proxies Focuses on NYSE Proposal to Drop Broker Voting, Broker/Dealer Compliance Rep., Apr. 8, 2009 (explaining that this rule change will help shareholders hold directors accountable).

326. See Press Release, SEC, SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors (May 20, 2009), available at http://www.sec.gov/news/press/2009/2009-116.htm [hereinafter SEC Votes to Propose Rule Amendments] (explaining that the SEC was voting on an amendment to provide certain shareholders the right to nominate candidates for the board of directors).

327. See Security Holder Director Nominations, 68 Fed. Reg. 60,784 (Oct. 23, 2003). The SEC explained that "the proposed rules are intended to create a mechanism for nominees of long-term security holders, or groups of long-term security holders, with significant holdings to be included in company proxy materials where there are indications that security holders need such access to further an effective proxy process." *Id.*

328. See Gary M. Brown, Soderquist on the Securities Laws § 10:4.4 (5th ed. 2008) (detailing the history of proposed Rule 14a-11).

holders with more say in corporate governance, the SEC, on May 20, 2009, announced a proposal for a new version of Rule 14a-11,³²⁹ which, like the prior proposal, would grant certain shareholders the right to participate in the nominating process.³³⁰ Three of the five Commissioners, including Chairman Mary Schapiro, supported the proposal.³³¹ Schapiro observed, "This proposal represents nearly seven years of debate about whether the federal proxy rules should support—or stand in the way of—shareholders exercising [this] fundamental right"³³²

New proposed Rule 14a-11 would allow shareholders of Exchange Act reporting companies to nominate directors if the shareholders meet ownership requirements that vary with the market value of a company's outstanding stock. 333 A shareholder of a "large accelerated filer," defined as a reporting company with a market value of at least \$700 million, would have to own at least 1% of the voting stock to participate in the nominating process. 334 For "accelerated filers"—companies with a market value of between \$75 million and \$700 million—a shareholder would have to own at least 3% of the voting stock to qualify. 335 Shareholders of companies with a market value below \$75 million—called non-accelerated filers—would have to own at least 5% of the voting stock. 336

Eligible shareholders would be able to nominate one director or 25% of the number of directors to be elected, whichever is greater. Such shareholders would not be permitted to acquire or hold the

^{329.} See SEC Votes to Propose Rule Amendments, supra note 326 ("[T]he Commission is proposing rule amendments that would provide shareholders with a meaningful ability to exercise their state law rights to nominate the directors of the companies that they own.").

330. Facilitating Shareholder Director Nominations, 74 Fed. Reg. 29,024 (June 18,

^{2009) [}hereinafter Facilitating Nominations].

^{331.} See Yin Wilczek, Proxies: In Split Vote, SEC Agrees to Propose Shareholder Proxy Access Rule Amendments, Sec. L. Daily (BNA), May 21, 2009 ("The Securities and Exchange Commission . . . voted 3-2 to propose changes to federal proxy rules that would facilitate the rights of shareholders under state law to nominate corporate directors."). Commissioners Casey and Paredes issued a statement that the proposals encroached on the prerogative of corporate boards and the jurisdiction of the states. Id. Commissioner Casey also criticized the proposals for using the financial crisis as an excuse to over-regulate companies that did nothing to contribute to the crisis. Id.

^{332.} SEC Votes to Propose Rule Amendments, supra note 326.

^{333.} See Wolters Kluwer Law & Business, SEC Votes to Issue New Proxy Access Proposals, http://business.cch.com/securitieslaw/news/05-22-09b.asp (last visited Apr. 3, 2010) (summarizing the proposal and the views of Commission members on the proposal).

^{334.} Facilitating Nominations, *supra* note 330, at 29,035; *see also* SEC Votes to Propose Rule Amendments, *supra* note 326 (discussing the provisions of proposed Rule 14a-11).

^{335.} Facilitating Nominations, supra note 330, at 29,035.

^{336.} Id.

^{337.} Id. at 29,043.

stock to effect a change in corporate control or to gain more than minority representation on the board.³³⁸ They would have to sign a statement declaring their intention to hold their stock until the next annual shareholders' meeting.³³⁹ Nominating shareholders would be liable for their misleading statements in the proxy materials.³⁴⁰

In conjunction with Rule 14a-11, the SEC has also proposed to amend Rule 14a-8(i)(8).341 Rule 14a-8 requires companies to include certain shareholder proposals in proxy statements, but Rule 14a-8(i)(8) provides that a corporation may exclude a shareholder proposal that "relates to a nomination or an election for membership on the company's board of directors."342 The SEC had long construed the phrase "relates to . . . an election" to exclude shareholder proposals to change corporate bylaws that would permit shareholders to nominate candidates for the board of directors. 343 In American Federation of State, County & Municipal Employees v. American International Group, Inc., 344 the United States Court of Appeals for the Second Circuit rejected the SEC's interpretation of the "election exclusion" in Rule 14a-8(i)(8) and held that the phrase "relates to . . . an election" applied only to shareholder proposals affecting a single election, rather than all elections.³⁴⁵ Thus, the court effectively eliminated the election exclusion. Not to be bullied by the Second Circuit, the SEC nullified the court's holding by codifying its interpretation of the exclusion.³⁴⁶ Under the Obama administration, however, the SEC has reversed course and it now supports shareholder participation in the nominating process.³⁴⁷

2. Delaware Corporate Law

Delaware recently amended its corporate code to allow bylaws to require the inclusion of shareholder nominees for the board of direc-

^{338.} Id. at 29,037.

^{339.} Id. at 29,045.

^{340.} Id. at 29,061.

^{341.} See SEC Votes to Propose Rule Amendments, supra note 326 (discussing the proposed amendment to Rule 14a-8(i)(8)).

^{342. 17} C.F.R. § 240.14a-8(i)(8) (2009).

^{343.} See id. (articulating this exclusion); see also Am. Fed'n of State, County & Mun. Employees v. Am. Int'l Group, Inc., 462 F.3d 121, 126 (2d Cir. 2006) (noting the SEC's interpretation of the phrase "relates to . . . an election").

^{344. 462} F.3d 121.

^{345.} *Id.* at 126, 129–30 (rejecting the SEC's position because the SEC had originally interpreted the exclusion to apply only to single elections, and the court deferred to the SEC's initial interpretation of the rule, rather than a subsequent interpretation).

^{346. 17} C.F.R. § 240.14a-8(i)(8).

^{347.} See Facilitating Nominations, supra note 330, at 29,071.

tors on proxy materials.³⁴⁸ The bylaws may provide for the reimbursement of shareholder expenses incurred in soliciting proxies.³⁴⁹

Until the SEC amends Rule 14a-8(i)(8) to allow shareholders to nominate candidates for boards of directors, the Delaware Code will conflict with the SEC's proxy rule. In the meantime, shareholders wishing to nominate candidates for the board of directors will probably have to prepare their own proxy materials.³⁵⁰

3. Critique of Changing the Nominating Process

The SEC's proposals and the new Delaware law both seek to increase shareholder power over the process of electing directors. Theoretically, shareholders would nominate and elect directors who would serve their interests rather than executive greed. Shareholder power over the nominating process is, however, a circuitous solution. It is a proposal to make three left turns to get to a destination, when one right turn would get you to the same place. That single right turn would give the owners of the corporation—the shareholders—the power to vote directly on executive compensation agreements. It should be noted, in addition, that having the power to nominate a director does not ensure that the nominee will be elected. Finally, proposals to increase shareholder power in the nominating process do not insulate shareholder-nominated directors from many of the corrupting influences detailed by Bebchuk and Fried such as the temptation to bargain with the CEO for favorable pay arrangements,

^{348.} Del. Code Ann. tit. 8, § 112 (2009). The Section provides as follows: The bylaws may provide that if the corporation solicits proxies with respect to an election of directors, it may be required, to the extent and subject to such procedures or conditions as may be provided in the bylaws, to include in its proxy solicitation materials (including any form of proxy it distributes), in addition to individuals nominated by the board of directors, one or more individuals nominated by a stockholder.

