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Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform

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Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform

*Omari Scott Simmons**

ABSTRACT

No corporate governance issue captures the imagination and frustration of the American public and politicians more than executive compensation. Despite decades of varied responses to address soaring executive compensation such as tax measures, board independence requirements, and mandated disclosures, executive compensation levels continue to soar, as does the saliency of executive compensation as a political issue. Most of the legal literature on executive compensation has focused on the conduct of wayward managers. This Article, however, examines the impact of political behavior (that is, lawmaker opportunism) on executive compensation reform. For lawmakers, executive compensation reform operates as a blue pill—a mechanism for lawmaker diversion and responsibility-shifting that diverts corporate constituent and scholarly attention away from more important corporate governance and socio-economic issues. This scenario threatens the prospect of optimal reform. Executive compensation reform is analogous to a service exhibiting credence characteristics. Credence characteristics are service attributes whose quality cannot be fully determined even after significant use. Examples of services with substantial credence characteristics include automobile repair services, medical treatments, and corporate law. In the corporate law context, corporate lawmakers—for example, the state of Delaware and the federal government—not only provide reform services, but also act as experts and diagnose corporate governance problems. Information asymmetries between lawmakers and various corporate constituencies (for example, managers, shareholders, and populist groups) create perverse incentives for opportunistic lawmaker behavior. The unobservable impact of executive compensation reform provides lawmakers with added discretion that is often used

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for incremental, moderate, or conservative corporate reforms, even in the face of crisis. On the other hand, sweeping reforms are unlikely because they pose a serious risk to political capital. Therefore, lawmaker cries for executive compensation reform should be approached with vigilance.

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I. INTRODUCTION

"[T]he [Matrix is the] world that has been pulled over your eyes to blind you from the truth."[1]

"Government is the solution to some problems and the source of others."[2]

NO corporate governance issue captures the imagination and frustration of the American public and politicians more than executive compensation.[3] Next to the decision to sell or merge a company, the selection of a CEO is perhaps the most important decision

1. THE MATRIX (Warner Bros. & Vill. Roadshow Pictures 1999). Due to the popularity of the 1999 film "The Matrix," the terms "blue pill" and "red pill" have become a popular metaphor for the choice between blissful ignorance or the examined life, respectively. *See id.* In the film, the protagonist Neo is given the choice between (i) a blue pill preserving the status quo of blissful ignorance or (ii) a red pill revealing the deeper truth of the Matrix. *Id.* Neo chooses the latter and his adventure ensues. *See id.* In essence, the Matrix is nothing more than a computer generated program to control the minds of human beings, who are unwittingly being harvested as an energy source for world-dominating machines. *See id.* In the words of the character Morpheus: "[The Matrix] is the world that has been pulled over your eyes to blind you from the truth." *Id. Similarly, this Article contends that executive compensation reforms over the past two decades are diversionary blue pills.*

2. Gordon Tullock, *Public Choice*, *in* 3 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 1040, 1044 (John Eatwell et al. eds., 1987).

3. *See* Joshua Chaffin, *Executives May Have to Return Bonuses*, FIN. TIMES (London), Apr. 10, 2003, at 7 ("Senator Chuck Grassley, chairman of the Senate finance committee, yesterday introduced the Corporate Accountability in Bankruptcy Act, which would allow trustees to recover bonuses, deferred compensation and loans extended to executives and officers the year prior to the company's bankruptcy filing."); Caroline Daniel, *Delta Chief to Have Pay Cut*, FIN. TIMES (London), Apr. 5, 2003, at 10 ("Leo Mullin, chief executive of Delta, is to cut his future pay package by about Dollars 9m, and take a 25 per cent salary cut effective immediately as political pressure grows on pay levels for airline executives."); Caroline Daniel & Jeremy Grant, *Success Must Dictate Bosses' Pay, Says Bush*, FIN. TIMES (London), Feb. 1, 2007, at 5 ("Governments should not decide the compensation for America's corporate executives but the salaries and bonuses of chief executives should be based on their success and improving their companies and bringing value to their shareholders." (quoting President George W. Bush)); Jeremy Grant, *Obama Joins Push on Executive Pay Awards*, FIN. TIMES (London), Apr. 21, 2007, at 4 (citing Senator Barack Obama's introduction of a say-on-pay bill in the Senate identical to the one Congressman Barney Frank introduced in the House of Representatives); David Leonhardt, *Anger at Executives' Profits Fuels Support for Stock Curb*, N.Y. TIMES, July 9, 2002, at A1 ("In a step that would have been unthinkable in the long economic boom of the 1990's, an expanding array of big investors, policy makers and even a few business leaders are arguing that top executives should be required to keep much of their own company stock for as long as they hold their jobs."); Richard A. Oppel, Jr., *Options Foe Is Not So Lonely Now*, N.Y. TIMES, Apr. 7, 2002, at B2 (describing how Congressman Carl Levin, D-Michigan, "proposed legislation that would strip companies of the lucrative tax

a board will make. In some instances, hiring a highly touted CEO can boost a company's market valuation by fifteen percent or more.[4] Despite the importance of the decision to hire a CEO, the amount of attention executive compensation receives exceeds its impact on corporate performance. This overemphasis is due, in large part, to lawmaker opportunism upon which this Article focuses.

Whereas most of the corporate law literature on executive compensation has focused on rent extraction by wayward corporate managers,[5] this Article uses a moderate form of public choice theory to examine the impact of lawmaker opportunism on the shape of executive compensation reform. Public choice theory generally assumes that political actors, like private market actors, are mainly self-interested and that the pursuit of lawmaker self-interest may result in government failure, that is, inefficient policies.[6] Thus, corporate lawmaker self-interest and opportunism, just like wayward corporate managers, can be a source of rent extraction, inefficiency, and welfare loss.[7] The existing legal literature, however, fails to capture the complexity of the executive compensation issue from a political perspective. This Article fills a critical gap in the legal literature by arguing lawmaker motivations, in large part, explain the inconsistencies, inefficiencies, perceived bias, and symbolism characterizing executive compensation reform for almost two decades.

The executive compensation debate achieved national prominence in the early 1990s in response to perceived excesses of the 1980s.[8] In 1992,

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benefits they receive when options are exercised, unless they deduct the cost of options on their income statements").

4. *See, e.g.*, Max Landsberg, *In Search of Excellence in CEO Succession: The Seven Habits of Highly Effective Boards* 1 (Mar. 15, 2006) (unpublished manuscript), http://www.heidrick.com/IC/Published/Governance/ (follow "In search of excellence in CEO Succession: seven habits of highly effective boards" hyperlink); *Tough at the Top*, ECONOMIST, Oct. 25, 2003, at 3; *see also* Rakesh Khurana & Nitin Nohria, The Performance Consequences of CEO Turnover 39 TBL. 2 (2000), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=219129.

5. *See* discussion *infra* Part II.C.

6. *See* Tullock, *supra* note 2, at 1041. A moderate form of public choice theory is a useful paradigm not only to analyze the shape of the U.S. corporate law regime, but also to predict when the interests of certain corporate constituencies (for example, managers, shareholders, and populist groups) are likely to prevail in regulatory outcomes. *See id.* A moderate form of public choice theory acknowledges other aspects of lawmaker utility beyond the maximization of political capital, such as public interest considerations. *See id.*

7. *See, e.g.*, Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q. J. ECON. 371, 371 (1983); Timothy J. Feddersen & Thomas W. Gilligan, *Saints and Markets: Activists and the Supply of Credence Goods*, 10 J. ECON. & MGMT. STRATEGY 149, 153 (2001); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976).

8. *See* Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CIN. L. REV. 713, 713-14 (1994) [hereinafter Murphy, *Politics*]; *see also* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 255-58 (1990) [hereinafter Jensen & Murphy, *Performance Pay*] (arguing community sentiment had constrained executive pay since the 1930s, decreasing CEO incentives). In 1991, Martin Sabo, a Democratic Congressman from Minnesota, introduced a bill that would prohibit corporate tax deductions for any executive pay exceeding twenty-five times the pay of the lowest company employee. Murphy, *Politics*, *supra*, at 727. The same year, Senator Carl Levin of Michigan introduced the "Corporate Pay Responsibility Act," which

presidential hopeful Bill Clinton promised to end the practice of allowing companies to take tax deductions for excessive executive pay.[9] Delivering on his campaign pledge, President Clinton helped revamp Internal Revenue Service (IRS) regulations to define executive compensation in excess of one million dollars as excessive and not deductible as a corporate expense.[10] In hindsight, calling this reform effort unsuccessful is an understatement.[11] In the wake of the Clinton Administration's tax reform, executive pay rose to all-time highs, tripling in just eight years.[12] Unfortunately, this failed attempt at reform is not an isolated occurrence.

Despite decades of varied responses to address soaring executive compensation such as tax measures, board independence requirements, and mandated disclosures, executive compensation levels continue to soar, as does the saliency of executive compensation as a political issue.[13] Not surprisingly, corporate scandals and the excesses of the early twenty-first century continue to draw shareholder and public attention to executive compensation and away from other important corporate governance and socio-economic issues. In some of these scandals, managers distorted earnings or engaged in other fraudulent conduct to enrich senior executives while shareholder value plummeted.[14] Under such circumstances, the impropriety is obvious. In other cases, hefty levels of executive compensation, even in the absence of fraud or accounting irregularities, are either (i) criticized for their tenuous link to performance or (ii) become a rallying cry of populist concern, especially when they coincide with poor

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was later preempted by changes to SEC proxy rules and disclosure requirements. *Id.* at 728-29.

9. David Leonhardt, *Why Is This Man Smiling?: Executive Pay Drops Off the Political Radar*, N.Y. TIMES, Apr. 16, 2000, at WK5 (asserting that President Bill Clinton vowed to curb chief executive salaries and passed a tax law during his first year in office; subsequently, the average chief executive's salary tripled in the eight years following the tax reform, yet executive pay "managed to disappear as a political issue").

10. Ryan Miske, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1675 (2004).

11. *See id.* at 1687 (asserting that the use of tax caps led to the unintended consequences of increased levels of pay because the caps functioned as minimum base salaries rather than the maximum).

12. *See* Leonhardt, *supra* note 9.

13. *See id.*; *see also* Nathan Knutt, *Executive Compensation Regulation: Corporate America, Heal Thyself*, 47 ARIZ. L. REV. 493, 494-95 (2005).

14. *See* Joann S. Lublin, *CEO Compensation Survey (A Special Report): Milestones or Missteps? A Rundown of Some of the Most Dubious Deeds in Executive Pay that Occurred or Surfaced During 2005*, WALL ST. J., Apr. 10, 2006, at R4 (citing questionable executive compensation scenarios); Gretchen Morgenson, *Executive Pay at Delphi Is Challenged*, N.Y. TIMES, Nov. 23, 2005, at C4 ("The lead plaintiffs in a class-action lawsuit against the Delphi Corporation yesterday asked the judge overseeing the company's bankruptcy to reject a proposed $110 million executive pay plan."); John Schwartz & Richard A. Oppel, Jr., *Enron's Collapse: The Chief Executive*, N.Y. TIMES, Nov. 29, 2001, at C1 ("Over the last decade or so, Mr. Lay earned some $300 million from Enron, mostly by exercising stock options. Earlier this month, when employees grew incensed at the prospect of his collecting a big severance package with the company's sale to Dynegy, he volunteered to walk away from $60 million in payments.").

corporate performance and unfavorable economic conditions.[15] Despite the varied perspectives on the executive compensation issue, the executive compensation debate, from a political standpoint, is inextricably tied to both shareholder wealth maximization and public accountability concerns that often diverge.[16]

In the midst of a severe economic recession and the contentious 2008 presidential election, presidential candidates indiscriminately invoked excessive executive compensation as a key corporate governance issue that reflected social inequities and demanded a regulatory response.[17] The advent of the Obama Administration reflects an even greater preoccupation with executive compensation reform.[18] Irrespective of political rhetoric and posturing, the reduction of executive pay for a few individuals at the top of the wealth pyramid may ameliorate populist outrage, but does not necessarily put money back into the hands of ordinary Americans.[19]

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15. *See* Murphy, *Politics*, *supra* note 8, at 725 (asserting that the executive compensation debate is a hybrid of populist backlash against high pay levels and shareholder efficiency concerns); *see also Book of Revelations*, ECONOMIST, Jan. 21, 2006, at 61 (describing how Michael Eisner, the former CEO of Walt Disney Corporation, "was a genuinely outstanding manager during the first part of his more than 20 years at the top of the firm. But he was then paid $800m over a 13-year period in which his company's shares did worse than government bonds"); Eric Dash, *For Ousted Citigroup Chief, a Bonus of $12.5 Million*, N.Y. TIMES, Nov. 12, 2007, at C5 (describing how Citigroup CEO Chuck Prince "can rest assured that he will leave with $68 million, including his salary and accumulated stockholdings; a $1.7 million pension; an office, car and driver for up to five years—all in addition to the bonus," despite the evaporation of his company's market valuation); Brett H. McDonnell, *Two Goals for Executive Compensation Reform*, 52 N.Y.L. SCH. L. REV. 586, 586 (2008) (acknowledging two dimensions to the executive pay problem—a corporate governance perspective and a social inequality perspective); Tom McGinty, *Say-on-Pay Doesn't Play on Wall Street*, WALL ST. J., May 22, 2008, at C1 ("From 2004 to 2007, top executives at Bear Stearns Cos., Citigroup, Goldman, J.P. Morgan, Lehman Brothers Holdings Inc., Merrill and Morgan Stanley got about $3.63 billion in salary, bonuses, stock grants and exercised options, according to figures disclosed for executives named in their proxy filings and compiled by Standard & Poor's.").

16. *See, e.g.*, McDonnell, *supra* note 15, at 588; Murphy, *Politics*, *supra* note 8, at 715; *Let the Fight Begin*, ECONOMIST, June 14, 2008, at 18 ("Executive pay is not only a measure of what society judges as fair; it is also a test of whether business is run for its shareholders.").

17. *See* John Edwards, Editorial, *My Plan to Stop Corporate Abuses*, WALL ST. J., Jan. 2, 2008, at A11 ("As president, I will immediately cap untaxed deferred compensation for executives."); David D. Kirkpatrick, *Shake, Rattle, and Roil the Grand Ol' Coalition*, N.Y. TIMES, Dec. 30, 2007, § 4, at 1 (describing how former Republican presidential candidate Mike Huckabee criticized executive compensation); David Leonhardt, *For Clinton, Government as Economic Prod*, N.Y. TIMES, Jan. 21, 2008, at A1 (mentioning how Senator Hillary Clinton, former Democratic presidential candidate, described some executive pay as "offensive" and "wrong" and said that she wants to consider proposals for new laws made by business school and law school professors); Joann S. Lublin, *U.S. News: Candidates Target Executive Pay*, WALL ST. J., Apr. 12, 2008, at A4 (describing how "Sen. McCain recently blasted what he called the 'outrageous' and 'unconscionable' rewards received by leaders of Bear Sterns Cos. and Countrywide Financial Corp. despite the credit crisis;" meanwhile, "[a]n Obama commercial that has aired in 14 states assails chief executives 'who are making more in 10 minutes than ordinary workers are making in a year'").

18. Edmund L. Andrews & Vikas Bajaj, *U.S. Plans $500,000 Cap on Executive Pay in Bailouts*, N.Y. TIMES, Feb. 3, 2009, *available at* http://www.nytimes.com/2009/02/04/business/04pay.html?_r=1&hp.

19. *See* McDonnell, *supra* note 15, at 592-95. The impact of executive pay on income inequality is fairly modest. *Id.* at 595-96. Empirical studies show executives' contribution

Similarly, occasional disgorgements and reductions of pay for underperforming CEOs and other senior executives provide only negligible benefits to certain corporate constituencies.[20]

In the broader political context, the overemphasis on executive compensation is a diversion from other pertinent socio-economic issues like the minimum wage, health insurance, social security, pension protection, and the sub-prime mortgage crisis that are more relevant to ordinary Americans and often addressed outside of the realm of traditional corporate law.[21] Lawmakers often link executive compensation, albeit tenuously, to broader economic turmoil, such as plant closings, unemployment, outsourcing domestic jobs, and income inequality.[22] For lawmakers, the matrix of executive compensation reforms operates like a blue pill, keeping corporate constituencies, especially populist groups, in a state of blissful ignorance, foregoing a deeper analysis that reveals the reality of lawmaker opportunism and manipulation.[23] This Article contends that corporate constituents and legal commentators, by ignoring the political construction of the executive compensation issue, are in essence taking a blue pill that threatens the prospect of optimal reform.

As executive compensation levels continue to rise despite decades of lawmaker reforms (or multiple blue pills), the impact of such reforms is in question.[24] For some corporate constituents, qualitative assessments of corporate reform prove difficult because corporate reform exhibits credence characteristics. Credence characteristics are service attributes whose quality cannot be fully determined even after significant use.[25]

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to income inequality is negligible because they comprise no more than five or six percent of individuals in the top income bracket. *See id.* at 592-93.

20. *See, e.g.*, Stuart Elliott, *Interpublic Executives to Give Up Stock Options*, N.Y. TIMES, May 21, 2003, at C1 ("Eight executives at the meeting, including the present chairman and chief executive and his two immediate predecessors, said they would relinquish more than 1.2 million stock options, with an unspecified amount earmarked to reward employees at lower levels at the agencies owned by Interpublic."); Gretchen Morgenson, *Cendant's Chief Is Taking a Pay Cut, But Some Say That It's Hard to Determine How Much of One*, N.Y. TIMES, Apr. 20, 2004, at C8 ("Bowing to shareholder pressure, Henry R. Silverman, the chairman and chief executive of the Cendant Corporation and recipient of one of the richest executive compensation packages in the United States, took a bit of a pay cut yesterday as the company announced changes to his employment contract.").

21. *See* ROBERT CHARLES CLARK, CORPORATE LAW § 1.4 (1986) (distinguishing between traditional corporate law and other laws affecting corporations). Examples of other laws affecting corporations include other types of regulation (for example, environmental, labor, health, and safety regulations). *Id.*

22. *See, e.g.*, Edmund L. Andrews, *Democrats Link Fortunes to Rise in Minimum Wage*, N.Y. TIMES, July 13, 2006, at A18 (describing the Democratic party's campaign linking executive pay to income inequality).

23. *See* THE MATRIX, *supra* note 1.

24. Knutt, *supra* note 13, at 506 (arguing that government regulation of executive compensation is usually ineffective and that companies should self-regulate to quell outrage, in order to prevent further government interference).

25. *See* Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67, 68-69 (1973); Wolfgang Pesendorfer & Asher Wolinsky, *Second Opinions and Price Competition: Inefficiency in the Market for Expert Advice*, 70 REV. ECON. STUD. 417 (2003); Asher Wolinksy, *Competition in a Market for Informed Experts' Services*, 24 RAND J. ECON. 380 (1993).