Id. The Section goes on to specify numerous conditions that a company might institute on a shareholder's nomination rights. *Id.*

^{349.} *Id.* § 113(a) ("The bylaws may provide for the reimbursement by the corporation of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors, subject to such procedures or conditions as the bylaws may prescribe "); *see also* CA, Inc. v. AFSCME Pension Plan, 953 A.2d 227, 235–37 (Del. 2008) (upholding the validity of a proposed bylaw providing for the reimbursement of shareholder expenses incurred in the process of nominating candidates for the board of directors because such a bylaw is procedural, rather than substantive, and it therefore does not encroach on the board's prerogatives).

^{350.} See Shari Qualters, Changes in Delaware Corporate Law Expected to Aid Activists Change Bylaws, Elect Directors, N.Y. L.J., Apr. 23, 2009 (noting that, until the SEC rule is amended, shareholders in Delaware corporations may have to disseminate their own proxy materials).

the desire to function as an amiable team player, and the impulse to cower to the demands of the omnipotent CEO.³⁵¹

C. Senator Schumer's Comprehensive Bill

Senator Schumer has introduced a bill, entitled the Shareholder Bill of Rights Act of 2009, which would increase shareholder power over corporate governance.³⁵² In touting his bill, Senator Schumer highlighted its goals:

By requiring both boards and managers to be more responsive to the concerns of their shareholders, I am confident we will create more accountability, more transparency, and ultimately more long-term stability and profitability within the corporations that are so vital to the health, well-being, and prosperity of the American people and our economy. 353

The bill would mandate say-on-pay resolutions on all annual proxy solicitations made under SEC regulations.³⁵⁴ Golden parachutes would also be put to a nonbinding vote of the shareholders.³⁵⁵

^{351.} See Bebchuk & Fried, supra note 35, at 31–33.

^{352.} S. 1074, 111th Cong. (2009). This bill was referred to the Committee on Banking, Housing, and Urban Affairs. Id.; see also Press Release, Congressman Gary Peters, Congressman Peters Introduces Bill to Empower Shareholders (June 12, 2009) (providing a summary of a related bill, the Shareholder Empowerment Act of 2009). Congressman Peters said, "As an investment advisor for over 20 years, shareholder rights issues have always been very important to me. This bill empowers shareholders, a company's true owners." Id. The bill contains many provisions similar to the provisions in Senator Schumer's proposal. Entitled the Shareholder Empowerment Act of 2009, this bill would (1) require directors to receive a majority vote in uncontested elections, (2) permit shareholders holding at least 1% of outstanding shares for at least one year to nominate candidates for director on corporate proxy materials, (3) eliminate voting by uninstructed brokers holding shareholder stock in street name, (4) prohibit compensation consultants from performing other services for corporations that have engaged them, (5) provide shareholders with say-on-pay, (6) prohibit the same person from serving as CEO and director, (7) strengthen clawbacks of pay awarded on the basis of fraud or faulty earnings statements, (8) prohibit golden parachutes for executives fired for poor performance, and (9) require compensation performance targets to be disclosed to shareholders. Id.

^{353.} Yin Wilczek, *Proxies: Two Bills, One Soon to Be Introduced, Give Shareholders Say on Pay, Nominations*, Sec. L. Daily (BNA), May 15, 2009 (quoting Schumer, who criticized many corporate boards of directors for neglecting the long-term interests of their companies and the shareholders). *But see* Lipton, *supra* note 159 (arguing that the influence of institutional investors such as hedge funds, which control more than 75% of the shares of major companies, has contributed to the short-term excessive risk-taking responsible for the failures of corporate governance and the onset of the current financial crisis).

^{354.} S. 1074 § 14A(a)-(b).

^{355.} *Id.* § 14A(c) (providing that golden parachute payments triggered by acquisition, merger, or other proposed sale of substantially all the assets of the issuer be subject to an advisory vote of the shareholders).

Perhaps recognizing that advisory votes provide a weak deterrent to executive pay abuse, Senator Schumer's bill would provide more substantive corporate governance solutions. Similar to the SEC's proposals and Delaware law, the bill would empower shareholders owning not less than 1% of the issuer's voting stock for at least two years to nominate individuals to the board of directors. Another Section of Senator Schumer's bill would require the chairperson of the board of directors to be independent and would not permit anyone to sit as chairperson who had previously served as an executive officer of the issuer. The bill would also require that, to be elected, a nominee for director in an uncontested election must receive a majority of votes cast. Finally, the bill would require the issuer to establish a risk committee, comprised of independent directors, to assess the risk-management practices of the issuer.

Aside from say-on-pay and shareholder rights to participate in the nominating process, which this Article has already discussed, the provisions in Senator Schumer's bill afford only minimal protections to shareholders who wish to constrain executive compensation. Requiring that the chairperson of the board be independent would not diminish the influence of a powerful CEO and other top managers. Disallowing former executive officers from sitting as a board's chairperson might reduce the influence of managerial power marginally, but it would not eliminate it. The requirement that nominees garner a majority, rather than a plurality, of votes would strengthen the position of shareholders who refuse to vote for company nominees for the board, but it would not provide them with any control over compensation packages.

The purpose of risk committees would be to curb the rampant speculation that foreshadowed the current financial crisis. By monitoring business strategies, risk committees might dissuade compensation committees from granting executives large blocks of short-term options, which reward imprudent risk-taking. This solution may

^{356.} See J. Robert Brown, Wachtell, Lipton and the Opening Salvo Against the Shareholder Bill of Rights (The Criticisms), RACE TO THE BOTTOM, May 15, 2009, http://www.theracetothebottom.org/shareholder-rights/wachtell-lipton-and-the-opening-salvo-against-the-shareholde. html (arguing that most of the reforms proposed by Senator Schumer are already underway and that the bill, if passed, would merely accelerate the process).

^{357.} S. 1074 § 4(d).

^{358.} Id. § 5(e)(2).

^{359.} *Id.* § 5(e)(4)(A).

^{360.} $Id. \S 5(e)(5)(A)$. The SEC would be empowered to issue rules regarding the establishment of risk committees. $Id. \S 5(e)(5)(B)$.

^{361.} See supra Part II.A-B.

sound promising, but it is not. Risk committees would likely fare no better than compensation committees. A corporation may churn out countless committees and the results will be more corporate clutter and cost without increased efficiency.

D. Government Control

Both Representative Frank and Senator Durbin have proposed separate pieces of legislation that would grant the federal government authority to control executive compensation. In addition, the statutory and regulatory framework applied to TARP recipients includes, among its numerous corporate governance provisions, pay caps. Both legislative proposals as well as the TARP framework will be discussed below.