Consumers of services with substantial credence characteristics (for example, automobile repair services, medical treatments, and corporate law) are never sure about the optimum amount (and even type) of the service needed.[26]

Consider the following scenario: In the act of treating an ailing patient a doctor recommends an invasive surgical procedure, a regimen of prescription medication (that is, five blue pills daily), plus exercise and rest. Assuming the patient's ailment improves, will the patient ever know whether the surgical procedure was necessary or superfluous? Would the blue pills and exercise regimen effectively cure the ailment? Or would the body's natural healing response over time, without the intervention of a doctor and medication, suffice? The patient in this scenario has limited information and relies on the doctor's expertise for both the diagnosis and treatment. Even after the medical services have been provided, the patient still may have limited ability to evaluate the quality of the services rendered. Given the bounded rationality of the patient, the doctor, with informational advantages, has perverse incentives to provide excessive treatment or withhold treatment where profitable.[27] Faced with this dilemma, the patient must resort to a number of crude heuristics to determine the quality of the medical services. The typical patient may: (i) study degrees on a doctor's office wall; (ii) seek a second opinion, if available, from another physician; or (iii) seek the opinion of respected acquaintances, friends, and family prior to selecting a physician. The provision of corporate reform is, at times, analogous to the above scenario.

In the corporate law context, corporate lawmakers—for example, the state of Delaware and the federal government—not only provide reform

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26. *See id.* at 69. Corporate regulation is more likely a service than a tangible good. *See generally* U.C.C. § 2-105 (2005) (providing a definition of goods under the UCC). But, regardless of whether one considers corporate regulation a service or good, the following analysis will not change.

27. *See* Feddersen & Gilligan, *supra* note 7, at 158 ("When consumers cannot observe the quality of a firm's product, there are strong incentives for opportunistic behavior, and the resulting equilibrium does not maximize social welfare. This result is well known and identifies the canonical failure of credence-good markets to attain economic efficiency."); Frank A. Sloan & Mark A. Hall, *Market Failures and the Evolution of State Regulation of Managed Care*, 65 J.L. & CONTEMP. PROBS. 169, 172-75 (2002) (describing the credence characteristics of medical services); *see also Sawbones, Cowboys and Cheats*, ECONOMIST, Apr. 15, 2006, at 78 (discussing 1990s studies of Swiss surgeons, who had the ability, as well as the incentives, to "overtreat" their patients due to information asymmetries, finding surgeons less likely to operate on the most sophisticated patients, for example, lawyers' spouses).

A similar example involves the provision of legal services. A lawyer communicates to her corporate client that, in order to comply with certain regulations, the client must do X, Y, and Z. Will action X suffice and eliminate the threat of noncompliance? Because legal services involve questions of judgment against a backdrop of uncertainty, the client must depend on the lawyer's judgment to not only provide services, but determine the adequate level of service. In the above scenario, actions X, Y, and Z are inevitably more costly than action X. *See* John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1311-14 (2001) (characterizing takeover-related legal advice as a credence service).

services but also act as experts and diagnose corporate governance problems.[28] The coupling of diagnosis and treatment, as well as information asymmetries between lawmakers and various corporate constituencies (for example, managers, shareholders, and populist groups), create incentives for opportunistic lawmaker behavior.[29] Accordingly, the credence characteristics of corporate reform have significant implications for corporate governance from both a supply and demand perspective. Instead of seeking pecuniary profit, lawmakers seek to maximize political capital. Unfortunately, due to information asymmetries, corporate constituencies have difficulty detecting lawmaker opportunism and, in some instances, lawmaker incompetence. Given the credence characteristics of executive compensation reform, there is an enhanced risk that lawmakers may mitigate political backlash and promote acquiescence without actually addressing fundamental flaws in the corporate governance system or foregoing more effective redistributive policies and interventions.

Although the actual seller-consumer scenario differs from the political context,[30] the supply and demand paradigm is nonetheless instructive for analyzing the incentives of lawmakers and how corporate constituents evaluate the efficacy of corporate reform services. Arguments asserting that regulation is efficient, inefficient, necessary, unnecessary, fair, or unfair must also "show what is 'in it' for the political actors when they move" in a particular direction.[31] The analysis of credence characteristics is a valuable complement to public choice approaches to corporate law scholarship because it explains how the unobservable impact of corporate reform facilitates even greater lawmaker discretion. Furthermore, it provides a realistic description of the interaction between lawmakers and various corporate constituencies by acknowledging the impact of political behavior and information asymmetries on the shape of U.S. corporate governance. Executive compensation is only part of a larger conversation that might sensitize researchers to the impact of credence characteristics on corporate reform.

Part II of this Article briefly describes the dynamics of executive pay decisions and the limitations of existing theories addressing executive pay. This Part argues that the primary deficiency among existing theories addressing executive pay (that is, the market forces theory, the optimal contracting theory, and the managerial power theory) is their insufficient

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28. Whereas corporate scholars have discussed the credence characteristics of corporate legal services, none have discussed corporate reform as a service exhibiting credence characteristics. *See, e.g.*, Coates, *supra* note 27.

29. *See* Winand Emons, *Credence Goods and Fraudulent Experts*, 28 RAND J. ECON. 107, 111 (1997) (asserting that even *ex-post*, consumers have difficulty determining the level of service needed *ex ante*).

30. In the buyer-seller scenario, the buyer in theory may choose other goods and services if in a position to do so. Also, the exchange of political capital is not as fluid as the exchange of monetary currency.

31. *See* Sam Peltzman, *George Stigler's Contribution to the Economic Analysis of Regulation*, 101 J. POL. ECON. 818, 824 (1993).

treatment of politics and lawmaker opportunism (as opposed to managerial incentives).

Part III illustrates the importance of credence characteristics in the corporate reform context. This Part explains how Delaware and the federal government, both arguably monopolist corporate lawmakers, supply corporate reform services to corporate constituencies (for example, managers, shareholders, and populist groups). However, corporate lawmakers not only provide reform services, they also act as experts diagnosing corporate governance problems for corporate constituencies. Credence characteristics and information asymmetries between lawmakers and corporate constituents create perverse incentives for lawmaker opportunism.

Part IV analyzes credence characteristic-laden services from a supply-side or lawmaker perspective. First, this Part argues that from a supply-side perspective, credence characteristics raise questions concerning how lawmakers may exploit information asymmetries to maximize political capital. Credence characteristics allow lawmakers to straddle the fence between political symbolism and conscientious resolution of corporate governance issues. Second, this Part explores how lawmaker diagnosis of the executive pay problem is often muddled and vacillates between the (i) shareholder wealth-maximization perspective; and (ii) the public accountability perspective. From a political standpoint, executive pay is inextricably tied to both of these perspectives that often diverge. Finally, this Part examines the shape of lawmaker reform services such as judicial arbitration services, procedural mandates to achieve independence, disclosure-related reforms, shareholder voting reforms, tax-related measures, and clawback measures. The total impact of these reforms, although beneficial, is difficult to discern and politically determined.

Part V explores executive pay reforms from a demand or corporate constituent perspective. From the demand perspective, credence characteristics raise questions concerning how corporate constituents discern the quality of corporate reform and lawmaker motivations. Corporate constituents have different perspectives concerning what constitutes quality reform and may experience varying degrees of information asymmetry that impact their ability to evaluate reform. Analogous to consumers in product and service markets, corporate constituencies, out of necessity, must rely on various heuristics as a proxy for quality when evaluating the efficacy of corporate reform. Examples of these mechanisms include: (i) third parties such as executive search firms, compensation consultants, institutional shareholders, corporate watchdogs, and academics; (ii) procedures signaling fairness; and (iii) the lawmakers' credible commitment and brand.

Part VI sets forth the key implications of the credence characteristic analysis on executive compensation reform. In lieu of a specific policy proposal, this Part examines the impediments to optimal reform. First, this Part contends that the analysis of credence characteristics provides a novel assessment of political effects on executive compensation reform. It

reveals how lawmakers and corporate constituents respond to the unobservable impact of executive compensation reform. Moreover, credence characteristics in the executive compensation reform context are only part of a larger conversation that might sensitize researchers to the impact of credence characteristics and political effects on corporate reform. Second, this Part posits that the credence characteristics of executive compensation reform provide greater discretion for lawmaker action, particularly in response to less informed constituencies (for example, populist groups). Lawmakers use this added discretion, even during periods of economic turmoil, to act conservatively and incrementally. Third, this Part contends that executive pay reform operates as a blue pill—a mechanism for lawmaker diversion and responsibility-shifting.[32] By singling out and seeking to limit pay for executives at the top of the wealth pyramid, lawmakers may divert pressure to improve the plight of those at the bottom via increasing the minimum wage or other redistributive policies and interventions. This diversion of populist outrage may have negative consequences for populist corporate constituencies.[33] Meanwhile, this same over-emphasis on executive compensation reform also diverts attention (arguably to the benefit of corporate managers) from more disruptive corporate reforms that shift the internal power relationships between managers and shareholders. Finally, this Part asserts that, despite the costs of lawmaker opportunism, political behavior may have the positive impact of mediating economic turmoil. Thus, in order to prevent greater future inefficiency or backlash, lawmakers may create moderately inefficient executive compensation rules.

II. LIMITATIONS OF EXISTING THEORIES ADDRESSING EXECUTIVE COMPENSATION

A. The Executive Pay Decision

The board is ultimately responsible for hiring the CEO,[34] often with the assistance of an executive search firm. Similarly, the board sets CEO compensation, often via a compensation committee aided by consultants.[35] The decision to hire a CEO is one of the most important deci-

32. *See* The Matrix, *supra* note 1.

33. Populist groups include broader stakeholder groups such as employees, unions, environmental and consumer watchdogs, and communities.

34. Douglas G. Baird, *Other People's Money*, 60 Stan. L. Rev. 1309, 1338 (2008). Although this article often focuses on the example of CEO pay, similar arguments apply to other senior executives.

35. In theory, the board manages the modern corporation, yet it delegates management authority to the CEO and senior executives. Such delegation to professional management is necessary to address transaction costs in the complex, modern, multi-division, publicly-traded company. *See generally* Alfred D. Chandler, Jr., The Visible Hand: The Managerial Revolution in American Business (1977). Meanwhile, the separation of ownership and control between managers and shareholders creates an additional set of transaction costs or agency costs. *See generally* Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property (1932).

sions a board is likely to make.[36] When hiring a new CEO, boards choose between external and internal candidates exhibiting a wide array of traits and competencies, such as: integrity, operational skills, financial acumen, persuasion, communication, accountability, and energy.[37] The board's primary concern in the competitive marketplace is securing the top candidate.[38] This aggressive quest for top talent is analogous to the free agency market in professional sports promoting high compensation levels.[39] In the executive search process for most large companies, compensation is most likely a secondary concern. The CEO compensation decision can coincide with hiring a new CEO or negotiating with an incumbent CEO. In either case, the CEO compensation decision is generally protected under the business judgment rule.[40]

In theory, executive compensation, when used effectively, can reduce agency costs and promote an array of predetermined corporate goals.[41] These performance goals generally fall into two categories: financial and operational objectives.[42] Examples of financial objectives include: net income; earnings before interest, taxes, depreciation, and amortization (EBITDA); earnings per share (EPS); and share price.[43] In addition to

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36. Landsberg, *supra* note 4, at 1.

37. *See* Heidrick & Struggles, *Inside the C-Suite* 4-5, http://www.heidrick.com/IC/Published/Leadership/ (follow "Inside the C-Suite" hyperlink) (last visited Jan. 20, 2009).

38. *See* ROBERT H. FRANK & PHILIP J. COOK, THE WINNER-TAKE-ALL SOCIETY 70 (1995).

39. *See id.* at 71 (asserting that the market for top executive talent resembles free agency in professional sports and escalates compensation). The hiring of internal candidates may not necessarily lead to significantly lower executive pay because companies must pay a premium to keep corporate all-stars from being poached by competitors. *See id.* at 70-71.

40. Where compensation is approved by disinterested and independent directors, courts will invoke the business judgment rule. The lack of director independence or disinterestedness, however, may give rise to entire fairness review, that is, greater judicial scrutiny assessing whether executive pay is fair and reasonable. *See In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27, 52, 73 (Del. 2006) (finding directors' approval of CEO compensation and no-fault termination severance protected by business judgment rule). *But see In re* Viacom Inc. S'holder Derivative Litig., No. 602527/05, 2006 N.Y. Misc. LEXIS 2891, at *12 (N.Y. Sup. Ct. June 23, 2006) (finding plaintiff raised sufficient questions about the independence of the compensation committee to avoid dismissal under the business judgment rule). In most public companies the independence and disinterestedness thresholds are easily met. Therefore, the business judgment rule presumption often applies in the public company context. Accordingly, a plaintiff must show that the compensation in question constituted a waste of corporate assets, that is, no reasonable relationship to the value of services rendered. *See* Beard v. Elster, 160 A.2d 731, 737 (Del. 1960). This is an extremely high burden for plaintiffs to meet. *See id.* at 737-39 (upholding disinterested board approval of stock options where "reasonable businessmen, fully informed, might differ").

41. *See* Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1872-73 (2001) (describing six categories of incentives to align management and shareholders: "compensation-related, job-preservation-related, liability-regime-related, future-employment-related, . . . social-status-related, and internalized").

42. *See* RiskMetrics Group, Explorations in Executive Compensation 13 (2008), *available at* http://www.riskmetrics.com/sites/default/files/RMGExplorationsinExecutiveCompensation20080520Final.pdf.

43. *Id.* at 13-14. There is considerable disagreement concerning the suitability of certain financial metrics. *See generally* Exacto Spring Corp. v. Comm'r., 196 F.3d 833 (7th Cir. 1999) (Posner, J.).

the standard financial performance-based compensation metrics such as share price, a firm's management, in their discretion, may also establish operational performance-based metrics such as customer service, product development, environmental stewardship, legal compliance, and diversity.[44] Independent of performance-based objectives, firms have additional concerns such as recruitment and retention of top executive talent that inevitably raise pay levels. When setting compensation performance goals and criteria, some degree of subjectivity is unavoidable.[45] Despite the existence of complex formulaic approaches to determine executive compensation, it is virtually impossible to discern the exact value that a CEO confers on an organization. In this sense, the imponderability of CEO impact resembles the imponderable impact of executive compensation reform.

B. Elements of Executive Compensation

Executive compensation has many moving parts that further complicate its regulation. Accordingly, "[e]ven with enhanced SEC disclosure requirements, quantifying and evaluating executive compensation today is a much more difficult proposition than it was twenty years ago."[46] Common elements of executive compensation include: (i) a fixed base salary; (ii) variable remuneration or bonus schemes, such as long term incentive plans (LTIPs) and stock options; (iii) perquisites, such as pensions, deferred compensation, insurance schemes, company cars, corporate jet usage, subsidized mortgages, box seats, and relocation costs; (iv) severance payments, such as golden parachutes and handshakes; and (v) charitable contributions.[47] In addition to these examples of recognized modes of compensation, new modes of remuneration are always developing.[48] While most executive pay derives from a managerial services contract (usually five years or less in duration), discretionary or highly subjective forms of remuneration are neither uncommon nor uncontroversial.[49] Whether executive compensation is contractual or discretionary, equity-based or non equity-based, the link to actual executive performance is never precise. David Walker describes the difficulty presented by multiple compensation elements:

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44. *See id.* at 14.

45. *See* Malcolm Gladwell, *Most Likely to Succeed*, The New Yorker, Dec. 15, 2008, at 37 (describing the NFL quarterback problem where it is nearly impossible in some professional fields to predict how candidates will perform once hired).

46. David I. Walker, *The Manager's Share*, 47 Wm. & Mary L. Rev. 587, 661 (2005).

47. *See id.*

48. *See* Susan Lorde Martin, *Executive Compensation: Reining in Runaway Abuses—Again*, 41 U.S.F. L. Rev. 147, 148 (2006) ("Corporate compensation consultants noted that whenever the government put limits on executive compensation, corporations automatically restored the lost benefits through alternative means.").

49. *See* Lucian Bebchuk & Jesse Fried, Pay Without Performance: The Unfulfilled Promise of Executive Compensation 95-111, 132-35 (2004) (discussing discretionary severance, retirement grants, and perquisites).

> Today executive stock options have supplanted cash salary as the largest single component of the average large company CEO's pay package, but options are only a small part of the picture. Modern CEO compensation packages include cash, options, restricted stock, phantom stock and options, a wide variety of bonus opportunities, not to mention an ever-expanding array of benefits and perks, many of which, such as SERPs and deferred compensation plans, represent significant financial commitments by shareholders.[50]

To be fair, new Financial Accounting Standards Board (FASB) rules require companies to disclose "fair value" expenses "for all forms of equity compensation, including options, in their financial statements."[51] Prior to these rules, "stock options were the most common equity vehicle due to their favorable accounting treatment."[52] As a result of the new FASB rules, companies are reevaluating whether to use a greater mix of equity incentives (for example, restricted stock).[53] However, an added effect of "dividing compensation between salary, bonuses, perks, golden parachutes, and the like tends to reduce salience and outrage and permit greater overall [managerial] appropriation."[54]

C. Prevailing Theories to Constrain Executive Compensation

The overwhelming majority of legal scholarship dedicated to executive compensation has focused on either aligning incentives of directors, who set executive pay packages, with shareholder interests or combating excessive pay levels. Given the perverse incentives of management, there is little doubt shareholders and the public have reason to question executive compensation approved by boards. However, shareholders and the public should also question the motivations of lawmakers behind the wave of executive compensation reform over the past two decades. Just like private actors, lawmakers are not immune from perverse incentives that compromise their ability to earnestly address executive compensation issues. Accordingly, the impact of flawed lawmaker diagnoses and recommended treatments is an under-explored dimension of the ongoing executive compensation discussion. This Article fills this critical gap in the legal literature.

There are three commonly used theories analyzing executive compensation: (i) the market forces theory; (ii) the optimal contracting theory; and (iii) the managerial power theory.[55] In general, these theories primarily target agency costs at the firm level, but they do not adequately ac-

50. Walker, *supra* note 46, at 661.

51. RiskMetrics Group, *supra* note 42, at 18-19 (discussing Accounting for Stock=Based Compensation, Statement of Financial Accounting Standards No. 123 (Fin. Acct. Std. Bd. rev. 2004)).

52. *Id.* at 19.

53. *See id.*

54. Walker, *supra* note 46, at 634-35 ("This can be thought of as a 'divide and prosper' strategy.").

55. These are not the only theories used to analyze executive compensation, but are the most pervasive.

count for lawmaker rent-seeking and political effects.[56] Moreover, there is both a firm level agency cost and an external public accountability dimension of the executive compensation issue. The latter dimension, however, is often ignored by existing theories.

1. *Market Forces Theory*

The market forces theory contends that "there is an overriding cap on managerial value extraction that is determined by external market forces—markets for corporate control, capital, products, and even the managerial labor market."[57] These "[e]xternal market forces, however . . . permit considerable slack, leaving one to question the extent to which such forces actually limit appropriation."[58] One form of potential appropriation is excessive executive pay. Although important, market discipline alone is an insufficient constraint.

The CEO labor market is not robust.[59] For example, "[t]he number of candidates that a Fortune 500 firm would consider in a CEO search would be few, and the number of openings each year, although perhaps growing, is few as well."[60] Also, the CEO selection process involves search costs, internal politics, social pressure, and often requires secrecy and confidentiality.[61] These factors often impair labor market efficiency.[62] Another key factor undermining external market discipline as a check on executive compensation is the lack of transparency concerning managerial appropriation.[63] As a result, the need for managers to preserve their reputations is an inadequate check on CEO salaries.[64] Kenneth Lay, Dennis Kozlowski, and Bernie Ebbers all had sterling reputations until irregularities were uncovered years later.[65]

The market for corporate control is also an insufficient form of external

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56. The managerial power theory does recognize exogenous forces such as outrage that act as a constraint on managerial discretion, but in a general way.

57. Walker, *supra* note 46, at 592.

58. *Id.* at 592-93. *But see* Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 19 (2000) (arguing that neither high levels of executive pay nor the wage gap should be a concern because the market operates effectively); Nicholas Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959, 975-78 (1980) (arguing that excessive compensation does not exist and that the market operates sufficiently); *see also* Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1265-67 (2004) (arguing that there are various market conditions besides board capture creating large wage differences, such as the tournament driven labor market, asymmetric bargaining power, CEO risk tolerance, and overall firm valuation).

59. *See* Walker, *supra* note 46, at 608.

60. *Id.* (footnotes omitted).

61. *Id.* (footnotes omitted); *see also* RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOS 32-48 (2002).

62. *See* Walker, *supra* note 46, at 608.

63. *See* KHURANA, *supra* note 61, at 32.

64. *See* Walker, *supra* note 46, at 608.

65. *See, e.g.*, Anthony Bianco et al., *The Rise and Fall of Dennis Kozlowski*, BUSINESS WEEK, Dec. 23, 2002, at 64; Darem Fonda, *After Bernie, Who's Next?*, TIME, Mar. 21, 2005, at 44; Shaheem Pasta, *Enron Founder Ken Lay Dies*, CNNMONEY.COM, July 5, 2005, http://money.cnn.com/2006/07/news/newsmakers/lay_death/.

discipline.[66] The effectiveness of the market for corporate control requires transparency and manager appropriation to be reflected in the share price.[67] If these conditions were met, one might expect that managers who failed to maximize value would face the external risk of removal from takeover even in the absence of board action.[68] There is evidence, however, suggesting that the takeover market is cyclical, characterized by high costs,[69] and influenced by impediments like poison pills and the availability of credit.[70] As a result, the market for corporate control is an inadequate restraint on managerial appropriation.

Finally, manager appropriation via compensation may not impact equity or debt markets to a significant degree because "mature public companies rarely make equity offerings" and the level of appropriation is not "large enough to affect a company's risk of insolvency [or] debt rating."[71] Because markets may not adequately constrain managers, investors rely on corporate governance that includes the selection of executives and their compensation as a disciplining mechanism.

2. *Optimal Contracting Theory*

The optimal contracting theory posits that contracting can effectively constrain agency costs via contracting with CEOs.[72] The optimal contracting theory assumes that the board is not captured or sufficiently independent to bargain at arms length.[73] This perspective more aptly describes the scenario where a firm hires an external CEO as opposed to negotiating with an internal candidate or incumbent CEO. The reality for most large companies is that there is a CEO firmly at the helm who, under certain circumstances, exerts significant pressure over the board,

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66. *See* Walker, *supra* note 46, at 608-09.

67. *Id.* at 605.

68. *Id.*

69. *Id.* at 608-09 & n.59. *But see* Henry G. Manne, *Bring Back the Hostile Takeover*, WALL ST. J., June 26, 2002, at A18 (arguing that the hostile takeover process is the ideal method to discipline management).

70. Murphy, *Politics*, *supra* note 8, at 716.

71. Walker, *supra* note 46, at 609-10. For similar reasons, product markets are an inadequate check on managerial appropriation.

72. *Id.* at 592. The optimal contracting model can be described as follows:

> [T]he 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, that is, the costs of (1) contracting with the manager, (2) monitoring the manager's performance, (3) bonding by the manager to maximize shareholder value, and (4) the residual slack or divergence that remains between the actions selected by the manager and those that would optimally benefit the shareholders.

Id.; *see, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976); Edward E. Lawler III et al., *Adding Value in the Boardroom*, 43 MIT SLOAN MGMT. REV. 92, 92 (2002) ("[B]oards must have three key ingredients in order to be effective: knowledgeable members, up-to-date company information and the power to counterbalance the CEO.").

73. *See* Walker, *supra* note 46, at 592.

thereby compromising the board's objectivity and independence.[74] This state of affairs calls into question contractual and discretionary compensation arrangements between corporate boards and CEOs.[75] Accordingly, the optimal contracting theory allows too much "slack" for rent extraction.[76]

3. *Managerial Power Theory*

The managerial power theory assumes that board members are "imperfect agents of shareholders" and therefore reaching optimal contracts with managers is not always realistic.[77] Proponents of this managerial power perspective often contend that mechanisms such as enhanced shareholder voting may be necessary to control pay.[78] Board members have relatively weak financial incentives to maximize firm value and often yield to executives who exercise significant influence over the board nomination process and remuneration.[79] The board's appropriation,

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74. *See id.* at 633. The Disney saga is an extreme illustration of this scenario. *See* FRANK & COOK, *supra* note 38, at 67.

75. *See* BEBCHUK & FRIED, *supra* note 49, at 61-79; Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 71 (2003); Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 985 (1993) (asserting that the overcompensation problem is in part created by directors' failure to monitor and bargain). This added suspicion is most warranted in situations involving a sitting CEO versus an external new hire.

76. *See* BEBCHUK & FRIED, *supra* note 49, at 62-63.

77. Walker, *supra* note 46, at 633; *see also* Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 755-56 (2002) (asserting that the executive compensation process is not optimal (that is, arms length) because executives use their influence to affect compensation packages); WARREN E. BUFFETT, THE ESSAYS OF WARREN BUFFETT: LESSONS FOR CORPORATE AMERICA 38-39 (1997) (asserting that there is often a lack of real arm's length transactions between boards and executives); *cf.* John E. Core, Wayne R. Guay & Randall S. Thomas, *2005 Survey of Banks Related to the Law: Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1159 (2005) (asserting that arm's length transactions are possible in theory only); Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129, 138 (2003) (arguing that arm's length transactions are not realistic because contracts, in reality, reflect a system of repeat players with outside relationships); *but see* Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1662 (2005) (asserting that even if there is control over the board, this is not a sufficient problem to warrant reform and abandon a director-based examination for one by shareholders).

78. *See* Bainbridge, *supra* note 77, at 1643-44.

79. Walker, *supra* note 46, at 633; *see* David Leonhardt, *A Prime Example of Anything-Goes Executive Pay*, N.Y. TIMES, June 4, 2002, at C1 ("During his rise to become one of the nation's more prominent chief executives, Mr. Kozlowski persuaded his board to give him hundreds of millions of dollars worth of cash, stock and perquisites."); Phyllis Plitch, *CEO Compensation Survey (A Special Report)—Breaking the Code of Silence*, WALL ST. J., Apr. 10, 2008, at R4 ("'It's camaraderie,' Mr. Hussein [a dissident director and second-largest stockholder at Quality Systems, Inc.] says, explaining why boards generally don't challenge management enough on compensation or other issues."); *see also* Marianne Bertrand & Sendhil Mullainathan, *Agents with and Without Principals*, 90 AM. ECON. REV. 203, 203 (2000) (discussing the "skimming view" of CEO pay); 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, 261 (2005) (describing data illustrating that managers' exertion of power over the contracting process leads to excessive compensation).

however, is not limitless, as David Walker asserts:

> Under the managerial power theory, appropriation by strong managers is limited by the outrage that excessive appropriation causes among financial analysts, institutional investors, and other corporate governance watchdogs. Outside directors are sensitive to this outrage, and limit managerial compensation accordingly. As a result, managers have an incentive to camouflage compensation in order to limit outrage.[80]

Ultimately, managers "will tend to follow the herd and avoid significant deviations from industry pay practices, but they will take advantage of low-salience means of extracting additional value."[81] For example, forms of grant date manipulation other than illegal options backdating, such as "spring-loading" and "bullet-dodging," follow this pattern.[82] Short of actual board representation (or *ex ante* input), institutional investors and other corporate constituents are limited to the *ex post* benefits of outrage and "Monday morning quarterbacking." Although the managerial power theory improves upon the market forces and optimal contracting theories, it is far from perfect. All of the above theories fail to adequately capture the political dimension of executive compensation. There is no panacea for executive compensation problems, and any potential solution must incorporate political effects.

III. CREDENCE CHARACTERISTICS IN THE CORPORATE REFORM CONTEXT

A. A Definition of Credence Characteristics and Services[83]

Generally, there are three types of goods and services: (i) search goods and services; (ii) experience goods and services; and (iii) credence goods and services.[84] The quality of search goods, such as clothing, footwear, and jewelry, can readily be discerned during the search process prior to consumption.[85] Search goods have "low pre-buying costs of quality de-

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80. Walker, *supra* note 46, at 592; *see also* Bebchuk, Fried & Walker, *supra* note 77, at 757 (discussing outrage as a factor in determining legitimate and acceptable compensation schemes). The discussion of outrage acknowledges the importance of external forces on managerial rent seeking, but does not directly address lawmaker rent seeking.

81. Walker, *supra* note 46, at 634.

82. *See* RiskMetrics Group, *supra* note 42, at 18. "Spring-loading" involves "making grants before releasing 'good' news likely to boost the stock price." *Id.*; *see also* M.P. Narayanan et al., *The Economic Impact of Backdating Executive Stock Options*, 105 Mich. L. Rev. 1597, 1601-05 (2007). "Bullet-dodging" involves "making grants after the release of 'bad' news" likely to reduce share price. RiskMetrics Group, *supra* note 42, at 18. Although these forms of option grant date manipulation are not illegal, like backdating, they are nonetheless discouraged by the investor community and best practice guidelines. *See id.*

83. This Article asserts that corporate reform is a service, but, whether considered a service or good, the following analysis will not change. *Cf.* U.C.C. § 2-105 (2005) (providing a definition of goods).

84. Victor Fleisher, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 Mich. L. Rev. 1581, 1600 (2006).

85. *See id.*

tection."[86] On the other hand, the quality of experience goods is not discerned during the search process, but rather after consumption.[87] Experience goods have "high pre-buying costs of quality detection," but low post-buying costs.[88] Examples of experience goods include jobs, movies, newspapers, wine, and food.[89] The third category of goods, credence goods, was first identified by Michael Darby and Edi Karni.[90] The quality of credence goods cannot fully be determined even after the search process and consumption.[91] Credence goods have "high pre-buying costs and high post-buying costs of quality detection."[92] Certain types of services are more likely to fall into this third category. Examples include health services, child day care, religious or spiritual guidance, and corporate reform.[93]

There is an important distinction between credence services and credence characteristics.[94] Credence characteristics are qualities that cannot be detected through inspection or ordinary use.[95] A good or service may include any mixture of search, experience, and credence characteristics.[96] On the other hand, credence services are services for which the customer's decision-making is dominated by credence characteristics.[97] Credence services, like credence characteristics, manifest "an asymmetry between seller and buyer with respect to knowledge acquisition" concerning service value.[98] In the credence service context, assessments of value will either be impossible to determine or require costly information and other proper circumstances.[99] The term "[o]ther proper circumstances" in this context applies to situations where the lapse of a considerable period of time may reveal the value of the service.[100] Situations involving the passage of considerable time also reveal the thin line that can exist between credence and experience services.[101] Similarly, a

86. MEN-ANDRI BENZ, STRATEGIES IN MARKETS FOR EXPERIENCE AND CREDENCE GOODS 2-3 (2007); *see also* Darby & Karni, *supra* note 25, at 68-69 (discussing Nelson's characterization of search and experience goods); Philip Nelson, *Information and Consumer Behavior*, 78 J. POL. ECON. 311, 311 (1970) (analyzing consumer behavior with respect to search and experience goods).

87. *See* Darby & Karni, *supra* note 25, at 68.

88. BENZ, *supra* note 86, at 2.

89. *Id.*

90. *See* Darby & Karni, *supra* note 25, at 68.

91. BENZ, *supra* note 86, at 2.

92. *Id.*

93. *Id.*

94. Esben Sloth Anderson, *The Evolution of Credence Goods: A Transaction Approach to Product Specification and Quality Control* (MAPP - Ctr. for Research on Customer Relations in the Food Sector, Working Paper No. 21, 1994), *available at* http://130.226.203.239/pub/mapp/wp/wp21.pdf.

95. *Id.*

96. Paul N. Bloom & James E. Pailin, Jr., *Using Information Situations to Guide Marketing Strategy*, 12 J. CONSUMER MKTG. 19, 20 (1995).

97. Anderson, *supra* note 94, at Executive Summary.

98. *Id.*

99. *See* Darby & Karni, *supra* note 25, at 69.

100. *See id.*

101. *Id.*

particular reform's effectiveness may become apparent after the passage of time. The sixteen year legacy of I.R.C. § 162(m) is a prime example.[102] The above-mentioned information asymmetries create strong incentives for opportunistic seller behavior and supply-side inefficiencies.[103] These risks are enhanced where a monopolist supplier is involved because the consumer has limited alternatives.[104]

There are two types of asymmetry implicated by credence characteristics.[105] The first type involves the customer's inability to know their needs or diagnose their problem.[106] The second type of asymmetry involves the customer's inability to determine the level of service necessary.[107] The interplay between these concepts exacerbates the customer's dilemma because "consumer ignorance and [the] additional cost of separate diagnosis and repair provide motivation for a service firm to defraud its customers."[108]

In the corporate law context, lawmaker incentives to reform may disappear where no transfer of political goodwill is involved.[109] Accordingly, there is a greater need to discipline lawmakers. In a sense, lawmakers are monopolist suppliers and the market for political capital is too imperfect to serve as an adequate restraint on the fraudulent expert or incompetent expert problems.[110] While political capital cannot be expressed in a monetary value, it nonetheless is an important measure of lawmaker utility.[111] Generally, there is less political risk associated with moderate regulation, whereas significant regulation poses greater political risks. However, contextual factors may alter lawmaker risk profiles. Corporate lawmakers with the exclusive authority to regulate may choose standards that are too lax or too onerous to ensure positive corporate performance.

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102. *See supra* note 9 and accompanying text.

103. *Id. See* Emons, *supra* note 29, at 107. The classic pig-in-poke phenomenon recognizes the act of information suppression. *See* Anderson, *supra* note 94, at 2 (citing George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970)); *see also* Wendy Wagner, *Using Competition-Based Regulation to Bridge the Toxics Data Gap*, 83 IND. L.J. 629, 637 (discussing adverse selection and quality detection).

104. GERAINT HOWELLS & STEPHEN WEATHERILL, CONSUMER PROTECTION LAW 3 (2d ed. 2005).

105. Brian Roe & Ian Sheldon, *Credence Good Labeling: The Efficiency and Distributional Implications of Several Policy Approaches*, 89 AM. J. AGRIC. ECON. 1020, 1020 n.1 (2007).

106. *Id.*

107. *Id.*

108. Darby & Karni, *supra* note 25, at 77.

109. *See* Emons, *supra* note 29, at 107 (asserting that a service person "may not perform an urgently needed repair if other activities are more profitable").

110. In the monopolist scenario, the consumer does not search. Ting Liu, *Credence Goods Markets with Conscientious and Selfish Experts* 6 (Boston Univ. Dep't of Econ., Working Paper No. 58, 2006), *available at* http://www.bu.edu/econ/workingpapers/working papers_2006.html (follow "Credence Goods Markets with Conscientious and Selfish Experts" hyperlink). It is important to note that consumers must contend with the fraudulent expert problem as well as the incompetent expert problem.

111. A corporate lawmaker's utility may also incorporate other concerns such as public interest motivations.

Accordingly, lawmaker opportunism may cause corporate constituent welfare losses.

B. Public Choice Theory and the Political Support Maximization Model

The political support maximization model of public choice theory is a useful paradigm to analyze executive compensation reforms in context, and also to predict when the interests of certain corporate constituencies are likely to prevail in regulatory outcomes.[112] Public choice theorists generally assume political actors, like private market actors, are mainly self-interested and that the pursuit of lawmaker self-interest may result in government failure, that is, inefficient policies. The analysis of credence services supplements the public choice framework by analyzing how the unobservable impact of regulatory output facilitates greater lawmaker discretion.

The federal government and Delaware, both arguably monopolist lawmakers, supply credence characteristic-laden services to various corporate constituents (for example, managers, shareholders, employees, and other populist groups) in the form of corporate regulation. Despite the ability of public choice theory to predict which groups are likely to wield more influence over lawmakers, there often is no clear answer to how much a specific corporate regulation benefits various corporate constituencies.[113] The answer to the substantive question of quality is complicated because it depends on a number of contextual variables, including (i) the type of corporate decision at issue—ownership, enterprise, or oversight;[114] (ii) the corporate constituent's vantage point—management, shareholders, or populist groups; (iii) the desired policy value—efficiency or fairness;[115] (iv) inter-temporal considerations—short-term versus long-term impact on business value; and (v) the degree of legal enforcement. In addition to these factors, the corporate reform quality inquiry is further constrained by credence characteristics. At a minimum, an adequate assessment of impact necessitates: (i) clear objectives for reform (that is, what executive compensation reform should ac-

112. Political utility maximization is a crucial element in public choice literature. *See generally* James M. Buchanan & Gordon Tullock, The Calculus of Consent: Logical Foundations of Constitutional Democracy (1962).

113. *See* Donald C. Langevoort, *The Social Construction of Sarbanes-Oxley,* 105 Mich. L. Rev. 1817, 1820 (2007) (arguing that "[t]here is no clear-cut answer to the question of how much SOX benefits investors").

114. *See* E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 Bus. Law. 393, 394 (1997) (discussing the types of decisions that Delaware courts address, which include enterprise, ownership, and oversight decisions). Enterprise decisions are standard decisions made by management, such as the decision to build a foreign production plant or what products to produce. *See id.* Ownership decisions involve ownership changes, such as mergers, acquisitions, and corporate takeovers. *See id.* Oversight decisions concern managers' monitoring role, such as ensuring that employees execute their responsibilities in compliance with the law. *See id.*

115. *See* Richard A. Posner, *Theories of Economic Regulation*, 5 Bell J. Econ. 335, 335 (1974).

complish); and (ii) empirical validation. In the executive compensation context, the first condition is a political decision that lawmakers have continually muddled and failed to satisfy, sometimes at the expense of vulnerable corporate constituents. Without clear objectives, empirical validation is a speculative exercise.

1. The Market for Political Capital

In the market for political capital there is an exchange between corporate constituents on the demand-side and lawmakers on the supply-side.[116] Similar to other markets, the group with the most effective demand is most likely to receive the political spoils.[117] Nobel Prize winner George J. Stigler is credited with laying the groundwork for the economic theory of regulation.[118] Before embarking on a description of Stigler's supply-demand apparatus, it is useful to describe the historical antecedents to the economic theory of regulation developed by Stigler and others. Public interest theory contends that lawmakers regulate in response to market inefficiency and inequity.[119] This approach assumes that regulation is efficient as well as costless and that lawmakers are motivated by the public interest.[120] The so-called capture theory reaches the opposite conclusion.[121] It holds that lawmakers maximize private wealth instead of social welfare and are captured by private interests.[122] Both the public interest and capture theories understate the complexity of the political process.