1. Regulatory Veto

On July 21, 2009, Representative Barney Frank introduced the Corporate and Financial Institution Compensation Fairness Act of 2009.³⁶² The bill was reported by committee only one week later, and on July 31, the House approved the bill by a vote of 237–185.³⁶³

The bill would require Exchange Act reporting companies to provide shareholders with advisory say-on-pay votes and nonbinding votes on golden parachutes triggered by mergers, acquisitions, or consolidations. The bill would also require compensation committee members to be "independent," defined as accepting no compensation from the company other than pay for serving as a director or committee member. Compensation consultants, hired by reporting companies, would also have to meet standards of independence prescribed by the SEC. Sec. 166

The most innovative but dubious provision of the bill would establish regulatory control over executive compensation arrangements. Recognizing that banks, broker-dealers, and other financial institutions engaged in speculative transactions that jeopardized the soundness of the economy, the bill would require such institutions to disclose to federal regulators, including the SEC, Federal Reserve, and FDIC, the structures of all incentive-based compensation arrange-

^{362.} H.R. 3269, 111th Cong. (2009).

^{363.} Michael Cohn, *House Says Yea on "Say on Pay*," WeBCPA, Aug. 3, 2009, http://www.webcpa.com/debits_credits/House-Says-Yea-on-Say-on-Pay-51214-1.html.

^{364.} H.R. 3269 § 2(i)(1)-(2).

^{365.} Id. § 10B(b).

^{366.} Id. § 10B(c).

ments.³⁶⁷ These disclosures would enable the regulators to determine if such arrangements were aligned with sound risk management or could have serious adverse effects on economic conditions. The bill would direct these federal regulators jointly to prescribe regulations that prohibit compensation arrangements encouraging dangerously excessive risk-taking.³⁶⁸

Although certain compensation arrangements of executives of financial institutions spawned reckless risk-taking and catastrophic financial loss, one must question whether federal regulators should have veto power over pay arrangements. Although regulators may set guidelines for corporate governance, they should not entwine themselves in corporate decisionmaking. Governmental bureaucrats are not equipped to decide executive pay. Just as federal regulators have no business telling a dressmaker what fabric to use in the production process, they have no business telling a dressmaker how much to pay its CEO. Fully informed shareholders must have the power to set the pay of executives who run their corporations.

2. Federal Pay Cap

Senator Durbin has proposed a bill, entitled the Excessive Pay Shareholder Approval Act, which would limit the annual compensation of any executive of a publicly traded company to 100 times the average compensation of all employees of the issuer unless at least 60% of shareholders vote to approve a higher compensation arrangement.

This provision would curb levels of executive compensation, but a federally imposed limit, even if subject to a shareholder override, does not provide a desirable resolution to the executive-compensation problem. First, the multiple proposed by Senator Durbin sets a floor for executive compensation. Companies that have paid their CEOs less than the 100 multiple would be drawn irresistibly to raise executive pay until it reached that level. Second, Senator Durbin's bill invites manipulation. Boards of directors will urge shareholders to

^{367.} Id. $\S 4(a)(1)$. The bill exempts institutions with under \$1 billion in assets. Id. $\S 4(e)$.

^{368.} Id. § 4(b). Clawbacks may not operate retroactively unless the challenged compensation structure has been in place for more than two years. Id. § 4(f).

^{369.} S. 1006, 111th Cong. (2009) (as proposed May 7, 2009). This bill has been referred to the Committee on Banking, Housing, and Urban Affairs. *See id.*; *see also* Roger Lowenstein, *Thain's Original Sin Rooted in Executive Pay*, Bloomberg, Jan. 26, 2009, http://www.bloomberg.com/apps/news?pid=20601039&sid=axxhbeptMUgE (proposing that Congress pass a law requiring that any executive compensation exceeding a fixed ceiling, \$5 million, for example, must be approved in a vote by the shareholders).

approve excessive pay arrangements for their executives in one-sided proxy disclosures that omit counterarguments. Companies are well-schooled in such manipulation, having tailored their SEC disclosures for decades. Third and most critically, this proposal, like Representative Frank's bill, concentrates too much power to control executive compensation in the federal government. Although shareholders might recoil at executive paychecks that exceed 100 times the average worker's wage, Congress should not establish dollar limits on pay. Granting shareholders power to override the cap, however, is a desirable feature of the bill. Shareholders should decide executive pay.

3. TARP Restrictions

In addition to the tax deductibility limitations and say-on-pay provision already discussed, the American Recovery and Reinvestment Act of 2009 establishes rules for corporate governance for recipients of TARP funds, and it imposes limits on executive compensation.³⁷⁰ Under a grant of authority from the American Recovery and Reinvestment Act, the Treasury Department,³⁷¹ on June 15, 2009, issued an Interim Final Rule on TARP Standards for Compensation and Corporate Governance.³⁷² The Rule seeks to align the pay of executives of TARP recipients with the interests of their shareholders and to help ensure the stability of the economy.³⁷³ This framework applies to all

^{370.} See generally Pub. L. No. 111-5, § 7001, 123 Stat. 115, 516–20 (amending 12 U.S.C. § 5221 (2006)). The compensation restrictions in the Act cease to apply at such time as the federal government holds only warrants to purchase an institution's common stock. *Id.* 371. The American Recovery and Reinvestment Act authorizes the Treasury Secretary to "promulgate regulations to implement this section." *Id.*

^{372.} Interim Final Rule, supra note 313. In February 2009, the U.S. Treasury announced additional compensation guidelines. See Press Release, U.S. Dep't of the Treasury, Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009), available at http://www.ustreas.gov/press/releases/tg15.htm (announcing that the new guidelines seek to ensure that TARP funds are not used for "inappropriate private gain"); see also Joseph E. Bachelder III, Executive Compensation: ARRA Amends EESA: Includes New Pay Limits at Affected Institutions, N.Y. L.J., Apr. 14, 2009 (summarizing provisions of the federal statutory rules and TG-15 and comparing the original provisions of the Emergency Economic Stabilization Act enacted on October 3, 2008, to the statutory amendments in the American Recovery and Reinvestment Act enacted on February 17, 2009). In addition to the Interim Final Rule, the Department of the Treasury has proposed legislation to control executive compensation of all reporting companies. Investor Protection Act of 2009, H.R. 3817, 111th Cong. (2009). This proposal would require all reporting companies to provide shareholders with say-on-pay votes, id. § 941(a), to provide shareholders with nonbinding votes to approve golden parachutes, id., to enhance the independence of compensation committees, id. § 942, and to provide compensation committees with the authority and funding to engage their own compensation consultants and counsel, id.

^{373.} See Interim Final Rule, supra note 313, at 28,396–97 (describing the statutory provisions that the Interim Final Rule implements).

TARP recipients unless the federal government holds only warrants to buy common stock.³⁷⁴ The Principal Executive Officer ("PEO") and Principal Financial Officer ("PFO") of institutions receiving TARP funds must certify annually compliance with the statutory and regulatory rules.³⁷⁵

Boards of directors of TARP recipients must establish compensation committees comprised of independent directors. The Every six months, compensation committees must review, with senior risk officers, both senior executive officer compensation plans and employee compensation plans. Such committees must limit features of all compensation plans that might lead to excessive risk-taking and they must eliminate features that might lead to the manipulation of earnings reports. Reporting companies must certify in their annual proxy statements that their compensation committees met these goals and how the committees did so; non-reporting companies must provide the same disclosures and certification to appropriate regulators. Sec. 1981.