Stigler's economic theory of regulation asserts that the state has a monopoly on coercive power and may use it to transfer wealth from one group to another.[123] For Stigler, "the problem of regulation is the problem of discovering when and why an industry (or other group of like-minded people) is able to use the state for its purposes, or is singled out by the state to be used for alien purposes."[124] The two major constituent groups in Stigler's economic theory of regulation are producers and consumers,[125] but in the corporate regulation context, groups are more diverse and pluralistic, involving managers, shareholders, employees, activist groups, and communities.[126] The dominant, although not universal, view has been that corporate managers prevail in this tournament or

116. Peltzman, *supra* note 7, at 212.
117. *Id.*
118. *Id.* at 211.
119. Posner, *supra* note 115, at 335.
120. *Id.* at 336.
121. *Id.* at 335-36.
122. *Id.* Peltzman observed, "[w]ithin a decade [by the 1970s], the benign view of regulation as promoter of the general interest had been mainly abandoned. The ascendant image was of the regulator captured by the regulated." Peltzman, *supra* note 31, at 822.
123. *See* George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. 3, 3 (1971).
124. *Id.* at 4.
125. Peltzman, *supra* note 7, at 212.
126. *See* Peltzman, *supra* note 31, at 822 (noting that subsequent elaborations of Stigler's theory have recognized broader constituencies).

auction for political spoils.[127] A "rational regulator will not . . . [aim to] distribute benefits equally" but "will seek a structure of costs and benefits that maximizes political returns."[128] This, however, does not necessarily mean lawmakers will invariably favor the groups with the greatest political muscle or those who can or desire to incur the transaction costs of mobilization. The "government as order-taker" analogy is too simplistic to account for the complex relationship between lawmakers and corporate constituents.[129] Furthermore, politicians, just like corporate constituents, seek to maximize their own self-interest[130] and may seek actions that enhance their own personal and political goals independent of interest group considerations. Any theory analyzing lawmaker opportunism must account for: (i) the fact of continued regulation in the face of considerable business opposition; and (ii) public interest motivations.[131]

2. *Exogenous Factors Shifting Political Balance*

The important question is not simply whether a supply-demand framework or interest group dynamics act as a constraint on lawmaker behavior,[132] but instead, what are the conditions under which corporate managers are not likely to prevail? Corporate scandals and "economic disruptions often change the distribution of political power and create opportunities for public policy entrepreneurs to rearrange things to their advantage."[133] Diffuse constituencies, despite lacking organization, may nonetheless participate in the political process when they are provided with "free (and easy to digest, perhaps entertaining) information" and "political saliency, a major national issue that commands attention and motivates action in the absence of political organization."[134] Executive compensation is the most politically salient corporate governance issue.[135] Rationally ignorant voters, concerned about macro economic performance" may respond by favoring executive pay reform policies, even if such policies have a trivial impact on the national economy or their own personal circumstances.[136] This scenario results in modest cyclical quick fixes—a band-aid instead of stitches or vice versa.

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127. *See* Peltzman, *supra* note 7, at 212 (discussing the economic theory of regulation developed by Stigler and others); *see also* Stigler, *supra* note 123, at 3 ("[A]s a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit.").

128. Peltzman, *supra* note 7, at 231.

129. Peltzman, *supra* note 31, at 828.

130. *Id.* at 822.

131. *See id.* at 827-28 (asserting that the theory of regulation must take into consideration industry resistance to regulation and industry interests).

132. *See* Peltzman, *supra* note 7, at 240.

133. Sam Peltzman, *The Economic Theory of Regulation After a Decade of Deregulation, in* BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS 1, 58 (William C. Brainard & George L. Perry eds., 1989).

134. *Id.* at 51-52.

135. *Corporate Law—Fiduciary Duties of Directors*, 119 HARV. L. REV. 923, 923 (2006).

136. *See* Peltzman, *supra* note 133, at 52.

For lawmakers, the pragmatic outcome to this scenario is a compromise among various interests, albeit slanted to preserve a broad coalition of support, thereby maximizing lawmaker utility. As a consequence of these dynamics, the corporate regulatory framework with respect to executive compensation is laden with policies that seem economically inefficient and resemble a placebo rather than a cure. Efficient regulation may lack political appeal, and at times, merely symbolic or inefficient policies have more political utility.[137]

IV. SUPPLY-SIDE INEFFICIENCIES: LAWMAKERS AS SUPPLIERS OF CREDENCE CHARACTERISTIC-LADEN SERVICES

In discussing the operation of credence services, it is important to analyze both the supply and demand aspects of the market. With regard to the supply-side of the equation, lawmakers provide the service of regulation.[138] In the corporate governance context, the suppliers of regulation are not monolithic and may have separate agendas.[139] The primary suppliers of corporate regulation are Delaware (primarily Delaware state courts) and the federal government (primarily the Securities & Exchange Commission (SEC) and Congress).[140] Additional suppliers of corporate regulation include other government agencies, such as the Internal Revenue Service (IRS), and self-regulatory organizations (SROs), such as the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and the National Association of Securities Dealers (NASD).[141] Despite the existence of numerous lawmakers, this Article focuses on two lawmaking bodies—Delaware and the federal government, as well as their "loosely controlled affiliates."[142] Traditionally, Delaware law has governed corporate internal affairs, while the SEC has addressed external issues of securities trading and disclosure.[143] This federal-state lawmaker

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137. *See* Peltzman, *supra* note 31, at 830; *see also* Ian Ayres, *Supply-Side Inefficiencies in Corporate Charter Competition: Lessons from Patents, Yachting and Bluebooks*, 43 KAN. L. REV. 541, 558-59 (1995); Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85, 90-92 (1990) (describing the Delaware corporate bar and its influence on corporate law); William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 724 n.40 (1998).

138. Peltzman, *supra* note 31, at 823.

139. *See id.* ("The suppliers in Stigler's theory are unspecified political actors.").

140. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV., 588, 592 (2003).

141. SRO rules are subject to approval of the SEC. 15 U.S.C. § 78s(b)(1) (2000). This list of suppliers or lawmakers reflects traditional corporate law and does not address the entire landscape of business regulation. *See* CLARK, *supra* note 21, § 1.4 (distinguishing between traditional corporate law and other laws affecting corporations). Examples of other laws affecting corporations include other types of regulation (for example, environmental, labor, health, and safety regulations). *Id.*

142. The SEC is accountable to Congress, and SRO's are indirectly controlled by the SEC. Roe, *supra* note 140, at 598-600.

143. *Id.* at 596. There is considerable debate, however, concerning the appropriate balance. *See* Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1605-06 (2005); *see also* E. Norman Veasey, Shawn Pompian & Christine Di Guglielmo, *Federalism vs. Federalization: Preserving the Division of Responsibility in Corporation Law*, 2005 ABA SEC. BUS. L. COMM. ON FED. REGULA-

interaction often "determine[s] whose interests and which ideas dominate American corporate law."[144] In addition, "[t]he dominant ideas and interests in Delaware differ from those in Washington."[145] Despite this potential divergence, the U.S. corporate law regime is, on balance, conservative.

A. DELAWARE

Delaware's dominance as the premiere situs of incorporation over the past century has been the subject of vigorous debate.[146] Within Delaware's legal regime, Delaware's judiciary, that is, the Delaware Court of Chancery and the Delaware Supreme Court, is the primary lawmaking body, while the Delaware General Assembly plays a secondary role.[147] Institutional alignment and a stable political climate contribute to Delaware's competitive advantage.[148] The relationship between the Delaware corporate bar, the General Assembly, the Division of Corporations, and the judiciary is best described as "symbiotic."[149] There is a significant

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TION 77, 77 (describing how Sarbanes Oxley blurs the traditional lines between Delaware and the SEC); *see generally* Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57 SMU L. REV. 353 (2004) (discussing the interplay between state and federal corporate law).

144. Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2494 (2005). "Thus we have our first conjecture concerning the federal-state interplay: The interests and ideas at the two levels differ. In Delaware, two main interests are in play, and they usually would like the rules to be made in the arena where they jointly have more power." *Id.* at 2504.

145. *Id.*

146. *See, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 37-38 (1993) (explaining the reasons for "Delaware's preeminence in the corporate charter market"); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 664-65 (1974) (describing Delaware besting New Jersey in the market for corporate charters); Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1064 (2000) (asserting that Delaware sustains its advantage through judge-made corporate law); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN L. REV. 679, 684 (2002) (arguing that Delaware is the only state actively courting public company incorporations); Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1208 (2001) (asserting that Delaware employs price discrimination through franchise taxes and litigation-intensive substantive law); Kahan & Rock, *supra* note 143, at 1578 (asserting that Delaware and the federal government complement each other by working on the areas that the other cannot regulate as effectively); Roe, *supra* note 140, at 590 (asserting that there can be no pure state-to-state race because of the threat of federal intervention); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256 (1977) (asserting that state competition is a race to the top benefiting shareholders).

147. *See* Fisch, *supra* note 146, at 1074.

148. *See* Kahan & Rock, *supra* note 143, at 1590, 1611-16.

149. *See* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1940 (1998); *see also* E. Norman Veasey, *"I Have the Best Job in America,"* DEL. LAW., Winter 1995, at 20, 23 (asserting that the Delaware Supreme Court has "excellent relations with the other two branches of state government"). E. Norman Veasey, the former Chief Justice of the Delaware Supreme Court, commented on Delaware's cooperative atmosphere:

> Delaware's size as the "small wonder" gives us an enormous advantage, particularly when coupled with the intelligence, approachability, cooperation and integrity of our public office holders. All three branches of government in Delaware are keenly aware of the reputation of the judicial branch of gov-

amount of "collegial interaction" between influential groups in Delaware, such as the relationship between Delaware's judiciary and the local bar, as well as the above-mentioned deference the General Assembly gives to the corporate bar.[150] Delaware does not have many legislative pressures to disrupt the development of law.[151] There is a lack of pressure from interest groups such as unions, environmental groups, and local communities.[152] Moreover, appointed judges in a plaintiff-driven system are not as sensitive to interest group pressures.[153] This independence arguably gives Delaware court opinions more legitimacy than some legislative outcomes.

Delaware is largely insulated from populist concerns, except to the extent the federal government makes Delaware lawmakers aware.[154] Due to these contextual factors, managers and shareholders are the primary interest groups influencing Delaware corporate lawmaking.[155] Beyond managers and shareholders, the federal government can be viewed as an additional interest group Delaware lawmakers must consider.[156] In exchange for corporate law and judicial arbitration services, Delaware receives not only political goodwill from corporate constituents, but also a significant windfall of franchise taxes.[157] In light of this windfall, why would federal lawmakers tolerate this rent extraction and not attempt to

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> ernment and of the enormous contribution that the judicial branch makes to Delaware's economy and to the well-being of our citizens. Delaware's judicial branch must, however, continuously explain and justify its processes to the other two branches and to the citizenry. We are making that effort. But, we need the help of the organized Bar, and we need for the other two branches of government to examine, advise, hear and support us.

Id. at 22.

150. *See* David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 160 (1997). William Cary viewed such interaction as problematic. *See* Cary, *supra* note 146, at 687–88.

151. *See* Kahan & Rock, *supra* note 143, at 1614.

152. Reincorporating in Delaware does not result in a significant loss of local employment, which is the case in other states. Carney, *supra* note 137, at 719. Rarely is Delaware the principal place of business. *See id.*

153. Delaware Supreme Court and Chancery Court judges are selected by a bipartisan judicial nominating commission and are ultimately appointed by Delaware's Governor. Del. Executive Order No. 4 (Feb. 1, 2001). Moreover, the Delaware State Constitution mandates a political balance on the Delaware Supreme Court. *See* DEL. CONST. art. IV, § 3. Under Delaware law, directors duties of loyalty and care run to shareholders and not to remote constituencies. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939). But even within the existing legal framework, directors have broad discretion to consider outside interests without triggering liability. *See id.* at 510-11. In this sense, Delaware law is malleable enough or provides ample discretion for management to accommodate populist concerns. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253 (1999); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 733 (2005).

154. Roe, *supra* note 143, at 2501.

155. *See id.* at 2499 ("Delaware responds primarily and directly to managers and investors. The stability of the corporate enterprise and of the incumbent actors is foremost in the Delaware decisionmakers' minds. Congress though deals with more interest groups and has a conception of the public interest that is wider than just boardroom stability and shareholder relations.").

156. *See id.* at 2501.

157. Mark Roe describes the Delaware lawmaking process as follows:

capture the spoils?[158] Plausible explanations for this phenomenon include: (i) avoiding blame and shifting responsibility; (ii) the competence of Delaware lawmakers versus their federal counterparts; and (iii) the popularity of the Delaware brand with powerful interest groups.[159] Yet there are times when the federal government is likely to act, usurping Delaware's authority—periods of economic turmoil or scandal.[160]

> Hence, one could say that investors and managers make Delaware corporate law and that they then bring in the Delaware judges—selected by bar committees—to arbitrate their disputes. Other groups and visions are therefore weaker in Delaware than they would be in an attentive federal forum. Delaware lawmakers do not have to placate employees or environmentalists or those with an affirmative action agenda. Delaware citizens who might side with such interests see the financial import of the corporate industry to Delaware, so their dissenting views fade and politicians can ignore them. Nor do the state-level dynamics alone induce Delaware players to consider policymakers' views of what is best for the American economy. Stated bluntly, if Delaware made corporate law that simultaneously offended investors and managers, then those players, who together fully control the reincorporation decision, could take the big franchise tax pot away from Delaware. For Delaware in the long run, and perhaps even in the short run, everything else is secondary.

Id. at 2501-02.

158. Mark Roe further describes the significant impact of franchise taxes to Delaware:

> The tax is the prize for winning the interstate race, with many seeing it as bonding Delaware to make good corporate law. The primary focus has been on the tax as motivating Delaware to do its job well. But bonding-to-quality isn't all that the tax accomplishes: The tax shapes who matters most in making American corporate law. It enhances managers' and shareholders' joint authority, since they're the players who can take that $500 million annual pot of gold away from Delaware, while diminishing outsiders' influence.

Id. at 2495.

159. Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265, 268-69 (1990); *see also* Omari Scott Simmons, *Branding the Small Wonder: Delaware's Dominance and the Market for Corporate Law*, 42 U. RICH. L. REV. 1129, 1129 (2008). Simmons describes federal reluctance to supplant Delaware:

> Despite having Commerce Clause powers to preempt Delaware corporate law, the federal government seems reluctant to exercise these powers. Delaware's brand equity among powerful constituencies (e.g., managers and shareholders), in part, explains the federal government's reluctance. Delaware's brand strength helps explain the manager and shareholder reluctance, aversion, or indifference toward greater federal intervention even where federal law may appear to favor their discrete interests. The federal-state interaction story is not simply about Delaware lawmakers fearing preemption. The federal government (e.g., Congress) also fears a backlash from the corporate manager-investor alliance, which arguably yields the greatest power in Washington.

Simmons, *supra*, at 1188.

160. Mark Roe explains the impact of Delaware's failure to act in the midst of corporate scandals and broader economic turmoil:

> When Delaware acts slowly— because, say, its primary interest groups disagree, or the correct policy resolution is unclear, or scandals call for quick action and Congress moves faster than Delaware—then Delaware's agenda-setting authority ends, its autonomy shrinks, and American corporate law goes national. The Sarbanes-Oxley Act of 2002—Congress's response to the Enron-class scandals—is the latest such instance.

Roe, *supra* note 143, at 2494-95.

Notwithstanding these periods, federal action is likely moderate and incremental. Meanwhile, Delaware's responses are measured and conservative. Some commentators argue Delaware's corporate law (particularly judicial opinions) is unnecessarily indeterminate as a result of interest group pressures.[161] Another plausible explanation for this indeterminacy is overall corporate complexity.[162] Other commentators contend that Delaware is pro-management and rarely finds directors personally liable.[163] But, Delaware courts influence corporate conduct beyond finding liability. As the *Disney* litigation illustrates,[164] even where a decision does not result in liability for board members, embarrassing details of corporate dysfunction may tarnish a company, a board member, or executive reputations.[165] Reputational risk is another salient reason for boardrooms to pay attention to Delaware court pronouncements.[166] Edward Rock has described the sermon-like approach of Delaware courts as follows: "The core of my claim is that we should understand Delaware fiduciary duty law as a set of parables or folktales of good and bad managers and directors, tales that collectively describe their normative role."[167] The *Disney* litigation fits this description. Corporate law sermons, although valuable, exhibit credence characteristics and their impact is difficult to ascertain.

B. The Federal Government

Compared to Delaware, federal government lawmaking is more pluralistic and involves more interest groups reflecting populist concerns.[168]

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161. *See* Kamar, *supra* note 149, at 1943-44.

162. *See* Eric W. Orts, *The Complexity and Legitimacy of Corporate Law*, 50 Wash. & Lee L. Rev. 1565, 1587 (1993) (arguing that corporate law must acknowledge technical and normative complexity to retain its legitimacy); *see also* David Skeel, Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From 6–10 (2005) (highlighting three enduring issues that stifle regulators: risk taking, competition, and complexity of organizations).

163. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); *see also* Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 Stan. L. Rev. 1055, 1055-56 (2006) (describing the limited prospect of personal director liability under U.S. corporate law).

164. *See* discussion *infra* Part IV.E.1.

165. *See* Bruce Orwall & Merissa Marr, *Judge Backs Disney Directors in Suit on Ovitz's Hiring, Firing*, Wall St. J., Aug. 10, 2005, at A1; *see also* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. Rev. 1009, 1016 (1997) ("Delaware courts generate in the first instance the legal standards of conduct (which influence the development of the social norms of directors, officers, and lawyers) largely through what can best be thought of as 'corporate law sermons.'").

166. *See generally* David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. Pa. L. Rev. 1811 (2001) (describing shaming in the corporate context).

167. Rock, *supra* note 165, at 1016, 1106 ("Delaware courts generate in the first instance the legal standards of conduct (which influence the development of the social norms of directors, officers, and lawyers) largely through what can best be thought of as 'corporate law sermons.'").

168. *See* Roe, *supra* note 143, at 2518-19. Mark Roe describes the broader interests implicated at the federal level:

> More goes on in Washington than wider coalition possibilities. Public-regarding policymakers in Washington see themselves as custodians for the

There is no federal corporation law; however, there are important federal statutes (that is, the Securities Act of 1933 and the Securities Exchange Act of 1934) addressing disclosure, insider trading, and periodic reporting.[169] In addition, the Sarbanes-Oxley Act of 2002 (SOX), federalizes certain aspects of corporate law (for example, the composition of a corporation's audit committee, the separation of accounting and auditing services, forfeiture of executive pay, and prohibitions on loans to corporate executives).[170] "[T]he SEC serves both as an enforcer of the federal securities laws as well as a major policy maker and promulgator of new securities rules."[171] When discussing business regulation, commentators often understate the panoply of other, non-traditional corporate law, regulations impacting corporations (for example, OSHA, ERISA, the Clean Air Act, etc.).[172] This broader set of regulations may address stakeholder concerns to a greater degree than the aforementioned federal securities statutes. There is a federal reluctance to directly regulate the internal affairs of the corporation (for example, altering existing power relationships between managers and shareholders).[173] Instead, the federal government prefers to use more indirect forms of regulation, such as disclosure, to prevent political backlash from powerful corporate constituencies.[174] This reluctance or responsibility-shifting by federal lawmakers results in moderate corporate regulation.[175]

> overall health of the American economy; accordingly, they could conclude that tight managerial accountability—beyond that which even interests institutional investors—would be best for the economy. The Council of Economic Advisors influences the President, the GAO writes reports, and the SEC often proposes rules that managers and institutional investors dislike. Of course, we shouldn't naïvely think that interests don't influence these players too, but the interests differ from Delaware's, and sometimes the public-policy players have enough slack to be able to act on their ideological preferences.

Id. at 2503-04.