Both the American Recovery and Reinvestment Act and Interim Final Rule impose limits on the types and amounts of compensation paid to executives of TARP recipients. The Act prohibits the payment or accrual of "any bonus, retention award, or incentive compensation" to certain executives while the company remains the recipient of TARP assistance. The Interim Final Rule elaborates on this restriction. For companies receiving less than \$25 million in TARP assistance, the prohibition applies only to the most highly paid employee. For companies receiving between \$25 million and \$250 million, the prohibition applies to the five most highly paid employ-

^{374.} American Recovery and Reinvestment Act \S 7001; Interim Final Rule, supra note 313, at 28,397.

^{375.} American Recovery and Reinvestment Act \S 7001; Interim Final Rule, supra note 313, at 28,402–03.

^{376.} American Recovery and Reinvestment Act \S 7001; Interim Final Rule, supra note 313, at 28,398.

^{377.} The rule defines "Senior Executive Officer" as the PEO, PFO, and the three next most highly paid executive officers. Interim Final Rule, *supra* note 313, at 28,395.

^{378.} American Recovery and Reinvestment Act § 7001; Interim Final Rule, *supra* note 313, at 28,397. If the common or preferred stock of a recipient of no more than \$25 million of TARP funds is not registered with the SEC under the Exchange Act, the recipient's board of directors is empowered to act in place of a Compensation Committee. American Recovery and Reinvestment Act § 7001.

^{379.} Interim Final Rule, supra note 313, at 28,399.

^{380.} Id.

^{381.} American Recovery and Reinvestment Act § 7001.

^{382.} Id.; Interim Final Rule, supra note 313, at 28,399.

ees.³⁸³ For companies receiving between \$250 million and \$500 million, the prohibition applies to Senior Executive Officers ("SEOs")³⁸⁴ and at least the next ten most highly compensated employees. 385 For companies receiving \$500 million or more, the prohibition applies to SEOs and at least the next twenty most highly compensated employees. 386 This prohibition, however, does not apply to long-term restricted stock or restricted stock units that do not fully vest while the company is a recipient of TARP funds³⁸⁷ and that are not greater than one-third the employee's annual compensation.³⁸⁸ TARP recipients must ensure that, for SEOs and the next twenty most highly compensated employees, any bonus, retention award, or incentive compensation based on materially inaccurate financial statements or performance metrics is subject to clawback.³⁸⁹

The Interim Final Rule authorizes the Department of the Treasury to appoint a Special Master for TARP Executive Compensation.³⁹⁰ Dubbed the "pay czar," Kenneth Feinberg is the current appointee.³⁹¹ The Special Master is empowered to interpret the provisions of the Emergency Economic Stabilization Act and Treasury rules that regulate corporate governance and executive compensation.³⁹² He is authorized to review compensation awarded before February 17, 2009, to employees of TARP recipients and to negotiate for the reimbursement of excessive compensation.³⁹³ The Interim Final Rule

^{383.} American Recovery and Reinvestment Act § 7001; Interim Final Rule, supra note

^{384.} The statute defines "senior executive officer" as "an individual who is 1 of the top 5 most highly paid executives of a public company, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934, and any regulations issued thereunder, and non-public company counterparts." American Recovery and Reinvestment Act § 7001(a)(1). The Interim Final Rule defines an SEO as the PEO, the PFO, and the next three most highly compensated employees. Interim Final Rule, supra note 313, at

^{385.} American Recovery and Reinvestment Act § 7001; Interim Final Rule, supra note 313, at 28,399.

^{386.} American Recovery and Reinvestment Act § 7001; Interim Final Rule, supra note 313, at 28,399.

^{387.} American Recovery and Reinvestment Act § 7001; Interim Final Rule, supra note 313, at 28,401.

^{388.} American Recovery and Reinvestment Act § 7001; Interim Final Rule, supra note 313, at 28,400. Contractual grants of such awards that became legally binding on or before February 11, 2009, are not subject to the prohibition. Id. at 28,401.

^{389.} American Recovery and Reinvestment Act § 7001; Interim Final Rule, supra note

^{390.} Interim Final Rule, supra note 313, at 28,403.

^{391.} Stephen Labaton, Treasury to Set Executives' Pay at 7 Ailing Firms, N.Y. TIMES, June 10,

^{392.} Interim Final Rule, supra note 313, at 28,404.

grants the Special Master broad powers over the recipients of "exceptional financial assistance."³⁹⁴ These recipients of multiple grants of financial assistance from the federal government include AIG, Citigroup, Bank of America, General Motors, GMAC, Chrysler, and Chrysler Financial.³⁹⁵ The Special Master has authority over these companies to disapprove compensation payments and structures for SEOs and other employees who are subject to the bonus, retention award, and incentive compensation limitations discussed above and to disapprove compensation structures for all other executives of these companies and their next 100 most highly compensated employees.³⁹⁶

The Interim Final Rule contains numerous other compensation-related provisions. It reaffirms that TARP recipients must provide shareholders with say-on-pay votes.³⁹⁷ Recipients of TARP funds may not award golden parachute payments, broadly defined to include severance pay,³⁹⁸ to SEOs or any of the next five most highly compensated employees.³⁹⁹ The Interim Final Rule prohibits gross ups to SEOs and the next twenty most highly compensated employees.⁴⁰⁰ TARP recipients must adopt "excessive or luxury expenditures" policies, file them with the Department of the Treasury, and, if they have websites, they must post their policies.⁴⁰¹ Similarly, they must disclose and justify all perquisites over \$25,000 paid to any employee subject to the bonus restrictions discussed above.⁴⁰² Finally, TARP recipients must disclose whether they have engaged a compensation consultant, and, if so, they must disclose all services that the consultant has provided to the company over the past three years.⁴⁰³

^{394.} Id.

^{395.} Mike Ferullo & Yin Wilczek, Administration Announces Rules, Pay Czar for TARP Firms; Proposal for All Companies, BNA TAX & ACCOUNTING, June 12, 2009, http://www.bnatax.com/insightdetail.aspx?id=2147483667.

^{396.} Interim Final Rule, *supra* note 313, at 28,402, 28,404.

^{397.} American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, \S 7001, 123 Stat. 115, 516–20 (amending 12 U.S.C. \S 5221 (2006)); Interim Final Rule, *supra* note 313, at 28,402.

^{398.} The American Recovery and Reinvestment Act broadly defines a "golden parachute payment" to mean "any payment to a senior executive officer for departure from a company for any reason, except for payments for services performed or benefits accrued." American Recovery and Reinvestment Act § 7001. Thus, the term "golden parachute" includes not only payments triggered by mergers or acquisitions but also severance pay.

^{399.} Id.; Interim Final Rule, supra note 313, at 28,399.

^{400.} American Recovery and Reinvestment Act § 7001; Interim Final Rule, *supra* note 313, at 28,399.

^{401.} American Recovery and Reinvestment Act \S 7001; Interim Final Rule, supra note 313, at 28,401-02.

^{402.} Interim Final Rule, supra note 313, at 28,402.

^{403.} Id.

These federally imposed rules on executive compensation apply only to recipients of TARP funds. 404 As the holder of preferred stock in these financial institutions, the federal government, having spent billions of taxpayer money to acquire the stock, has a substantial interest to establish limits on how recipients spend those funds. 405 It should not ordinarily be the government's role, however, to entangle itself in the affairs of corporate governance. The government has no defensible role in prescribing dollar limits for executive compensation for non-recipient companies. Its only role should be to enable shareholders to participate in the process of setting executive compensation.