169. *See* Roe, *supra* note 143, at 2498.

170. *See generally* 15 U.S.C. §§ 7261-7266 (2006).

171. Kenneth M. Rosen, *"Who Killed Katie Couric?" and Other Tales from the World of Executive Compensation Reform*, 76 FORDHAM L. REV. 2907, 2910 (2008) (describing how the phenomenon of concurrent reform by multiple regulators presents perils).

172. *See* CLARK, *supra* note 21, § 1.4 (distinguishing between traditional corporate law and other laws affecting corporations).

173. *See* Roe, *supra* note 143, at 597.

174. *See* Macey, *supra* note 159, at 284, 290.

175. Donald Langevoort's reflections on Sarbanes Oxley reforms reflect this notion of moderate and incremental change:

> To me, the Democratic reform proposals came closer to touching on some of the real problems in the world of corporate behavior, but in ways that by themselves still will not change all that much. They are best seen as a shot across the bow, perhaps saving the heavier ammunition for a time when they hold a stronger political hand. Sarbanes-Oxley did some very good things, especially in the accounting and auditing area, but in the end—and notwithstanding the Sturm und Drang rhetoric—it is still fairly moderate legislation.

Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1143 (2003) (discussing the effectiveness of post-Enron reforms).

Although there is greater potential for populist concerns to be addressed at the federal level, increased interest group pluralism does not necessarily negate manager and shareholder influence. Even if there is more law on the books, the impact of such provisions is often determined by the degree of enforcement.[176] Furthermore, there remains a crucial distinction between public-regarding and earnestly pursuing the public interest.[177] Knee-jerk responses to populist outrage may not qualify as earnestly pursuing the public interest, especially when symbolic measures are used to mitigate outrage from less informed constituencies. Given the credence characteristics of corporate reform, federal lawmakers have greater capability and incentives to camouflage their rent seeking. Federal lawmaking, subject to its own set of political constraints, has resulted in a range of responses to the executive compensation problem. The impact of these federal responses illustrate indeterminacy is not unique to Delaware and may even be a greater problem in the federal context.

C. Maximizing Political Capital

Corporate constituents pay with votes and other indirect forms of political support.[178] Political capital is an important form of currency that is exchanged between lawmakers and corporate constituents, and its importance is not undermined by the fact that it is less transparent than prices in the actual buyer-seller context. Thus, "[t]he currency with which the demanders bid is obviously a bit more complex than the stuff reported in the monetary aggregates"; political capital "includes votes delivered in support of politicians, campaign contributions, jobs in the political afterlife, and so forth."[179] For corporate constituents like corporate managers, political capital is an "intangible asset that provides corporations with long term value extending beyond an isolated policy issue [or dispute]."[180] Similarly, lawmakers seek to maximize political capital by generating broad political support.

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176. *See id.* at 1141 ("Suffice it to say that, for any number of reasons, there will be no increase in SEC funding large enough to substantially eliminate the expectations gap. Sarbanes-Oxley only makes things marginally better.").

177. Mark Roe asserts:

> Public-regarding need not, as I am using it here, be identical to being in the public interest. Congress might react to headlines and want to be seen as acting on the volatile issues of the day, but without having long-term national well-being uppermost in mind. Reaching toward the public interest is only a subset of public-regarding actions. Nevertheless, two broad currents of thinking—populist public opinion and productivity-promoting policy—can flood through Washington and carry Congress away. Neither is as important in Delaware.

Roe, *Delaware's Politics*, *supra* note 143, at 2503-04; *see also* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1527–29 (2005) (explaining SOX's shortcomings as a product of crisis-mode legislation).

178. *See generally* Jill E. Fisch, *How Do Corporations Play Politics?: The FedEx Story*, 58 VAND. L. REV. 1495 (2005) (describing a case study of FedEx to illustrate the various ways corporations buy and use political power)

179. Peltzman, *supra* note 31, at 823.

180. Fisch, *supra* note 178, at 1498.

At first glance, it seems rational for lawmakers to target the most valuable consumer segment. Yet the credence characteristics of corporate reform allow lawmakers to satisfy multiple constituencies simultaneously, providing lawmakers with a broader set of options to address populist outrage and market instability.[181] Because credence characteristics make lawmaker motivations easier to camouflage, corporate constituents, particularly those with greater informational constraints, find it difficult to determine clear winners and losers. By the time these corporate constituents discern the impact of a particular regulation, public outrage has waned, only to reappear in the future. Here, political incentives and short-termism may hinder earnest exploration of issues, resulting in modest, incremental, or superficial change. Executive compensation reform tracks this pattern.

Lawmakers may camouflage unnecessary or superficial reforms, lack of expertise, incompetence, short-term commitment to an issue, and responsibility.[182] Interestingly, this creates several dilemmas for corporate constituents. Perhaps the most important dilemma is the enhanced risk that regulators may manipulate corporate constituents in order to mitigate political backlash, promote acquiescence, and silence critics without addressing fundamental flaws or root causes of a particular issue. This raises the question of how corporate constituents can limit the risk of manipulation and constrain lawmaker opportunism that leads to suboptimal reform.

1. The Relevance of Public Opinion

For Adolf Berle, checks on a corporation's economic power include competition, profits, political intervention, and public consensus or sentiment.[183] These latter two constraints are particularly relevant to the executive compensation debate. The forces of political intervention and public opinion may work in conjunction to influence firm performance.[184]

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181. *See* BENZ, *supra* note 86, at 53.

182. *See* Macey, *supra* note 159, at 275-78 (discussing how Congress can shift blame by deferring to federal agencies and, even more so, to state lawmakers); *see also* Lisa M. Fairfax, *The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms*, 31 J. CORP. L. 675, 699 (2006) ("First, when viewed in light of its classical meaning, corporate rhetoric can be characterized as a mechanism designed to persuade relevant audiences regarding the validity of the corporate enterprise and its agents' behaviors.").

183. ADOLF A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 39, 54, 58 (1954). Similarly, Michael Porter recognizes five forces that limit corporate power. *See* MICHAEL E. PORTER, COMPETITIVE STRATEGY: TECHNIQUES FOR ANALYZING INDUSTRIES AND COMPETITORS 6 (1980).

184. David Vogel describes the combined impact of public opinion and government action:

> There is a way in which corporations can be forced to make decisions not dominated by the logic of capital accumulation, but it cannot be achieved through "corporate accountability." It requires the direct intervention of the government. At best, corporate activists can supplement government regulation; what they cannot do is substitute for it. . . . The corporate challenge movement has not and, indeed, cannot adequately address these fundamen-

Public opinion is a crucial component of modern politics;[185] and the perception of the corporation as a quasi-public institution has elevated the status of public opinion in the corporate governance arena.[186] Although the public opinion concept is imprecise, ascertaining general public sentiment is an informative exercise for boards, lawmakers, and academics alike. Public opinion functions as a crude measure of public legitimacy for corporate governance.[187] It tends to be cyclical and intense.[188] Yet it does not always "spring immaculately or automatically into people's minds;" it may be partially manufactured.[189] In and of themselves, citizen demands may not have a significant impact on corporate conduct, but such demands are more likely to be successful when coupled with lawmaker intervention or the threat thereof.[190]

> tal issues because they can only be addressed through the governmental process.

DAVID VOGEL, LOBBYING THE CORPORATION: CITIZEN CHALLENGES TO BUSINESS AUTHORITY 225-26 (1978).

185. Murray Edelman describes the amorphous nature of public opinion:

> Social change varies crucially both with what particular groups believe about public issues and with what the public perceives as change. Yet "public opinion" is an exceptionally ambiguous and volatile term and idea. And it is readily subject to mistaken beliefs about its current or past content. People with conflicting political aspirations rarely agree on what "public opinion" is at any particular time and place, and each group's perception is likely to support its own policy preferences. Because there is no "public" but rather many different ones that change constantly, this multiplicity of perceptions of public opinion is inevitable.

MURRAY EDELMAN, THE POLITICS OF MISINFORMATION 52 (2001).

186. *See* BERLE, *supra* note 183, at 60 ("The corporation is now, essentially, a nonstatist political institution, and its directors are in the same boat with public office-holders. If ever corporate managers base their continued tenure on power and not on reason, the end is disaster.").

187. As Adolf Berle asserts:

> [A] modern American corporation understands well enough that it has a "constituency" to deal with. If its constituents—notably its buyers—are unsatisfied, they will go to the political state for solution. Hardly any present-day board of directors or corporation management would take the position that it could afford to disregard public opinion—or would last very long if it did.

Id. at 56-57 (arguing that public opinion is a check on the power of corporations).

188. *Id.* at 57 ("A disadvantage (not peculiar perhaps to a political as contrasted with an economic balancing force) is the fact that movements of public opinion tend to be sluggish in commencing, and extreme once they start. A situation has to be really out of hand before public pressure begins to assert itself, and when it does passions run high."); Martin, *supra* note 48, at 147 (asserting that concern over executive compensation fluctuates over time).

189. EDELMAN, *supra* note 185, at 53.

190. Public opinion undoubtedly impacts lawmaker and corporate manager decision-making. According to a study of directors, eighty-three percent of directors indicated that public perceptions of pay had at least a somewhat important impact on executive compensation decisions. *See* USC CTR. FOR EFFECTIVE ORGS. & HEIDRICK & STRUGGLES, 10TH ANNUAL CORPORATE BOARD EFFECTIVENESS STUDY: 2006-2007, at 27, http://www.heidrick.com/IC/Published/Governance/ (follow "10th Annual Corporate Board Effectiveness Study (2006-2007)" hyperlink) [hereinafter BOARD EFFECTIVENESS STUDY]; *see also* Fairfax, *supra* note 182, at 693 (asserting that self-generated reports addressing "corporate responsibility" or "corporate citizenship" reflect a conscious effort by business leaders, albeit rhetorically, to acknowledge their corporations' obligations to the community).

D. Diagnosing the Problem: Metrics of Assessment for the Executive Compensation Problem

The executive compensation debate is plagued by the lack of agreement concerning the proper diagnosis or characterization of the problem. The credence characteristics of executive compensation reform provide self-interested lawmakers with greater flexibility to choose a diagnosis of the executive compensation problem that is the most politically profitable. As a result, lawmaker diagnosis and recommended treatment regimens are at times inconsistent and muddled. But in order to evaluate the efficacy of executive compensation reforms, it is first necessary to establish a clear diagnosis of the problem (that is, metrics and goals) upon which to discern the effectiveness of regulation.

Corporate constituents, from managers to populist groups, view the executive compensation issue differently.[191] In general, the executive pay problem is articulated from either: (i) an investor protection-agency cost perspective;[192] or (ii) a public accountability-excessive compensation perspective.[193] Historically, the executive compensation debate focused on excessive pay.[194] In more recent history, the problem has been recast in terms of pay-for-performance.[195] Despite the widespread adoption of pay-for-performance rhetoric by most legal scholars and the business community, the political construction of the executive compensation issue unavoidably implicates both perspectives. This stems from supply and demand considerations such as: (i) lawmaker attempts to maximize political capital; or (ii) in the absence of political intent, lawmaker incompetence and corporate constituency perceptions. Whereas most legal

Mark Roe's description of "backlash" acknowledges the importance of broader public sentiment beyond the manager-shareholder constituency. *See* Mark J. Roe, *Backlash*, 98 Colum. L. Rev. 217, 217 (1998). Lucien Bebchuk acknowledges the direct impact of constituency outrage on executive compensation decisions. *See* Bebchuk & Fried, *supra* note 49, at 65. From Bebchuk's perspective, only powerful constituents, like institutional shareholders, are likely to influence firm executives. *See id.* at 50. Bebchuk's description of outrage does not address the interaction of public outrage with lawmaker intervention or the threat thereof. *See id.* at 66.

191. This Article uses the phrase "executive compensation problem" in broad terms to encompass yet recognize the difference between pay for performance issues versus excessive compensation in an absolute sense.

192. Jensen & Murphy, *Performance Pay*, *supra* note 8, at 225-26.

193. *See, e.g.*, Kevin J. Murphy, *Top Executives are Worth Every Nickel They Get*, Harv. Bus. Rev., Mar.-Apr. 1986, at 125, 125. These two viewpoints often mirror the ongoing shareholder wealth maximization versus stakeholder debate.

194. *See* Charles M. Yablon, *Bonus Questions: Executive Compensation in the Era of Pay for Performance*, 75 Notre Dame L. Rev. 271, 271-72 (1999); *see also* Jensen & Murphy, *Performance Pay*, *supra* note 8, at 254-58 (arguing that community sentiment had constrained executive pay since the 1930s, decreasing CEO incentives).

195. *See, e.g.*, Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, Harv. Bus. Rev., May-June 1992, at 28, 28-29 (asserting that the major issue is creating pay-for-performance via procedural safeguards in the compensation committee setting); Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, Harv. Bus. Rev., May-June 1990, at 138, 138-39 (arguing for attachment of pay and performance); Murphy, *supra* note 193, at 125 (asserting that the question of executives being paid too much is the wrong question to ask; instead, lawmakers should focus on relatedness of pay and performance).

scholars assume that corporate lawmakers often reject the stakeholder or public accountability model of corporate governance, the shape of executive compensation reform illustrates that public accountability concerns have not been completely disregarded.

1. *The Accountability of Corporate Power: Investor Protection and Public Accountability*

Adolf Berle chronicled the development of a new professional class of manager, envisioning the CEO more as a statesman than a robber baron.[196] From Berle's perspective, CEOs made a good living, but nothing to rival the wealth of robber barons.[197] The professional CEO class that Berle envisioned was driven by a strong sense of professional obligation.[198] In light of recent corporate scandals, Berle's initial observations were perhaps overly optimistic. Despite his overstated optimism, Berle's characterization of corporate power as the primary issue in corporate governance is instructive.

The accountability of corporate power remains the threshold issue in corporate governance, encompassing both an internal and an external dimension.[199] The internal dimension reflects the promotion of economic efficiency via preventing managerial abuse at the expense of shareholders. This is the traditional agency cost analysis. Meanwhile, the second external dimension reflects a populist uneasiness with the accountability of corporate power and the need to address negative externalities as well as broader stakeholder concerns.[200] These two perspectives raise ques-

196. *See* ADOLF A. BERLE, JR., POWER WITHOUT PROPERTY: A NEW DEVELOPMENT IN AMERICAN POLITICAL ECONOMY 3-10 (1959).

197. *See id.* at 4.

198. *See generally id.*

199. *See id.* at 77 ("Power, next to sex and love, is perhaps the oldest social phenomenon in human history."). Adolf Berle and Gardiner Means, in their seminal book *The Modern Corporation and Private Property*, addressed two dimensions of corporate power: (i) the internal minimization of agency costs resulting from the separation of ownership and control between diffuse shareholders and executives; and (ii) the external abuse of corporate power at the expense of society at large. *See* BERLE & MEANS, *supra* note 35, at 11-13, 17-18.

200. The former perspective has dominated the corporate governance debate in the United States, whereas the latter has received limited acceptance. *See, e.g.*, Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439-41 (2001) (asserting that shareholder wealth maximization is the dominant corporate governance paradigm around the world). *But see* Fairfax, *supra* note 182, at 680 (providing a stakeholder definition encompassing any group of individuals impacted by corporate actions, irrespective of whether such groups desire corporate profit maximization); Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1274 (1999) (asserting that non-shareholder interests are often implicated by corporate decisions); Cynthia A. Williams, *Corporate Social Responsibility in an Era of Economic Globalization*, 35 U.C. DAVIS L. REV. 705, 716 (2002) ("The progressive alternative, which is derived from the stakeholder theory of the corporation, suggests that corporate managers' underlying social obligations are more extensive than maximizing shareholders' wealth within the confines of the law. Specifically, progressive scholars contend that directors . . . ought to consider the implications of their actions on employees, consumers, suppliers (in some cases), the community, and the environment.").

tions concerning who is and who should be the targeted audience of executive compensation reform.

a. Is Executive Compensation Reform a Matter of Agency Costs and Internal Abuses of Corporate Power?

The pay-for-performance perspective on executive compensation is consistent with traditional agency cost analysis. It stresses the importance of using performance-based compensation to align shareholder and manager interests in order to reduce agency costs.[201] In practice, aligning pay with performance often demands less fixed compensation and more variable compensation based upon various performance-related benchmarks (for example, sales targets, cost reduction, etc.) deemed important to the firm.[202] Long term incentive plans (LTIPs), stock options, restricted stock, and other forms of equity compensation are also used to promote such alignment.[203] Yet aligning pay with performance may not necessarily lower compensation—indeed, it may do the exact opposite.[204] If the idea is to provide incentives for performance, a perfectly plausible outcome is an increase or ratcheting-up of pay. A number of commentators assert that the crux of the issue is not the actual level of compensation, but rather the tenuous link between pay and performance and the lack of effective procedural mechanisms to constrain abuses of director discretion.[205]

The only way to effectively constrain the absolute level of pay is to establish a cap.[206] However, the agency cost or pay-for-performance debate perspective sidesteps the inquiry into substantive measures, such as capping pay to constrain executive compensation, and instead defaults to the presence of procedural safeguards like shareholder voting, director independence, and disclosure. This perspective usually does not question absolute levels of pay provided that fair procedures exist for determining pay. But according to a joint study by Heidrick & Struggles and the University of Southern California Marshall School of Business,[207] approximately forty percent of directors think executive pay is too high in most cases, although over seventy-five percent think their own company's CEO compensation program is effective.[208] The virtual impossibility of

201. *See* Yablon, *supra* note 194, at 272, 279.

202. *See* Murphy, *Politics*, *supra* note 8, at 721-25.

203. *See* Walker, *supra* note 46, at 661.

204. *See id.* at 634-35.

205. *See, e.g.*, BEBCHUK & FRIED, *supra* note 49, at 194.

206. *See* Murphy, *Politics*, *supra* note 8, at 727; Yablon, *supra* note 194, at 303-07 (advocating a $3 million deductibility cap on total pay).

207. Heidrick & Struggles is "the world's premier provider of senior-level executive search and leadership consulting services, including talent management, board building, executive on-boarding and M&A effectiveness." *See* Heidrick & Struggles, About Us, http://www.heidrick.com/About/ (last visited Nov. 15, 2008).

208. *See* BOARD EFFECTIVENESS STUDY, *supra* note 190, at 26-27. This study used responses from 768 directors at 660 of the 2,000 largest publicly traded companies in the United States and is the largest study of its kind. *Id.* at 2.

determining the correct absolute pay levels,[209] in part, explains the preference among many legal scholars for procedures and the reluctance to acknowledge the impact of extremely high pay levels, in an absolute sense, on firm performance.

Excessive pay levels, however, can lower the size of dividends paid to shareholders, reduce earnings per share, and lead to other forms of organizational inefficiency. For example, intra-firm salary comparisons between employees throughout an organization may relate to firm efficiency goals.[210] Organizational theory acknowledges how the perceived unfairness of executive pay (stemming from large pay discrepancies) may have a negative impact on employee morale, turnover, competitiveness, and profitability.[211] On the other hand, the realistic prospect of higher pay and rewards most likely increases worker productivity.[212] Finally, poor pay practices may signal broader deficiencies within the firm, such as a lack of board independence and objectivity.[213] The underlying issue in the above-mentioned examples, however, remains agency costs.[214] Despite the indisputable benefits of aligning pay with performance, it is unrealistic to expect the removal of all "slack" from executive pay decisions. A more realistic target is a palatable amount of slack in light of contextual constraints.

b. Is Executive Compensation Reform a Matter of Public Accountability and the External Abuse of Corporate Power?