VII. A Proposal to Give Shareholders Control over Executive Compensation

The list of strategies intended to control executive compensation is long. It includes the oversight of fiduciaries, disclosure regulations, litigation, the tax law, shareholder say-on-pay, shareholder participation in the nomination of directors, and adjustments to the mechanisms of internal corporate governance. Legislators and regulators are groping among these alternatives and proposing countless measures. All these strategies have failed and will continue to fail because they do not confront the problem directly. Additionally, federally imposed limits on executive pay, though effective, are undesirable. Perhaps by necessity, Congress has become enmeshed in operating the financial and automotive sectors of the economy. The goal should

^{404.} Other pending bills would also regulate TARP funds. The Economic Recovery Adjustment Act of 2009 was introduced by Senator Whitehouse on February 12, 2009. S. 431, 111th Cong. (2009). Referred to the Committee on Banking, Housing, and Urban Affairs, this bill would establish the position of Taxpayer Advocate within the Department of Justice to monitor the executive compensation of TARP fund recipients and to reach compensation reduction agreements when appropriate. *Id.* § 4. It would also create a Temporary Economic Recovery Oversight Panel to review agreements reached by the Taxpayer Advocate and recipients of TARP funds. *Id.* § 7. On February 3, 2009, Representative Bilirakis introduced an amendment to the Emergency Economic Stabilization Act requiring the Secretary of the Treasury to establish a database on which most institutions receiving TARP funds would have to disclose the total compensation of their 100 most highly paid employees. H.R. 807, 111th Cong. (2009).

^{405.} See Semiannual Monetary Policy Report to the Congress: Before the S. Comm. on Banking, Hous., and Urban Affairs, 111th Cong. (2009) (statement of Chairman Ben S. Bernanke) (discussing the Capital Assistance Program and the Capital Purchase Program through which the federal government purchases preferred stock in distressed banking institutions seeking financial assistance).

^{406.} See Gerald F. Seib, Obama Aspires to a 'Light Touch,' Not a Heavy Hand, Wall St. J., June 17, 2009, at A2 (noting that the federal government is "a majority shareholder of General Motors" and that President Obama is expected to propose "new oversight of big financial institutions" and "new capital requirements for banks"); David Wessel, Obama Dis-

be to end government control over the economy as soon as practicable, not to expand it. The government serves an imperative regulatory role, but it cannot replace entrepreneurship. The inefficiencies that the national government invariably brings to whatever enterprises it manages warn against government intervention in the private sector.

A. The Shareholder Compensation Committee

Shareholders must have a binding vote to determine what compensation packages their companies will offer to executives. A system must establish a workable set of procedures to solicit the input of shareholders, while ensuring that the exercise of shareholder power does not disrupt corporate governance.

Amendments to Section 14 of the Exchange Act⁴⁰⁷ and Rule 14a-8⁴⁰⁸ should provide that the bylaws of reporting companies may, upon approval of a majority vote of the shareholders, require the creation of a "Shareholder Compensation Committee." To propose such a bylaw, a shareholder would need a minimum stake in the company. For example, for a period of at least one year, the shareholder might be required to have owned at least 1% of the company's outstanding stock or to have spent a minimum of \$25,000 to purchase the stock. The company would have to include the proposal in its annual proxy statement. Both the proposal and the company's inevitable opposition might be limited to 2000 words.

The purpose of the Committee would be to analyze and, if appropriate, make counterproposals to the directors' recommendations for compensating the CEO, the CFO, the next three most highly paid executives, and the chairperson of the board of directors. These six people would be defined as "Covered Individuals." The bylaws could designate any reasonable number of members to sit on the Committee. The company would assume the costs of the election for Commit-

plays a Taste for Big Risk, Wall St. J., June 18, 2009, at A2 (reporting on President Obama's initial economic agenda, which includes the acquisition of massive equity holdings in the financial and the automotive industries).

^{407.} Sections 14(a)–(c) regulate proxy solicitations and delegate the authority to promulgate appropriate rules and regulations to the SEC. See 15 U.S.C. § 78n(a), (c) (2006). 408. Rule 14a-8(i) contains exclusions to the right of shareholders to make proposals in company proxy statements. See 17 C.F.R. § 240.14a-8 (2009). Two are relevant. The first allows a company to exclude a shareholder proposal "[i]f the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization." Id. § 240.14a-8(i)(1). The other allows a company to exclude a shareholder proposal "[i]f the proposal deals with a matter relating to the company's ordinary business operations." Id. § 240.14a-8(i)(7). The SEC should amend Rule 14a-8 so that neither of these exclusions prevents the establishment of Shareholder Compensation Committees.

tee members. To shelter small companies from the costs of compliance, a threshold requirement might exempt companies with a public equity float⁴⁰⁹ of less than \$75 million.⁴¹⁰

Current or former company directors and executives and others with close social or economic ties to them would be excluded from participating on the Committee. The Committee ultimately elected would therefore be separated from the influences of managerial power. To run for membership on the Committee, a shareholder would have to satisfy the same minimum ownership requirements as required to propose the change to the bylaws. This requirement would disallow shareholders with insignificant or short-term stakes in the company from running. Six months before the annual shareholders' meeting, the company would provide shareholders with a "Notice of Election" informing them of their right to run for the Shareholder Compensation Committee. Shareholders would be informed in the Notice of Election that election results will be made available on a recorded telephone message and on a designated Internet website.

Those shareholders wishing to run for the Committee would have to certify that they intend to hold their entire equity interest in the company until the annual shareholders' meeting. The Notice of Election materials would inform candidates that, as fiduciaries, Committee members would be bound by the duty to act for the best interests of the company and to refrain from disclosing to anyone any information, confidential or otherwise, provided to them as Committee members. Candidates would have to acknowledge in writing that a breach of these duties could result in civil liability and criminal prosecution in the event of intentional sabotage. These certifications would help ensure the diligence and good faith of Committee members.

Candidates would provide a brief statement of perhaps up to 500 words, supporting their qualifications to serve on the Committee. To prevent the influence of managerial power from intruding into the election process, the statute would disqualify current and former officers and directors and their close family relatives from voting. All

^{409.} The term "public equity float" means stock held by non-affiliates of the company. *See* Brown, *supra* note 328, § 4:3.1, at 4-14–4-15. An affiliate is "a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified." 17 C.F.R. § 230.405 (2009).

^{410.} The \$75 million figure comports with the SEC's definition of a "smaller reporting company," which is subject to simplified reporting requirements. *See* Smaller Reporting Company Regulatory Relief and Simplification, 73 Fed. Reg. 934, 935–36 (Jan. 4, 2008) (to be codified at 17 C.F.R. pts. 210, 228, 229, 230, 239, 240, 249, 260, 269) (defining "smaller reporting companies" as having a public equity float of less than \$75 million, or if such calculation is impracticable, annual revenues of less than \$50 million in the last fiscal year).

other shareholders, defined as "Qualified Shareholders," would be eligible to vote.

Committee members would receive all information provided to the director compensation committee. The overbroad "competitive harm" exception, which directors often use to avoid disclosing specific executive-compensation performance goals, would be replaced with a more restrictive standard that would permit the directors to withhold from the Committee only trade secrets as traditionally defined by state law. For information to qualify as a trade secret (1) the information would have to be of significant value to the company; (2) the information would have to be undisclosed and unknown to the public; and (3) the company would have to have taken reasonable steps to maintain the secrecy of the information. 411 Performance standards, by definition, would not be trade secrets. The directors would therefore have to reveal qualitative and quantitative performance compensation standards applied to each of the Covered Individuals. 412 The Committee would have the authority to hire an independent compensa-The company would pay the tion consultant to advise it. compensation consultant's fee.

The director compensation committee would develop proposed annual compensation packages for the company's Covered Individuals. 413 While devising the compensation packages, the board of direc-

Id.

^{411.} See Unif. Trade Secrets Act \S 1(4) (amended 1985), 14 U.L.A. 537–38 (2005). This Section defines a trade secret as follows:

[&]quot;Trade secret" means information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

^{412.} See Donahue, supra note 154, at 77–78 (arguing that the current "competitive harm" standard should be tightened because companies often use the standard to conceal quantitative and qualitative performance standards, confounding efforts to analyze the linkage between pay and performance).

^{413.} The directors would have to furnish the Shareholder Compensation Committee with simple but clear summaries of pay arrangements with other directors. Since detailed explanations and justifications for the pay of directors other than the chairperson would not be required, the scope of disclosures would diminish compared to disclosures in the CD&A. It would be unnecessary for the Shareholder Compensation Committee to propose alternatives for all directors because, if the chairperson of the board's compensation were subjected to the scrutiny of the Shareholder Compensation Committee, the company would probably not pay ordinary directors more than the chairperson unless a company had substantial justification. In any event, if the board voted to pay its members unreasonably high compensation, the Shareholder Compensation Committee, though not making alternative proposals, would so inform shareholders.

tors would also be working on plain English compensation-related narrative disclosures and tables it intended to include in the proxy materials. At least ninety days prior to the annual shareholders' meeting, the board of directors would furnish the Shareholder Compensation Committee with (1) its proposals (presumably adopted from those of the director compensation committee), (2) its intended proxy disclosures, and (3) all non-trade-secret materials that it considered in reaching its recommendations. If the board changed its intended proxy disclosures, it would have to notify the Shareholder Compensation Committee of such changes immediately.

The Shareholder Compensation Committee would review the recommendations of the board. To the extent that it approved the board's recommendations, it would inform the shareholders of the approval in the proxy materials. To the extent that it disapproved of the board's recommendations, it would provide its counterproposals with a statement explaining why it believed its counterproposals are superior to the proposals of the directors. It would provide its responses to the company no later than sixty days before the annual meeting. This timetable would enable the board of directors to comply with the requirement that shareholders receive notice of the availability of proxy materials on the Internet at least forty days before the annual shareholders' meeting. The members of the Shareholder Compensation Committee would be subject to civil liability and criminal prosecution for any intentional material misrepresentation they made in the proxy materials.

The proxy materials would contain a prominent disclosure informing shareholders that they have a determinative vote on executive compensation. Only Qualified Shareholders could vote on the executive compensation proposals of the two committees.

B. Possible Criticisms and Responses

Most of the arguments opposing other corporate governance solutions might be raised against the proposal in this Article. Each of these objections and others will be stated and answered.

^{414.} See 17 C.F.R. § 240.14a-16(a)(1) (2009) (requiring that companies provide shareholders with notice of Internet availability of proxy materials forty days prior to the annual shareholders' meeting).

^{415.} See supra notes 322-24 and accompanying text.

1. Institutional Resistance

a. Objection

Short-term institutional investors, such as hedge funds, own huge blocks of stock in publicly traded corporations. Because their interests are short term, they support compensation arrangements such as fully vested option grants, which encourage reckless risk-taking. They would therefore oppose bylaw proposals to establish Shareholder Compensation Committees because such Committees would tend to recommend compensation arrangements that would remove incentives for executives to engage in excessively high-risk strategies. If short-term institutional investors failed to prevent the adoption of bylaws providing for the establishment of Shareholder Compensation Committees, they would vote for proposals that would provide management with incentives for high risk-taking.

b. Response

Longer-term institutional investors, such as mutual funds and pension funds, have vast holdings in public corporations. Their interests tend to be aligned with the long-term interests of companies. Such investors oppose excessive risk-taking. Saving millions in executive compensation would also serve the interests of these longer-term investors. They would be inclined to support bylaw amendments to establish Shareholder Compensation Committees, particularly where directors and executives had a history of extracting bloated pay from their companies. Mutual funds and pension funds would similarly tend to support compensation proposals that discouraged excessive risk-taking and that did not award exorbitant pay to executives. Pressure arising from shareholder activism, as well as the media coverage it elicited, would also influence mutual funds and pension funds to support bylaw changes and reasonable compensation packages. Their votes, along with the votes of non-institutional investors, would offset the votes of hedge funds.

To avoid public censure, directors would not be inclined to propose plans that would encourage reckless risk-taking. If they did propose such plans, Shareholder Compensation Committees, in their counterproposals, would expose the objectionable parts of directors' proposals. Mindful of this scrutiny, directors would likely go to great lengths to propose conservative, performance-based packages. Thus, the approach recommended in this Article would act as a constraint on both the level and types of compensation that directors would propose. If directors stubbornly insisted on ignoring their fiduciary duties to their companies, they would incur the condemnation of the

print and television media, as well as bloggers. The potential for public outrage would encourage directors to make proposals that serve corporate interests.

2. Expense

a. Objection

The proposal made in this Article would require mailing a Notice of Election to shareholders. Preparing, printing, and mailing costs would be significant. Companies would also have to bear the added expense of including in their proxy materials the recommendations of the directors and those of the Shareholder Compensation Committee. Finally, the cost of a compensation consultant to advise the Shareholder Compensation Committee would be substantial.

b. Response

Instituting this Article's proposal would reduce corporate expenses. The inevitable retrenchment of executive pay would more than offset whatever additional expenses might result. There would be other savings. The disclosures made by the directors and the Shareholder Compensation Committee would obviate the need for the CD&A and tabular disclosures required under SEC regulations. Both the directors and Shareholder Compensation Committee would undoubtedly provide detailed materials, but the scrutiny that each would apply to the other's proposals would motivate both committees to provide more focused, better explained, and more concise disclosures than those made under current SEC requirements. Anything less would alienate the shareholders. SEC disclosure requirements would become unnecessary for companies establishing Shareholder Compensation Committees. The SEC might therefore consider suspending, or at least reducing, its disclosure requirements for companies governed by the regime proposed in this Article. Given the extensiveness of current SEC disclosure requirements, the proposal made in this Article would probably diminish the burden of disclosure on participating companies.

As with proxies, shareholders could opt for Internet disclosure of all election and compensation-related materials.⁴¹⁷ Electronic disclosures would entail minimal expense. Individual disclosures of candi-

^{416.} See Brown, supra note 328, § 10:4.3 ("In a large corporation . . . postage costs alone may be several hundred thousand dollars, or more, for a single mailing").

^{417.} See 17 C.F.R. § 240.14a-16(j) (2) (providing that companies must, at a shareholder's request, furnish proxy materials via the Internet).

dates could be limited to a manageable number of words, say, 500. Thus, the election materials would not be lengthy or unduly expensive to print. Postage costs would be a worthwhile expense to enlist shareholder participation. Paying one additional consultant, in addition to the lawyers, auditors, investment bankers, directors' compensation consultant, and celebrity spokespersons on the payroll, would not materially change the finances of corporations with a public float of over \$75 million.