From the prevailing shareholder protection perspective, as long as CEO pay is adequately linked to performance measures, there is no ex-

209. *See Pay Attention*, ECONOMIST, June 14, 2008, at 77. A range of factors are employed to determine CEO compensation, such as company performance, CEO performance, pay of CEOs with peer companies, pay of other employees within the company, company culture, and concern over public perception. *See* ABA Comm. on Corp. Law, *Corporate Directors Guidebook*, 62 BUS. LAW. 1479, 1528-29 (2007). There are also a host of intangible and contextual factors that may influence the remuneration decision. The global market for executive talent has not brought down executive pay in the United States. *See Pay Attention*, *supra*. Whereas one would expect lower agency costs in private equity firms, the salaries for CEOs of private equity firms are even greater than those of publicly traded companies where agency costs are greater. *See id.*

210. *See, e.g.*, Christine Jolls, *Fairness, Minimum Wage Law, and Employee Benefits*, 77 N.Y.U. L. REV. 47, 55 (2002). The more generalized comparisons of executive pay to average U.S. worker salaries has a socio-economic fairness dimension. *Id.*

211. George A. Ackeloff & Rachel E. Kranton, *Identity and the Economics of Organizations*, 19 J. ECON. PERSP. 9, 19-22 (2005); Jolls, *supra* note 210, at 48, 55 (arguing that workers respond positively to fair wage behavior; that is, higher pay leads workers to work harder); Donald C. Langevoort, *Opening the Black Box of "Corporate Culture" in Law and Economics*, 162 J. INSTITUTIONAL & THEORETICAL ECON. 80, 86-87 (2006); Susan J. Stabile, *One for A, Two for B, and Four Hundred for C: The Widening Gap in Pay Between Executives and Rank and File Employees*, 36 U. MICH. J.L. REFORM 115, 142 (2002) ("This perception [of unfairness] has adverse consequences in terms of morale, productivity, absenteeism, and turnover.").

212. *See* Jolls, *supra* note 210, at 52.

213. *See* Bebchuk & Fried, *Agency Problem*, *supra* note 75, at 77.

214. *Id.* at 71.

cessive pay problem.[215] This perspective, however, does not adequately capture the range of lawmaker motivations or the politically constructed meaning of executive compensation reform.[216] Another key dimension of the executive pay problem maintains that excessive pay is about fairness to broader non-shareholder constituencies such as employees.[217] At a basic level, people interpret fairness by looking at the pay of others, and when they witness a gap they perceive unfairness, irrespective of how rational the sentiment.[218] This dimension of executive compensation reform is an outgrowth of the external perception of corporations as quasi-public institutions that should be subject to accountability measures resembling those found in government, such as transparency, accountability, and the participation of external voices.[219] With respect to executive compensation reform, "it is entirely possible that deeper instincts about the modern corporation as a politically accountable institution played a role" in the adoption of various measures.[220] The accountability of corporate power to external non-shareholder constituencies is an undeniable undercurrent of executive compensation reform.[221] This stakeholder-oriented perspective is often criticized because the more stakeholder con-

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215. *See* Stabile, *supra* note 211, at 117.

216. *See* Langevoort, *supra* note 113, at 1820.

217. Stabile, *supra* note 211, at 157 ("To attempt to establish an acceptable pay ratio, we need to identify what is a reasonable compensation ratio in terms of the goals we are seeking to attain, i.e., addressing employees' perception of fairness and achieving a relationship in pay that we believe is socially just."). Nonetheless, the difficulty of casting the executive compensation problem solely in terms of excess gives rise to a number of issues, namely, the lack of agreement on what is excessive, the appropriate benchmark for comparison, and, even if one assumes public accountability is a problem, the appropriate remedy.

218. Stabile, *supra* note 211, at 142 (asserting that people decide if they are being treated fairly by looking at others' pay, and when they witness gaps they perceive unfairness); *see also* Carol Hymowitz, *Pay Gap Fuels Worker Woes*, WALL ST. J., Apr. 28, 2008, at B8 ("According to the Congressional Research Service, the average pay for CEOs was more than 180 times average worker pay, up from a multiple of 90 in 1994"); Alan Murray, *CEOs Get Off the Ropes on Executive Pay*, WALL ST. J., July 5, 2006, at A2 ("Today, the Business Roundtable, a lobbying group of chief executives of 160 of the largest companies in the U.S., is releasing a study showing the pay of CEOs, while still lush compared to that of a Starbucks barista, isn't as outrageous as some press reports suggest.").

219. *See* Langevoort, *supra* note 113, at 1829 (asserting that SOX regulation is consistent with the emerging conception of the public director).

220. *See id.* at 1828 (discussing the motivations behind SOX reforms).

221. *See* Fairfax, *supra* note 182, at 678 ("[S]ociety, including investors, may find the stakeholder norm more palatable, particularly during times of corporate misbehavior when society perceives the profit maximization norm as having generated that behavior."); Theresa A. Gabaldon, *The Story of Pinocchio: Now I'm a Real Boy*, 45 B.C. L. REV. 829, 829 (2004) (arguing that "corporate irresponsibility stems from the failure of corporations to address the concerns of non-shareholders and the failure of shareholders and regulatory watchdogs to look beneath the corporate surface"); Dalia Tsuk Mitchell, *From Pluralism to Individualism: Berle and Means and 20th-Century American Legal Thought*, 30 L. & SOC. INQUIRY 179, 180 (2005) (arguing that Berle and Means' seminal book, *The Modern Corporation and Private Property*, raises questions concerning the accountability of corporations to society at large).

cerns are implicated, the less discipline it arguably exerts on managers.[222]

Notwithstanding these concerns, Adolf Berle and other commentators described the modern corporation as a major social institution rivaling government institutions.[223] The modern corporation touches virtually every aspect of contemporary life, and yet the accountability and expectation of democratic procedures that citizens expect from government are not necessarily reflected in the modern corporation.[224] This accountability gap, during periods of crisis, often translates into negative public opinion, outrage, or backlash among populist constituencies.[225] The judgment of the marketplace that Adam Smith touted in the eighteenth century did not contemplate the scope and scale of the modern corporation that Berle witnessed.[226] The notion of the corporation as a public institution and increasing citizen pressures have "helped politicize the [corporate] environment" and the executive pay debate.[227] These pressures are "a reflection of widespread public mistrust of *both* business and

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222. Langevoort, *supra* note 113, at 1833 (describing the major criticism of stakeholder approaches as making firm accountability open-ended and allowing managers to easily justify self-interested actions).

223. *See* Norton E. Long, *The Corporation, Its Satellites, and the Local Community*, *in* THE CORPORATION IN MODERN SOCIETY 202, 202 (Edward S. Mason ed., 1959). For some commentators, "[t]he large corporation takes its place along with the church and the armed services as an organization that transcends the local territory and cuts across political boundaries, at times even those of the nation and state." *Id.* at 202 ("For some of the members at least, the corporation represents a value-laden institution that outranks the local community as a focus of loyalty and a medium for self-realization.").

224. Berle's observations were not unique:

> The corporate accountability movement represents an attempt to realize in practice what scholars such as Latham, Dahl, and others have argued in theory—namely that corporations wield the power of governments and should, therefore, be treated like governments. The movement is accurately described as a movement for corporate *accountability* because its basic thrust is to make corporate officials as responsive to those affected by their decisions as are elected officials. By reviving the symbols and mechanisms of corporate governance—the annual meeting, the annual report, the proxy resolutions, the board of directors—the advocates of corporate accountability are attempting to make the relationship between the officials of the private sector and the public resemble more closely that between government officials and their constituencies.

VOGEL, *supra* note 184, at 6-7.

225. *See id.*

226. Berle recognized that "in addition to market power, the large corporation exercises a considerable degree of control over nonmarket activities of various sorts." Edward S. Mason, *Introduction*, *in* THE CORPORATION IN MODERN SOCIETY, *supra* note 223, at 1, 4; *see also* BERLE, *supra* note 183, at 37 ("The [judgment of the market place] assumption was made by Adam Smith in 1776 in the *Wealth of Nations*, and has been steadily carried forward. The point of importance is that the assumption has lost most of its validity in mid-twentieth century."). Berle openly asserted: "For practical purposes, the judgment of the market place in relation to application of capital has little application in the greatest and most dynamic areas of American industry." *Id.* at 40. In light of the complexity of the modern corporation, Berle asserted that the study of the modern corporation should not be limited to legal analysis, but rather, it should embrace a more interdisciplinary approach utilizing social science (that is, politics, economics, history, sociology, etc.) to capture the essence of corporate impact. *See* Adolf A. Berle, Jr., *Foreword*, *in* THE CORPORATION IN MODERN SOCIETY, *supra* note 223, at ix, ix-xi. Nonetheless, some commentators adopt a form of market fundamentalism even Adam Smith would hesitate to endorse.

227. VOGEL, *supra* note 184, at 226-27.

government."[228]

Executive compensation has an important symbolic link to discussions of broader economic turmoil, such as the wage gap, unemployment, and outsourcing, as well as the sub-prime mortgage crisis and stock market bubbles. Executive compensation, like the wage gap, is often invoked as a societal litmus test for fairness. Indeed, statistics demonstrating that Fortune 500 executives make 364 times that of the average worker undeniably raise eyebrows and a range of emotions from envy to disdain.[229] Such headlines heighten populist concern that large corporations are self-perpetuating plutocracies accountable only to themselves at the expense of workers and other populist constituencies. From a broad social perspective, some commentators contend that societal rewards are warped and that CEOs are overcompensated when one compares his or her societal contribution to entrepreneurs, such as Bill Gates, who promote job creation, while other CEOs do not.[230] Furthermore, these commentators argue that excessive executive compensation has broader negative economic impacts because an unreasonable amount of talented people will flock to business schools instead of pursuing other professions, thereby reducing the talent pool for other professions.[231]

Linking the executive pay debate closely to worker or populist interests highlights the tension between a more libertarian view of the corporation versus the corporation as a quasi-public institution. Every company, including nonprofits, has the goal of controlling expenses, and senior managers have discretion to pursue multiple cost reduction strategies, such as

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228. *Id.* (emphasis added). Despite growing citizen demands for public accountability, commentators argue this perspective is problematic:

> The notion of the corporation as a public institution or private government is both informative and misleading. It is informative in that it illuminates the extent to which the social impact of the corporation does resemble that of a government. But it is deceptive to the extent that it obscures the inability of the corporation to command compliance with its decisions. The reason that a corporation, unlike a democratically elected government, cannot be politically accountable to those affected by its decisions, is because the most important decisions made by any firm are out of the control of those who govern it; they are dictated by the imperatives of a market economy.

Id. at 225.

229. *See* Robert B. Reich, *CEOs Deserve Their Pay*, WALL ST. J., Sept. 14, 2007, at A13.

230. EDELMAN, *supra* note 185, at 16-17 ("As a result of the focus on image rather than social contribution and the highly disparate and inequitable returns to workers it is highly unlikely that a system that rewards merit will ever be instituted in countries such as the United States, in which corporate power has become dominant both in the economy and in the public realm. In this key respect things can only get worse, because rewards, punishments, and incentives generally are warped."); Vito Tanzi, *Tax System Reform Can Address Unrest over High Pay*, FIN. TIMES (London), Mar. 2, 2007, at 15 ("Market economies derive their legitimacy and political support from the belief that the incomes received by those who operate in them reflect their contributions to the economy."); Yablon, *supra* note 200, at 301; *but see* John E. Core, Wayne R. Guay & Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1165-66 (2005) (asserting that U.S. executives have performed in a manner worthy of some commendation, even as the market dropped, because compared to European and Asian company losses, the U.S. companies still had superior performance by losing less).

231. A similar claim can be made for the legal profession and professional sports. *See* FRANK & COOK, *supra* note 38, at 3, 6, 108-09.

layoffs, retraction of employee benefits, outsourcing, and industry exit. Ironically, a CEO's pursuit of cost reduction strategies, such as layoffs and the achievement of cost reduction targets, often lead to greater compensation. In most major companies, job creation is not a direct goal and labor is merely viewed as a factor of production.[232] For many companies, the appropriate role of the corporation is to produce goods and services society values en route to maximizing shareholder wealth—not job creation or employment guarantees.[233] The employee-at-will doctrine characterizes most modern employment arrangements and the power of organized labor has waned over the past several decades.[234] Barring self-employment, employees have no expectation of employment security—only a portable 401(k) plan. Despite public accountability concerns, the prevailing trend reflects a more libertarian corporation.

E. Lawmaker Reform Services

Despite the difficulties with diagnosing the executive pay problem presented in the preceding Sections, corporate lawmakers undoubtedly find the diagnosis of executive pay problems significantly easier than designing effective policies and reforms. The matrix of current executive compensation reform policies is a prime example of this difficulty. This Section explores the current shape of executive compensation reform and its limitations. The collective impact of these executive compensation reforms is imponderable.

1. *Judicial Arbitration Services*

Generally, courts are reluctant to weigh-in on executive pay issues except where payment constitutes waste and bears little relationship to performance.[235] Judges recognize the difficulty of articulating a concise set of rules and the *ex post* second guessing of business decisions with a strong operational component, like executive compensation.[236] Where the board is sufficiently independent and disinterested, the business judgment rule provides significant managerial discretion.[237] The epic *Disney*

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232. *See* Stabile, *supra* note 211, at 171. Some commentators find this worker indifference troubling. *Id.* ("We are not looking to eliminate pay disparities, but to eliminate undeserved disparities. Implicit in that may be the need to develop a different notion of employees, viewing them as important stakeholders in the company.").

233. Former General Electric CEO Jack Welch expresses this sentiment:

> You can look at it any way you want and I don't care what you say. We had 425,000 employees and $25bn of business. When I left we had 310,000 and $125bn, five times the revenue, 25 per cent fewer people. So, were we too bad [as an organization], or was I Neutron Jack?

Francesco Guerrera, *Ol' Blue Eyes Is Not Coming Back*, Fin. Times (London), July 26, 2008, at 3.

234. *See generally* Michael L. Wachter, *The Rise and Decline of Labor Unions*, 30 Reg. 23 (2007).

235. *See* Beard v. Elster, 160 A.2d 731, 737 (Del. 1960). .

236. *See* Exacto Spring Corp. v. Comm'r., 196 F.3d 833, 838 (7th Cir. 1999) ("[J]udges are not competent to decide what business executives are worth").

237. Clark, *supra* note 21, §§ 3, 4.

litigation reflects this judicial reluctance to second guess executive compensation despite significant board dysfunction.[238] In essence, the *Disney* cases addressed two decisions by Walt Disney Company's board: (i) the approval of Michael Ovitz's hiring as president of the company pursuant to a contract providing generous severance and other terms; and (ii) after the board had reconstituted, the approval of a "no-fault" termination for Mr. Ovitz that triggered severance payments in excess of $130 million.[239] The Delaware Supreme Court's opinion in *Brehm v. Eisner* captures the tension:

> This is potentially a very troubling case on the merits. On the one hand, it appears from the Complaint that: (a) the compensation and termination payout for Ovitz were exceedingly lucrative, if not luxurious, compared to Ovitz' value to the Company [that is, a fourteen month tenure]; and (b) the processes of the boards of directors in dealing with the approval and termination of the Ovitz Employment Agreement were casual, if not sloppy and perfunctory. . . . From what we can ferret out of this deficient pleading, the processes of the Old Board and the New Board were hardly paradigms of good corporate governance practices. Moreover, the sheer size of *the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions*.[240]

Ultimately, the *Disney* litigation did not result in liability for Disney's directors, who approved Ovitz's compensation.[241] Nonetheless, the decision sent a warning signal to corporate boardrooms.[242] The subsequent Chancery Court opinion noted that the conduct of the Disney directors

238. *See generally In re* The Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006); Brehm v. Eisner, 746 A.2d 244 (Del. 2000); *In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005); *In re* The Walt Disney Co. Derivative Litig., 825 A.2d 275 (Del. Ch. 2003); *In re* The Walt Disney Co. Derivative Litig., 731 A.2d 342 (Del. Ch. 1998). *But see In re* Viacom Inc. S'holder Derivative Litig., No. 60527/05, 2006 N.Y. Misc. LEXIS 2891, at *22 (N.Y. Sup. Ct. June 23, 2006) (finding that the plaintiff raised sufficient questions about the independence of the compensation committee to avoid dismissal under the business judgment rule). The lack of director independence may give rise to entire fairness review. *See* Aronson v. Lewis, 473 A.2d 805, 809-11 (Del. 1984). Robert Clark describes the business judgment rule as follows:

> The rule is simply that the business judgment of the directors will not be challenged or overturned by courts or shareholders, and the directors will not be held liable for the consequences of their exercise of business judgment—even for judgments that appear to have been clear mistakes—unless certain exceptions apply.

CLARK, *supra* note 21, § 34; *see also* FRANKLIN A. GEVURTZ, CORPORATION LAW 278-79 (2000) ("The idea underlying the rule is that courts should exercise restraint in holding directors liable for (or otherwise second guessing) business decisions which produce poor results or with which reasonable minds might disagree. This seems to be a sensible notion. After all, business decisions typically involve taking calculated risks.").

239. *See In re The Walt Disney Co. Derivative Litig.*, 906 A.2d at 35.

240. *Brehm*, 746 A.2d at 249 (Veasey, C.J.) (emphasis added).

241. *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d at 697.

242. *See generally* Laura M. Holson, *Ruling Upholds Disney's Payment in Firing of Ovitz*, N.Y. TIMES, Aug. 10, 2005, at A1; Bruce Orwall & Merissa Marr, *Judge Backs Disney Directors in Suit on Ovitz's Hiring, Firing*, WALL ST. J., Aug. 10, 2005, at A1; Editorial, *Regulating Fantasyland*, N.Y. TIMES, Aug. 12, 2005, at A18.

fell "significantly short of the best practices of ideal corporate governance," but was nonetheless in good faith.[243] The Chancery Court decision used sermon-like language to describe the objectionable conduct of Disney CEO Michael Eisner, asserting that he "enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom."[244] In essence, the court acknowledged that the board was "stacked" with friends and acquaintances of Eisner, who "were certainly more willing to accede to his wishes."[245] Despite the reluctance of the Delaware courts to find liability, *Disney* arguably established an outer limit of legally permissible board conduct with respect to the executive compensation decision and the public admonishment of the Walt Disney board encouraged other boards to give executive pay decisions greater attention. However, the crucial lessons from *Disney* are relatively clear. As long as directors observe procedures and act in good faith when relying on independently-retained experts, director liability remains a remote possibility.[246]

2. *Procedural Reforms and Mandates to Create Independence*

The 1990s witnessed the emergence of the compensation committee role.[247] The increased focus on the compensation committee was driven in part by executive compensation scandals, IRS executive pay regulations, judicial inquiry, and enhanced disclosure surrounding compensation committee procedures.[248] Today, stock exchanges provide specific procedural and structural requirements for compensation committees of listed companies.[249] In general, the listing rules emphasize pay-for-performance and independence.[250] Yet procedural requirements mandating that remuneration committees be composed of non-executive directors do not necessarily mean diversity of thought on executive pay. Arguably, non-executive directors, many of whom are former CEOs or other high-

243. *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d at 697.