3. Executive Departures

a. Objection

If a Shareholder Compensation Committee recommended pay below that recommended by the directors, and if the voting shareholders approved the lower offer, the affected Covered Individual might refuse the offer. That person might quit the company. Such a departure might deprive the company of a valued manager, and in any event, might leave the company with a key position vacant. The result would be disruption of corporate operations and the collapse of the stock price.

b. Response

Covered Individuals would be reluctant to quit their jobs unless they had negotiated for and secured other positions. Even if the compensation offer did not satisfy a Covered Individual, he or she would probably prefer that job to unemployment. A dissatisfied Covered Individual might begin looking for a job for the coming year, but the directors, in their disclosures, would have informed shareholders of this possibility. The shareholders' vote would indicate their willingness to lose the services of that Covered Individual, perhaps because of lackluster performance, lack of vision, or excessive risk-taking. Furthermore, as more and more shareholders took control of executive compensation, pay levels of competitors would fall. Fewer alternatives for exorbitant pay would be available.

Nevertheless, some Covered Individuals might quit. The costs to the company, however, would not be dire. The importance of CEOs has been exaggerated and mythologized. Few managers are indispensable. Replacements could be enlisted from outside or inside the

^{418.} See Rakesh Khurana, Searching for a Corporate Savior 190 (2002) (observing that "[d]espite the lack of a convincing link between the CEO and corporate performance, firms continue to buy into the mythology that the key to improving long-term performance... is hiring an external savior"); Andhra Pradesh, Senior Management Not Indispensable,

company. 419 Large companies employ scores of talented, energetic, mid-level and upper-level managers who scramble for the top positions in their firms. If Covered Individuals departed precipitously, fresh talent would replace them like air rushing into a vacuum. If departing managers thwarted efforts at transition, they would suffer damage to their reputations. Such a prospect would encourage cooperation. Even if the stock price fell when a CEO left a company, once revenues and earnings showed that the CEO was expendable, the stock price would rebound.

The board of directors would negotiate employment contracts with newly hired or promoted executives replacing those who chose to leave the company. The following year, when the new top managers were presented with pay offers approved by shareholder vote, they would probably not be as disposed as their predecessors to refuse those offers. New CEOs or CFOs would be eager to establish their credentials as effective top managers. In addition, the culture of the company would have begun to change. After only a few years, shareholder control over pay would have become accepted, and Covered Individuals would not be inclined to rebel.

4. Sabotage

a. Objection

Unscrupulous corporations might pay their cronies to purchase blocks of a competitor's stock to make them eligible to run for and to

HINDU, Apr. 24, 2005, available at http://www.hinduonnet.com/2005/04/24/stories/2005042413710400.htm (reporting findings of the president of the Confederation of Indian Industry that mid-level and even low-level managers can replace senior managers with excellent results for the firm); Carole Spiers, The Myth of Indispensability, Gulf News, Oct. 14, 2008 (providing examples debunking the myth that managers are indispensible); Analysis: Executive Compensation and Whether CEOs Are Worth Millions of Dollars (National Public Radio broadcast Oct. 7, 2002), available at 2002 WLNR 13873130 (discussing executive compensation with Rakesh Khurana, a professor at the Harvard Business School, who stated that based on the research "it's not clear we even have a CEO effect" on company performance).

419. Compare Rakesh Khurana & Nitin Nohria, The Performance Consequences of CEO Turnover 23–26 (Working Paper, 2000), available at http://ssrn.com/abstract=219129 (reporting the following empirical findings: (1) CEO turnover does not generally lead to change in company performance; (2) the forced departure of a CEO replaced by an outsider leads to improved company performance; and (3) the forced departure of a CEO replaced by an insider has no effect on company performance), with Wei Shen & Albert A. Cannella, Jr., Revisiting the Performance Consequences of CEO Succession: The Impacts of Successor Type, Postsuccession Senior Executive Turnover, and Departing CEO Tenure, 45 ACAD. MGMT. J. 717, 728–29 (2002) (finding that when inside managers replace senior executives who are forced out of companies, firm performance improves, although performance falls when outside managers replace departing senior executives).

be elected to their rival's Shareholder Compensation Committee. Malcontents and crackpots, who have a sufficient stake in companies, might serve on Shareholder Compensation Committees just to cause havoc.

b. Response

The statute would punish bad faith conduct. Any shareholder whose conduct in connection with running for or serving on a Shareholder Compensation Committee was motivated by bad faith would be subject to both civil liability and criminal prosecution. Any person or corporation would be civilly and criminally responsible for knowingly causing the inclusion of material misrepresentations or omissions in election disclosures for the Shareholder Compensation Committee. Individuals and corporations would be subject to civil liability and criminal prosecution for aiding and abetting a violation.

5. Shareholder Ignorance

a. Objection

Shareholders lack the knowledge of company operations, finances, policy, and past executive performance to make intelligent compensation decisions. Nor do they have the expertise to fashion complex compensation packages, which involve not only salaries, but also more exotic forms of compensation such as options, restricted stock, and stock appreciation rights. Finally, they are unfamiliar with the practices of other similarly situated companies whose compensation packages might provide valuable guidance.

b. Response

Members of the Shareholder Compensation Committee would have disclosed their qualifications in the election process, and shareholders would have elected them based on those disclosures. It is likely that at least some of the members of the Committee would have the expertise to analyze both the materials provided to them and the recommendations of the directors. Even if some of the members of the Committee lacked in-depth knowledge of executive compensation practices, the Committee would be authorized to hire an independent compensation consultant to provide expert advice and guidance. Many directors, some who sit on compensation committees, are not experts on executive compensation and rely on compensation consultants.

As part of the process, the directors would provide the Shareholder Compensation Committee with all the information they used in reaching their compensation decisions, including financial information, performance evaluations under quantitative and qualitative performance metrics, and benchmarking. The directors would also have to provide the Shareholder Compensation Committee with proposed performance metrics for the coming year. If critical of the directors' proposals, the Shareholder Compensation Committee would show, in its proxy disclosure, why it disagreed with the directors' recommendations. It would explain its proposals fully and attempt to show why its proposals would be preferable to those of the directors. If its arguments were incomplete, unclear, or otherwise unpersuasive, shareholders would vote for the directors' proposals.

Knowing that their recommendations would be scrutinized by the Shareholder Compensation Committee, the directors would scrupulously justify their proposals. Any tendency that the directors had toward making extravagant recommendations would be tempered by the scrutiny of the Shareholder Compensation Committee and the public reaction that the Committee's criticisms would provoke. The executive-compensation tug-of-war resulting from competing proposals would furnish shareholders with all the information they would need to vote intelligently.

6. Shareholder Apathy

a. Objection

Even if all relevant information were placed in front of shareholders, they would not expend the effort to analyze or even read it. Many would not bother to cast a vote. Providing shareholders with control over executive compensation would be turning the decisionmaking process over to a cadre of the inattentive. If shareholders did exercise their vote without having analyzed the information in the proxy materials, their decisions would be a pin-the-tail-on-the-donkey exercise.