244. *Id.* at 763.

245. *Id.* at 760. For example, the board included an administrator of a school attended by Eisner's children. *Id.* at 761 n.488.

246. *See id.* at 771-72. Richard Grasso's recent exoneration at the hands of the judiciary signals both the continued reluctance by courts to displace compensation decisions and business' growing confidence in the courts as opposed to other lawmakers. *See* People *ex rel.* Spitzer v. Grasso, 893 N.E.2d 105, 107-08 (N.Y. 2008) (dismissing four non-statutory counts against Grasso); People *ex rel.* Spitzer v. Grasso, 861 N.Y.S.2d 627, 654 (N.Y. App. Div. 2008) (dismissing two statutory counts against Grasso); Jenny Anderson, *Stock Exchange's Former Chief Wins Court Battle to Keep Pay*, N.Y. TIMES, July 2, 2008, at A1; *see also* Jeffrey Rosen, *Supreme Court Inc.*, N.Y. TIMES MAG., Mar. 16, 2008, at 38 (asserting that there is market bias at the Supreme Court).

247. *See* Murphy, *Politics*, *supra* note 8, at 715.

248. *See id.* at 737.

249. For example, NYSE listing standards expressly require listed companies to have an independent compensation committee with a written charter. NYSE, Inc., Listed Company Manual § 303A.05 (2004) (asserting that committees must "review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO's compensation level based on this evaluation").

250. *See, e.g.*, *id.*

level executives, maintain a similar world view.[251] Moreover, CEOs may exert power over directors, undermining arms-length bargaining.[252] Stock exchange rules are helpful, but not completely effective.[253] As Lucien Bebchuk notes: "While procedural requirements may mitigate problems arising from carelessness and insufficient attention, however, they do not address those arising from directors' incentives and tendencies to use their discretion in ways that favor executives."[254] With the assistance of consultants and lawyers, directors experience little trouble providing justifications for their decisions, "sometimes by merely using boilerplate language."[255]

3. *Disclosure-Related Reforms*

Since 1938, the SEC has promulgated rules on compensation disclosure to give investors a meaningful impression of executive compensation in corporate reports, proxy statements, and registration statements.[256] These rules have emphasized tabular disclosure, narrative disclosure, and a mixture of the two.[257] Despite these disclosure enhancements, the ability of corporate directors and executives to circumvent these regulations and award significant non-performance-based compensation remains. In 1992, SEC disclosure regulations helped make the activities of the compensation committee highly visible to corporate constituencies.[258] The purpose of these regulations was to give shareholders more meaningful information concerning the pay of top executives.[259]

In 2006, the SEC adopted new regulations prescribing more extensive requirements for disclosure of executive compensation, related party transactions, and compensation committee procedures.[260] Companies

251. *The Pay in Your Boss's Pocket*, ECONOMIST, July 30, 1994, at 17 ("[N]on-executives on remuneration committees— are often executive at other companies, and so have an incentive to bid up the going rate for the job.").

252. *See* BEBCHUK & FRIED, *supra* note 49, at 4-5. The CEO may ultimately play a significant role in board remuneration. *Id.*

253. *Id.* at 4.

254. *Id.* at 195.

255. *Id.*

256. *See, e.g.*, 17 C.F.R. § 229.10 (2008); 17 C.F.R. § 229.402 (2007).

257. *See, e.g.*, 17 C.F.R. § 229.402(k).

258. Martin, *supra* note 48, at 148 & n.10 (citing 17 C.F.R. §§ 228, 229, 240, 249 (1992)); *see also* 17 C.F.R. § 229.402(k) (1992).

259. Martin, *supra* note 48, at 148-49. The 1992 regulations generated more comment than any subject in SEC history up until that time. *Id.* at 149. A significant amount of criticism came from business leaders who initially raised competition concerns. *Id.* at 148-49.

260. Jeremy Grant, *SEC Rule Puts Top Salaries Under Scrutiny*, FIN. TIMES (London), July 27, 2006, at 24 ("Disclosure of executive pay and perks in America received their biggest overhaul in 14 years yesterday when the Securities and Exchange Commission approved a new set of rules designed to help investors better understand how top company officers are rewarded."); *see* Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732, Exchange Act Release No. 54,302, Investment Company Act Release No. 27,444, 71 Fed. Reg. 53,158 (Sept. 8, 2006); *see also* Christopher Cox, Chairman Sec. & Exch. Comm'n, Opening Statement at an SEC Meeting: Proposed Revisions to the Executive Compensation and Related Party Disclosure Rules (Jan. 17, 2006), http://www.sec.gov/news/speech/spch011706cc.htm.

must disclose compensation for their top five executives in their annual disclosure documents and include a detailed compensation discussion and analysis (CD&A).[261] The CD&A is management's disclosure, rather than the compensation committee's.[262] The purpose behind the CD&A is to discourage boilerplate disclosures that fail to provide meaningful company specific information.[263] The CD&A explains in detail the information contained in the compensation tables. But, even with the existing disclosure requirements, significant elements of pay, such as non-contractual severance payments and charitable contributions, remain excluded.[264]

Without question, enhanced disclosure requirements act as a constraint on managers and improve the monitoring capabilities of corporate constituents.[265] But, if past history is any indication of future performance, disclosure rules cannot fully curb abuses or pay levels. In certain instances, enhanced disclosure may actually lead to higher pay levels,[266] and it can give rise to more opaque forms of compensation.[267] Although effective, disclosure presents a "double-edged sword," as David Walker explains:

> [E]nhanced disclosure is a double-edged sword. Increased disclosure requirements concerning compensation element A may lead executives to favor a less efficient, but more opaque, compensation element B. Thus, in order for mandatory disclosure to increase shareholder value, disclosure practice must stay tightly attuned to compensation practice, effectively preventing executives from circumventing the requirements. In addition, enhanced disclosure may lead to executive compensation ratcheting upwards as firms benchmark compensation against each other.[268]

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261. *See id.* § 229.402(a), (b) (2007). SEC proxy statement disclosure regulations are found in Regulation S-K Items 402 and 407, 17 C.F.R. §§ 229.402, 229.407 (2006).

262. The compensation committee, however, is required to include a Compensation Committee Report in the corporation's annual disclosure documents. 17 C.F.R. § 229.407(e).

263. *See* 17 C.F.R. § 229.402(b). In addition to explaining tabular information, the CD&A provides answers to the following questions: (i) What are the objectives of the company's compensation programs?; (ii) What is the compensation program designed to reward and not reward?; (iii) What is each element of compensation?; (iv) Why does the company choose to pay each element?; (v) How does the company determine the amount for each element?; and (vi) How does each element fit into the company's overall compensation objective? *Id.* § 229.402(b)(1).

264. *See* Walker, *supra* note 46, at 657-58 (footnotes omitted).

265. *See* LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914) ("Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.").

266. Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1264 (2004) (suggesting that enhanced disclosure may ratchet up pay).

267. *See* Walker, *supra* note 46, at 656-57 ("Managers have an interest in concealing compensation and will respond to new disclosure requirements by inventing new, opaque compensation elements. Thus, adequate disclosure will be a continuing race between regulators, on the one hand, and corporate executives and their compensation consultants, on the other."); *see also* Martin, *supra* note 48, at 153.

268. Walker, *supra* note 46, at 658.

To be fair, the quality of disclosures regarding equity compensation, the metrics used, and greater transparency concerning perquisites have improved over time in conjunction with financial statement treatment of equity compensation.[269] These enhancements move toward providing corporate constituents a bottom-line snap shot of executive compensation. An additional benefit of disclosure is that it may also lead companies to revisit compensation practices, not to simply comply with regulations but also to avoid public embarrassment.

4. *Reforms Targeting Shareholder Input and Voting*

a. Approval of Equity Compensation Plans

In 2003, the SEC approved new self-regulatory organization (SRO) rules mandating shareholder approval of equity compensation plans.[270] The NYSE and NASDAQ shareholder approval requirements for equity compensation plans require shareholder approval for equity compensation plans and for the material alteration of such plans subject to certain exceptions.[271] Approval of a plan, however, is not synonymous with approvals of grants to specific individuals under a plan. Shareholders may lobby their dissatisfaction with equity compensation plans, but they have little control over executive pay. Such plans are often broadly worded to leave the board significant discretion.[272] A broadly worded plan, once approved by shareholders, allows directors to make changes, year after year, without triggering an additional shareholder voting requirement.[273] Moreover, shareholders do not approve the specific number of options given to a particular executive.[274] Therefore, these requirements alone cannot ensure that equity-based compensation serves shareholder interests.[275] Even with veto power over equity compensation plans, the exercise of such power still provides broad discretion for directors to award large bonuses with tenuous links to performance. On balance, SRO approval requirements "merely expand an already common practice that has not proven to be an effective constraint on boards."[276]

b. "Say-on-Pay"

In an attempt to create greater shareholder input on the specific issue of executive compensation, a number of legislators have proposed "say-

269. *See* RiskMetrics Group, *supra* note 42, at 20-21.
270. *See* Self-Regulatory Organizations, Exchange Act Release No. 48,108, 68 Fed. Reg. 39,995 (June 30, 2003).
271. *See* NYSE, Inc., Listed Company Manual § 303A.08 (2004); NASD Rule 4350(i)(1)(A) (2004).
272. BEBCHUK & FRIED, *supra* note 49, at 196.
273. 2 CORPORATE GOVERNANCE: LAW AND PRACTICE § 16.03 (Bart Schwartz & Amy L. Goodman eds., 2004).
274. BEBCHUK & FRIED, *supra* note 49, at 196.
275. *Id.*
276. *Id.*

on-pay" legislation.[277] On March 1, 2007, Massachusetts Congressman Barney Frank introduced House Bill 1257, "The Shareholder Vote on Compensation Act."[278] This legislation requires public companies to provide detailed executive compensation plans for shareholder approval at each annual meeting of shareholders, and it also requires separate shareholder approval for executive compensation related to a merger, acquisition, or disposition.[279] The House of Representatives approved this bill with a vote of 269 to 134, and the bill was referred to the Senate in accordance with legislative procedures.[280] On April 20, 2007, Senator Barack Obama introduced the "Shareholder Vote on Executive Compensation Act" in the U.S. Senate.[281] This bill is virtually identical to the bill that Congressman Barney Frank introduced in the House of Representatives.[282]

The above-mentioned say-on-pay proposals are advisory and non-binding.[283] Thus, shareholders can articulate dissatisfaction, but cannot veto pay packages. Say-on-pay measures may have a modest impact, but will not "prevent headline-grabbing paydays" nor "further political outrage, and more red-faced bosses coming under fire."[284] Without the actual ability to veto pay packages, is there any value to say-on-pay measures? Certainly. Say-on-pay votes, although advisory, provide a warning signal to wayward management, who may rethink future actions to avoid being voted out.[285] The adoption of advisory say-on-pay measures may also provide a benefit to management by ameliorating shareholder and non-shareholder constituency outrage by signaling democratic virtues with which corporate constituencies may identify. In other words, even if advisory say-on-pay measures are merely symbolic, they may have a tangible impact on shareholder satisfaction and director discretion.[286] However, the hidden costs of these mandatory one-size-fits-all proposals are unknown.[287]

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277. *See* Jeremy Grant, *SEC Chief Looks to Europe on Rights for Shareholders*, FIN. TIMES (London), Feb. 23, 2007, at 15 ("The issue of whether—and how—to allow shareholders in US companies greater say in choosing board directors and setting executive pay is moving centre stage as the proxy voting season gets under way.").

278. *See* H.R. REP. NO. 110-88 (2007) (discussing legislative history of H.R. 1257).

279. *See* Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong., § 2 (2007) (as passed by House, April 20, 2007).

280. *Id.*

281. *See* Shareholder Vote on Executive Compensation Act, S. 1181, 110th Cong. (2007).

282. *Compare id.*, *with* H.R. 1257.

283. H.R. 1257; S. 1181.

284. *Pay Attention*, *supra* note 209.

285. *See Fair or Foul?*, ECONOMIST, June 14, 2008, at 78.

286. While executive pay is also an important socio-political issue in Europe, the European executive earns forty percent of what an American executive earns. *See Pay Attention*, *supra* note 215. The global market for executive talent has led to an increase in executive pay among European firms, yet shareholders harbor less dissatisfaction with European firms due in part to the shareholders' ability to vote on compensation packages. *See id.* Such votes are most often non-binding or advisory as opposed to binding. *Id.*

287. *See* Rosen, *supra* note 171, at 2932.

In addition to legislation, shareholders, via shareholder resolutions, have attempted to amend corporate by-laws to provide for advisory votes on executive pay.[288] RiskMetrics predicts nearly "70 'say on pay' resolutions will be tabled in 2008 . . . , up from 52 in 2007."[289] While some companies have adopted such resolutions, the majority of companies still have not.[290]

5. *Tax-related Reforms*

The Internal Revenue Code (IRC) and tax-related regulations have often been used to influence executive compensation. These tax-related reforms targeting executive pay have been the subject of significant controversy and criticism. Congress enacted tax laws to stem perceived abuses of executive compensation in two primary areas: (i) the level of compensation; and (ii) change-in-control agreements.

a. Tax Deductibility Limits on Non-Performance-Based Pay

In 1993, Congress passed legislation with the express purpose of containing the level of executive compensation in response to widespread public "scrutiny."[291] Despite these intentions, the legacy of Section 162(m) has more to do with escalation of pay than its limitation. Section 162(m) of the Internal Revenue Code limits tax deductions for executive pay over $1 million; however, there is an important exception for qualified performance-based compensation for which companies are allowed to receive deductibility.[292] Despite the deductibility cap under 162(m), most large public companies continue to pay CEOs and senior executives total compensation in excess of $1 million and have little difficulty claiming tax deductibility for compensation well in excess of $1 million.[293] In essence, 162(m) stipulates that as long as pay is loosely tied to performance metrics and certain procedural requirements are met (for example, independent compensation committee), companies can escape the deductibility cap.[294] As a consequence of 162(m), there was a seismic shift from fixed base pay to the award of share options based upon performance.[295] The stated goals of 162(m) are unrealized, as executive compensation has risen to all-time highs.[296] The failure of 162(m) rests on a faulty premise that performance-based compensation incentives will re-

288. *Fair or Foul*, *supra* note 285.
289. *Id.*
290. *Id.*
291. Revenues Report to Accompany Recommendations from the Committee on Ways and Means, H.R. REP. NO. 103-111, at 646 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 877.
292. Miske, *supra* note 10, at 1684.
293. *Id.* at 1687.
294. *Id.* at 1691-92.
295. *Id.* at 1688.
296. *Id.* at 1684 (asserting that the use of tax caps led to the unintended consequences of increased levels of pay-for-performance because the caps functioned as a minimum base salary rather than the maximum); *see also* Knutt, *supra* note 13, at 495 (arguing that tax and disclosure reforms aimed at executive compensation are ineffective).

duce overall pay.[297] But another plausible outcome is for such incentives to ratchet-up overall pay.

b. Change-in-control Golden Parachute Limitations

In addition to 162(m), "golden parachute" tax laws under the IRC seek to limit excessive parachute payments in the event of a change of control.[298] These provisions impose a twenty percent tax penalty on "excessive parachute payments."[299] Not unexpectedly, there are multiple exceptions that limit the regulation's effectiveness. For example, companies can avoid the regulation by showing that pay reflects (i) personal services to be offered on or after the date of change in control or (ii) services already rendered before such date.[300] These golden parachute tax measures, however, led to another unintended consequence known as the excise tax gross-up.[301] A gross-up operates when companies make an agreement that, in the event an executive becomes liable for excise taxes under the golden parachute provisions, the company will compensate the executive for any resulting taxes.[302] According to one study, excise tax gross-ups can cost companies over three dollars for every dollar of tax paid, operating as a hidden merger cost.[303]

6. *Clawback Provisions: Sarbanes Oxley Act Section 304 Forfeiture of Bonuses*

Section 304 of the Sarbanes-Oxley Act of 2002 (SOX) requires the CEO and CFO of a firm required to restate earnings due to material noncompliance of financial reporting requirements under the securities laws to repay to their company any bonus or other incentive or equity-based compensation received during the 12 months following the filing of the misleading financial statement, or any profits realized from the sale of stock within that 12-month period, if the restatement results from misconduct.[304] The statute, however, does not specify what degree of misconduct or whose misconduct is necessary to trigger the regulation. In the first six years following passage of Section 304, there have been

297. *See* Miske, *supra* note 10, at 1687.

298. *See* 26 U.S.C. §§ 280G, 4999 (2000).

299. 26 U.S.C. § 4999(a).

300. *See id.* § 280(G)(b)(4). The golden parachute regulations also provide guidance for how options are to be valued pursuant to a change in control. The methodology loosely tracks the Black-Scholes model formula for valuing options. *See* RiskMetrics Group, *supra* note 42, at 31-33. Even under-water options are ascribed some value for purposes of the golden parachute tax rules.

301. Miske, *supra* note 10, at 1681.

302. *Id.*

303. *See* RiskMetrics Group, *supra* note 42, at 31 (citing Randy Myers, *Minimize Parachute Penalties*, 192 J. ACCT. 33 (2001)).

304. BEBCHUK & FRIED, *supra* note 49, at 185 (citing Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 304, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28 and 29 O.S.C.)).

clawbacks in only a small number of cases.[305]

All of these cases involved a corporate officer who personally committed fraud and misconduct.[306] Although the statute does not expressly require the officer from whom the clawback is sought to personally engage in misconduct, the statute has been construed narrowly. The ultimate impact of the SOX clawback provisions hinges on their enforcement.[307]

V. THE DEMAND SIDE: CORPORATE CONSTITUENCIES AS CUSTOMERS

The demand side of the corporate reform market involves several categories of customers who have (i) asymmetric power to extract gains from the regulatory process, (ii) varied abilities to detect regulation quality, and (iii) different incentives to acquire information about public policy.[308] Within this context, the interests of managers and large shareholders prevail over diffuse corporate constituents such as small individual shareholders and populist groups. Corporate managers and institutional shareholders have a large enough stake in regulatory outcomes to overcome rational ignorance or apathy over business policies. Alternatively, other corporate constituents, such as small individual shareholders and non-shareholder populist constituencies, have weaker incentives to gather and acquire information regarding both favorable and unfavorable business policies.

A. Corporate Managers

The corporate firm is arguably the chief consumer of executive compensation regulation. The corporate firm, however, is an aggregation of discrete interest groups that should be subdivided. Corporate managers (for example, directors, CEO, CFO, etc.) who steer and monitor the firm are a key constituency. In theory, the board of directors has the ultimate responsibility to manage and monitor the firm, but, in reality, the CEO implements and most likely creates strategy. The board, often via committees, hires the CEO and sets their compensation.[309] Corporate managers have significant operational expertise and informational advantages when compared to other corporate constituents. Moreover, corporate managers are more likely to interact with lawmakers via lobbying, gov-

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305. *See generally* Rachael E. Schwartz, *The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 Bus. Law. 2 (2008).

306. *Id.*

307. Section 402 also places restrictions, subject to limited exceptions, on personal loans to directors and executive officers of listed companies. *See* Securities Exchange Act of 1934, Pub. L. No. 73-291, §13(k), 48 Stat. 881 (codified as amended at 15 U.S.C. § 78m(k) (Supp. 2002)); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 402, 116 Stat. 745, 747 (codified at 15 U.S.C. § 78M(k) (Supp. IV 2004)).