^{420.} One study shows that shareholders have declined to exercise their power under state law to amend bylaws to permit shareholders to opt out of anti-takeover restrictions. See Yair Jason Listokin, If You Give Shareholders Power, Do They Use It?: An Empirical Analysis 2–3, 13 (Yale Law & Econ. Research, Paper No. 383, 2009), available at http://ssrn.com/abstract=1400263 (concluding that simply increasing shareholder power may not alter corporate governance). The author may well be correct, but the proposal made in this Article would likely lead to action. Shareholder interest in reducing executive compensation—an issue of intense public concern—is probably much keener than shareholder interest in securing the right to opt out of a takeover that may never occur.

b. Response

Shareholder apathy is spawned by powerlessness. If shareholders had the clout to determine executive compensation, they would be eager to exercise that power. Rampant outrage suggests that shareholders are not mired in passivity. The reluctance of shareholders to wade through the CD&A results from its length, lack of clarity, and evasiveness. Competitive recommendations made by directors and Shareholder Compensation Committees would have to be understandable and persuasive to attract the votes of shareholders. Finally, a prominent notice would appear on the cover of every proxy statement:

SHAREHOLDERS HAVE A BINDING VOTE TO DETERMINE THE COMPENSATION OF DESIGNATED EXECUTIVES AND OF THE CHAIRPERSON OF THE BOARD. SEE PAGES X-XX FOR MORE DETAILS.

One supposes that most shareholders would turn to page X.

7. Shareholder Meddling

a. Objection

Corporate law establishes clear roles for directors and shareholders. Shareholders are passive investors, while directors are entrusted with the responsibility to function as guardians. The proposal made in this Article would upset the balance of power. Other proposals might follow that would further weaken the authority of directors until shareholders would have veto power over many, if not all, decisions of management. An erosion of managerial power would hobble corporate decisionmaking and jeopardize profits. Investors would flee from enterprises subject to shareholder interference.

b. Response

The fiduciary approach does not adequately control executive compensation. Soaring executive pay provides proof of this failure. Either because of conflicts of interest with or lack of commitment to shareholder interests, directors have not and will not negotiate reasonable compensation packages with CEOs and other top executives. Blind allegiance to a flawed system is not a solution.

^{421.} See supra Part III.C.

^{422.} See supra Part II.A-C.

^{423.} See supra notes 1-19 and accompanying text.

The fiduciary model, however, works admirably in allocating power to directors and officers to determine business policy and strategy. Only executive compensation is at issue. No one is arguing to scrap the broad powers of directors or managers. No one is arguing to abandon the business judgment rule. This proposal seeks merely to provide the owners of corporations—the very investors that the officers and directors represent—with the authority to avert compensation abuse.

8. Federal Intrusion

a. Objection

Over the years, the federal government has exercised more and more authority. During the financial crisis, the federal government has expanded its influence by purchasing substantial equity stakes in financial and automotive companies. The national government is simply too powerful. The need to contain the expansion of federal power is particularly acute in areas such as corporate law that are generally reserved to the states. Congress and the SEC would be violating the principle of federalism if they assumed power to establish rules of corporate governance. 424

b. Response

Exorbitant executive compensation presents a discrete and unique problem that has worsened over the years. The states have not exercised their power to curb executive pay. Given this default, the problem of executive compensation is a legitimate area of federal concern. This Article does not propose a wholesale imposition of federal authority over corporate law issues. Federal regulation of this specific area does not signal a tide of intrusion or the demise of federalism.

Individual states would not adopt corporate law that would implement the approach suggested in this Article. To avoid losing power over executive compensation, principals of companies would not incorporate in jurisdictions giving shareholders a determinative vote on compensation packages. Companies already incorporated in jurisdictions that followed the proposal made in this Article would change their states of incorporation. Such a migration would induce many states, wishing to garner corporate filing and renewal fees, to retain

^{424.} See Yin Wilczek, Proxies: Industry Expected to Sue if SEC Adopts Proxy Access; Lawsuit Risk Can Be Reduced, Sec. L. Daily (BNA), June 15, 2009 (pointing out that business leaders who oppose proposed Rule 14a-11, which would increase shareholder rights to nominate candidates for director positions, will argue that the proposed rule would usurp power from the states).

the status quo. The only effective strategy for the adoption of the approach advocated in this Article is federal legislation with supplementary administrative regulation.

VIII. CONCLUSION

Everyone wants to make more money. Just about no one voluntarily turns down an extra buck. Athletes, rock musicians, and movie stars rake in astronomical sums. The public views them with awe and envy, but most people accept the verdict of the free marketplace. The free market, however, does not decide executive pay. The fractured corporate governance structure does. Although directors are chastened to be prudent with company assets, they shovel corporate funds at managers. Managerial power and a lack of commitment to safeguard someone else's money explain this failure of corporate governance. Shareholders are an amorphous lot. They are a faceless, numberless aggregation of transients who quietly trade in and out of the corporate body politic. Directors are more influenced by day-to-day pressures in the boardroom than they are guided by the admonitions of abstract legal principles, the interests of impersonal business entities, or the welfare of that ineffable aggregation.

The problem is not merely one of pay without performance. Directors could link every dollar of executive compensation—or every ten million dollars—to performance, and pay could still be and almost certainly would be outlandishly high. Doing a good job does not excuse corporate looting. The free market provides no answers because of the failure of so many directors to negotiate efficient compensation arrangements. The so-called "free" market is an expensive proposition for shareholders. Benchmarking is useless. Pegging pay levels to the plundering of other corporate vaults just leads to more plundering. The only fair method is to vest in the shareholder the power to set executive pay.

The question is how to shift this power from directors to share-holders without disrupting the mechanisms of corporate governance. One answer is creating a workable framework for establishing Share-holder Compensation Committees. Provided with all the information available to the directors and guided by a compensation consultant, such Committees, if dissatisfied with the directors' proposals, would offer alternatives. Shareholders would no longer have to navigate through dense, confusing, and sometimes misleading disclosures. The directors would have an incentive to present their recommendations clearly and concisely, or they would face defeat. The Shareholder Compensation Committee would strive to provide both

focused criticisms of contested proposals and understandable explanations of its counterproposals. Shareholders would determine the compensation of the chairman of the board and the top executives running their companies. Stripped of millions in salary, options, and restricted stock, those executives would not tolerate making less than their subordinates. The pay of lower ranking managers would tumble. 425

Countless proposals to curb executive pay are swirling through Washington. The public is fed up, President Obama is engaged, 426 and Congress is prepared to act. Corporate lobbyists will condemn this proposal as an assault on big business, small business, capitalism, freedom, and all the values that America holds dear. The lawmakers should rebuff them. This is a simple matter of billions of dollars and trillions of cents.

^{425.} Cf. Kara Scannell, SEC Ready to Require More Pay Disclosures, WALL St. J., June 3, 2009, at C1 (reporting that the SEC is contemplating new disclosure requirements covering low-ranking executives).

^{426.} After issuing executive compensation guidelines applying to recipients of TARP funds, President Obama deferred to Congress, which enacted even tougher restraints than those proposed by the President. See Deborah Solomon, White House Set to Appoint a Pay Czar, Wall St. J., June 5, 2009, at A2 (explaining that after the Obama administration issued guidelines for executive pay, "Congress . . . chimed in with even tougher rules"). On June 17, 2009, President Obama unveiled a comprehensive economic regulatory plan, which supports many of the proposals adopted in the Interim Final Rule. Seeking to curb excessive executive compensation, the plan proposes (1) the use of performance-related metrics for compensation, (2) the alignment of compensation with sound risk management, (3) the reexamination of golden parachutes and supplemental retirement packages to achieve alignment with shareholder interests, (4) say-on-pay, and (5) the enhancement of the independence of compensation committees and compensation consultants. Dep't OF THE Treasury, Financial Regulatory Reform 29–30 (2009), http://www.financial-stability.gov/docs/regs/FinalReport_web.pdf.