308. *See* Peltzman, *supra* note 31, at 823 (discussing rational ignorance among consumers); Peltzman, *supra* note 7, at 240; Stigler, *supra* note 123, at 8-9.

309. *See, e.g.*, Heidrick & Struggles, *Building High-Performance Boards II* (2006), http://www.heidrick.com/NR/rdonlyres/FD74D2C1-7F07-4B88-BB40-9D60E0DB1298/0HS_PerformanceBoards.pdf.

ernment procurement, and other forms of government interaction.[310] In carrying out their duties, "[d]irectors and officers simply assume or state that the main effort is to maximize shareholder value, and that other groups must be kept happy enough to achieve this goal."[311]

B. Shareholders

The shareholder is often touted as the underpinning of corporate governance. There is considerable debate concerning the optimal degree of shareholder influence on firm decision-making and whether shareholder wealth maximization is the optimal measure of corporate performance.[312] In theory, shareholders, if dissatisfied with management, can either vote directors out or sell their shares.[313] In reality, shareholders' ability to vote out directors is constrained, and even shareholders with large stakes in a company may be reluctant to sell their stake.[314] The modern shareholder is not a monolithic concept and can be divided into various subgroups.[315] For example, the comparison of "institutional shareholders" to "individual shareholders" illustrates varied degrees of information asymmetries, business acumen, investor time horizons, and apathy.[316]

1. *Individual Shareholders*

Generally, individual shareholders are too numerous, diffuse, and apathetic to individually participate in monitoring the firm. The billionaire investor Carl Icahn is an exception.[317] The impact of individual shareholders is perhaps overstated when one considers that most U.S. citizens hold company shares indirectly via mutual funds.[318] Given information asymmetries, individual shareholders have limited incentives and capacity to discern the quality of legal reforms.

310. *See, e.g.*, Fisch, *supra* note 178, at 1504-07.

311. Robert C. Clark, *Major Changes Lead Us Back to Basics (A Response to the Symposium on My Treatise)*, 31 J. Corp. L. 591, 596 (2006).

312. *See* Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. Corp. L. 637, 646-47 (2006) (acknowledging that certain stakeholder interests are not reflected in measures of shareholder wealth and questioning the suitability of shareholder wealth as a unitary basis for corporate regulatory decisions).

313. *See* Jason M. Loring & C. Keith Taylor, *Shareholder Activism: Directorial Responses to Investors' Attempts to Change the Corporate Governance Landscape*, 41 Wake Forest L. Rev. 321, 324 (2006).

314. *See id.* (asserting that an institutional investor might not be able to pull out, or "vot[e] with its feet," for fear of causing market repercussions of major shifts in large portfolios).

315. *Id.* at 323.

316. *See id.* at 323-25 (analyzing support for shareholder proposals for both individual and institutional investors).

317. *See* Shawn Tully, *The Hottest Investor in America*, Fortune, May 30, 2007, *available at* http://money.cnn.com/magazines/fortune/fortune_archive/2007/06/11/100060832/index.htm?postversion=2007053010 (describing Carl Icahn's shareholder activism and his impact on the reduction of a particular CEO's bonus); *cf.* Langevoort, *supra* note 113, at 1835-36 ("To be sure, successful exercise of investor power has been uneven and episodic—many institutional investors remain conflicted and unwilling to oppose management, so that activists rarely expect an easy majority of votes.").

318. *See* Loring & Taylor, *supra* note 313, at 323.

2. *Institutional Shareholders*

On the other hand, institutional shareholders (for example, mutual funds and pension funds) have greater capacity to monitor firms and participate in firm governance.[319] Yet such capacity does not necessarily transform into action. The primary concern for most institutional investors is promoting shareholder wealth maximization via controlling managerial costs.[320] This leaves institutional investors moderately conservative and indifferent to a range of reforms that do not directly implicate shareholder wealth maximization. Nonetheless, there is some evidence suggesting that institutional investors play a more activist monitoring role.[321] For example, public pension funds and labor-managed funds break the mold of ambivalence and are more activist and "attentive to constituencies whose interests diverge from share price maximization."[322] This subset of institutional investors often places greater emphasis on security and moderate risk—qualities that employees, retirement savers, and the general public may find appealing.[323] These funds often voice concerns over executive pay levels and are more likely to blur the line between public accountability and shareholder wealth maximization.[324] Some commentators argue that managers of pension funds are, in essence, bureaucrats with limited incentives to push for more efficient compensation relationships.[325]

C. Populist Groups

Populist groups form another major customer segment for executive compensation reform. Populist groups include broader stakeholder groups, such as employees, unions, environmental and consumer watchdogs, and communities. These groups often define executive compensation differently than managers and look beyond shareholder-wealth maximization;[326] yet, their connection to firm decision-making is more tenuous, and their claims of corporate accountability have strong political

319. *Id.* at 323 ("The institutional investor, because of its fiscal impact on a company, generally wields more power than does an individual investor. This power also has an impact on voting because institutional investors are occasionally 'able to put enough pressure on management to convince the company to implement the proposal without going through with a vote.'" (quoting Marc H. Follardori, *Shareholder Proposals*, *in* 3 Preparation of Annual Disclosure Documents 2004, at 25, 91 (Klaus Eppler et al. eds., 2004))).

320. Langevoort, *supra* note 113, at 1836.

321. *See* Jennifer Levitz, *Do Mutual Funds Back CEO Pay?*, Wall St. J., Mar. 28, 2006, at C1 (discussing a study showing institutional shareholder support for executive pay plans and opposition to other shareholder proposals on executive compensation). Even if shareholder involvement was the norm, certain governance concerns remain: (i) short-termism; (ii) pursuit of social agendas; and (iii) lack of management expertise. These criticisms are most likely to apply to individual investors.

322. Langevoort, *supra* note 113, at 1836.

323. *See id.* at 1836-37.

324. *See id.*

325. *See, e.g.*, Murphy, *Politics*, *supra* note 8, at 726.

326. *Id.* at 715.

and fairness-related undertones.[327] Populist attacks on wealth discrepancies are understandable in light of the declining significance of unions, global labor competition, and economic turmoil, especially where CEOs are perceived as benefiting from the turmoil.[328]

D. Addressing Risks: How Can Corporate Constituents Identify the Quality of Regulation Given Information Constraints?

In most of the literature regarding credence services, the government is treated as a potential third-party monitor or information-gatherer to address market failure. This Article takes a different vantage point and casts lawmakers as suppliers of regulatory reform services who share similar conflicts and constraints as private evaluators.[329] The credence qualities of corporate reform are costly to evaluate and, as a result, some external monitoring or information-gathering function becomes extremely valuable.[330] Given informational constraints, corporate constituents rely on various quality proxies as a risk reduction strategy. These corporate constituent decision-making heuristics include, but are not limited to: (i) third parties and reputational intermediaries; (ii) lawmaker credible commitment and brand equity; and (iii) legitimizing procedures.

1. *Third Parties and Reputational Intermediaries*

Due to the credence characteristics of executive compensation reform, corporate constituencies rely on third-party input to make quality determinations. In this sense, corporate constituencies seek input like a patient seeking a second opinion. Although imperfect, third-party perspectives are undoubtedly a useful decision-making heuristic for corporate constituencies.

a. Institutional Shareholders

Institutional shareholders may have the resources and information to limit the amount of manipulation by lawmakers and executives. Institutional shareholders may provide information to more diffuse and rationally apathetic shareholders (as well as shareholders who lack the financial capacity to gather information and monitor corporate activity). Institutional shareholders may also develop their own best practice guidelines to supplement what the existing regulatory regime and the market ignore. Institutional shareholders, particularly groups of them who vote according to such best practice guidelines, undoubtedly catch the attention of senior management. There are notable examples of increased activism by institutional shareholders in response to executive compensation. For example, a coalition of pension funds withheld votes from ten of Home De-

327. *See id.* at 717.
328. *Id.*
329. *See* Darby & Karni, *supra* note 25, at 87.
330. *Id.* at 86.

pot's eleven directors for their failure to link pay to performance.[331] Coupled with the impact of proxy advisory services, such as Institutional Shareholder Services (ISS), institutional shareholders have even greater potential to influence pay practices. In this sense, institutional shareholders can occupy a quasi-diagnostic role for smaller shareholders and, in the case of pension funds, populist constituencies like employees.

b. Compensation Consultants and Executive Search Firms

i. Compensation Consultants

Generally, compensation consultants provide advice and support to boards or board committees that are ultimately responsible for executive compensation decisions. On certain engagements, compensation consultants may not offer advice, but simply analyze data.[332] The use of compensation consultants by committees has received a significant degree of criticism and concern from academics and regulators alike.[333] Specifically, consultant over-reliance on surveys with skewed methodology has received criticism for ratcheting up executive pay.[334] The "Lake Wobegon effect" is well documented, and no strong candidate desires pay at or below the mean in their peer group.[335] Almost everyone, including CEOs and directors, believes he or she is above average. A key problem with over-reliance on survey data is that consultants may select an inappropriate peer group as a benchmark.[336] The Richard Grasso pay scandal was an outgrowth of this problem.[337] The average peer company used to benchmark Grasso's pay had a median revenue of $26 billion, twenty-five times that of the NYSE, median assets 125 times higher, and a median

331. *See* Press Release, Am. Fed'n of State, County & Mun. Employees, AFSCME Seeks to Hold Home Depot Board Accountable for Excessive Executive Pay (May 22, 2006), http://www.afscme.org/press/6661.cfm.

332. *See Executive Pay: The Role of Compensation Consultants, Hearing Before the H. Comm. On Oversight and Government Reform*, 110th Cong. (2007) (testimony of Donald L. Lowman, Managing Director, Towers, Perrin, Forster & Crosby, Inc.) [hereinafter Lowman Testimony], *available at* http://ovresight.house.gov/documents/20071205125920.pdf.

333. *See id.*; Stabile, *supra* note 217, at 132 (asserting that compensation consultants are influenced by who hire them now but also in the future).

334. *See* NAT'L ASS'N OF CORP. DIRS., REPORT OF THE NACD BLUE RIBBON COMMISSION ON EXECUTIVE COMPENSATION AND THE ROLE OF THE COMPENSATION COMMITTEE 13 (2003) ("The tendency of some compensation committees to pay at the 75th percentile has led to upward ratcheting of pay that is not always justified by individual or company performance, and that does not always consider the company's financial circumstances.").

335. *See* FRANK & COOK, *supra* note 38, at 104-05 ("The phenomenon has most often been explained in motivational terms by authors who note that the observed biases are psychologically gratifying. Thus, since it is unpleasant to think of oneself as below average, a cheap solution is simply to think of oneself as above average."); Martin, *supra* note 48, at 163 ("Graef Crystal, a well-known compensation consultant, has found after studying hundreds of companies, almost no relationship between CEO pay and profits, but rather between an individual CEO and other CEOs: a third of companies want their CEO's pay package to be in the top 25% and no company wants to pay their CEO below the industry average.").

336. *See* Gretchen Morgenson, *Peer Pressure: Inflating Executive Pay*, N.Y. TIMES, Nov. 26, 2006, *available at* http://www.hytimes.com/2006/11/26/business/yourmoney/26peer.html.

337. *Id.*

number of employees thirty times greater.[338] To be fair, this is an extreme example, and most consultants rely on factors other than surveys.[339] In the words of a prominent compensation consultant, "[s]urvey data should inform, but not determine, pay levels" and "should be used judiciously, in conjunction with a host of other factors."[340]

Compensation consultants have also come under fire for potential conflicts of interest when a consulting firm simultaneously provides executive compensation consulting and other consulting services to a single corporate client.[341] Some critics assert that a rule barring multiple arrangements would resolve the conflicts.[342] There are, however, credible contrary arguments. Larger firms with numerous clients arguably are not as beholden to a single company for their revenues, whereas smaller firms that specialize may be less objective due to additional financial pressures.[343] Therefore,

> far from presenting an obvious or attractive solution to the perceived problem of conflict of interest in the delivery of executive compensation consulting services, a rule barring firms from accepting both executive compensation and other types of consulting engagements from the same company actually could exacerbate the risk that a company could receive conflict-compromised advice.[344]

Despite the emphasis on compensation consultants, one cannot underestimate how improved disclosures by large companies have also placed significant upward pressure on pay.

ii. Executive Search Firms

The role of executive search firms is often understated in the executive compensation literature. Top executive search firms have firsthand insight into the executive talent market and search criteria for both CEOs and directors.[345] Thus, board members may look to executive search firms for guidance concerning CEO candidates and compensation.[346] Specifically, search firms may "provide input on a candidate's desired compensation and assist the client in formulating an offer, presenting [the offer] to the candidate, and negotiating [the offer's] acceptance."[347] Moreover, "[s]hould extensive, complex negotiations be required, the client and search firm may choose to tap an external compensation consultant until an agreement is reached."[348] Search firms also provide CEO succession planning that may lower search costs, identify strong internal

338. *See id.*
339. *See* Lowman Testimony, *supra* note 332, at 11-12.
340. *Id.*.
341. *See id.* at 1-6.
342. *See id.* at 5-6.
343. *Id.* at 6.
344. *Id.*
345. *See* Heidrick & Struggles, *supra* note 309, at 9.
346. *Id.*
347. *Id.* at 20.
348. *Id.*

candidates, and prevent firms from overpaying a mediocre CEO candidate in periods of crisis.[349] The search firm mandate differs from the compensation consultant mandate. For the search firm, securing top CEO talent is the primary objective while compensation is a secondary concern.[350] The market for top executives is extremely competitive, resembling free-agency in professional sports.[351] Companies are likely to pay even more to secure external CEO candidates during periods of economic turmoil because candidates are reluctant to move and desire greater compensation in exchange for additional risk associated with changing positions.[352]

c. Institutional Investor Advisory Services

Institutional investors, despite having greater capacity to monitor and gather information, may have too small a stake in a company or too limited industry expertise to monitor it actively. Thus, consultancies play a prominent role by advising institutional investors. RiskMetrics Group, formerly ISS, advises institutional investors on how to vote at annual meetings and provides company-specific ratings to the investor community.[353]

i. Proxy Advisory Services

Proxy advisory service organizations (especially ISS, boasting over 300 institutional and corporate clients worldwide) are a growing force in corporate governance.[354] ISS notably incorporates pay-for-performance methodology into its advisory services.[355] For example, where a disconnect exists between CEO performance and pay and ISS guidelines, ISS is likely to recommend a vote against an equity compensation plan.[356]

ii. Corporate Governance Ratings

The Corporate Governance Quotient (CGQ) is a "rating system . . . designed in collaboration with a panel of industry and academic experts,

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349. *See* Heidrick & Struggles, *supra* note 37, at 2-3.

350. *See id.* at 3. However, one cannot rule out the potential influence of search firm compensation that might include one-third of the sum of an executive's first year base salary plus bonus.

351. *See* FRANK & COOK, *supra* note 38, at 71 (asserting that the market for top executive talent resembles free agency in professional sports and escalates compensation).

352. *See id.*

353. *See generally* RiskMetrics Group, Company History, http://www.riskmetrics.com/history (last visited Nov. 9, 2008).

354. *Id.* ISS was acquired by RiskMetrics Group in 2007. *Id.*

355. RiskMetrics Group, 2007 Compensation FAQs, http://www.riskmetrics.com/about/policy/2007_compensation_FAQ (last visited Nov. 9, 2008).

356. In 2004, ISS incorporated pay-for-performance factors into "its proprietary quantitative model for determining whether to . . . vote for or against proposed equity compensation plans." 2 CORPORATE GOVERNANCE: LAW AND PRACTICE, *supra* note 273, § 16.05. "If the potential cost (including both shareholder value transfer and voting power dilution) of the proposed plan, when combined with existing plans, exceeds the cap or . . . violates ISS repricing guidelines (expressly allowing repricing of underwater stock options without shareholder approval), ISS [generally] recommends a vote against . . . the proposed plan." *Id.*

in order to assist institutional investors in evaluating the quality of corporate boards and the impact their governance practices may have on performance."[357] The CGQ relies on sixty-five criteria, and at least ten of these criteria relate directly or indirectly to executive compensation.[358]

d. Academics

Academics have a tangible and useful role to play in corporate governance by raising difficult questions for lawmakers and educating corporate constituencies. Congressional testimony, op-ed pieces in the mainstream press, books, and articles by legal scholars are all potential sources of academic impact.[359] In certain circumstances, this may require an appraisal about the limits of legal measures as well as the need for enhancements. But the perspective must recognize the contextual environment (for example, political and economic) within which companies operate.[360] Academic influence may also hinge on the ability of academics to persuade lawmakers or to educate powerful corporate constituencies like institutional shareholders.

e. Activist Organizations and Corporate Watchdogs

Non-shareholder activists and corporate watchdogs can be a significant source of information for corporate constituents in need of information to discern the quality of the reform and the lawmaker's commitment to their concerns.[361] Activist and watchdog organizations arguably improve corporate constituent utility via information gathering. Absent the need for activist endorsement or acquiescence, lawmakers may have little incentive to provide services addressing populist concerns.[362] The AFL-CIO and Public Citizen are examples of activist organizations.[363] Activist organizations often "use a variety of tactics—picketing, demonstrations,

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357. RiskMetrics Group, Frequently Asked Questions About Corporate Governance Quotient (CGQ®), http://www.riskmetrics.com/sites/default/files/CGQ%20?FAQ.pdf (last visited Nov. 9, 2008).

358. *See* RiskMetrics Group, Summary: CGQ® Ratings Criteria for U.S. Companies, http://www.riskmetrics.com/sites/default/files/CGQ_Criteria_US.pdf (last visited Nov. 9, 2008). Examples of CGQ criteria include: cost of option plans; whether option re-pricing is permitted in plan; shareholder approval of option plans; performance-based compensation; and options backdating. *Id.*

359. *See, e.g.*, *Empowering Shareholders on Executive Compensation: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. (2007) (written testimony submitted by Lucian A. Bebchuk, William J. Friedman, and Alicia Townsend Friedman), *available at* http://www.house.gov/apps/list/hearing/financialsvcs_dem/htbebchuk0308007.pdf; Lucian Bebchuk, Op. Ed., *Investors Must Have Power, Not Just Figures on Pay*, FIN. TIMES (London), July 27, 2006, at 13 (arguing for greater shareholder power over executive compensation).

360. As Adolf Berle observed, the modern corporation defies a narrow characterization and approach to study. Berle, *supra* note 226, at ix–vx.

361. Feddersen & Gilligan, *supra* note 7, at 150-51.

362. *See id.* at 152.

363. *See* AFL-CIO, About Us, http://www.aflcio.org/aboutus/ (last visited Jan. 20, 2009); Pub. Citizen, http://www.citizen.org/ (last visited Jan. 20, 2009). Although unions may also hold shares, such interests are minimal.

boycott calls, or standing before political or administrative agencies and courts—to attract the media and the public to some moral or political issue."[364] Yet, activists themselves are constrained by their own self-interest and bias.[365] Accordingly, the activist vantage point may also distort regulatory outcomes.

f. Best Practice Guidelines

In addition to traditional regulators, organizations with an interest in corporate governance, such as the Business Roundtable; the Blue Ribbon Commission of the National Association of Directors (NACD); proxy advisory services, such as Institutional Shareholder Services; and institutional investors, like TIAA-CREF, have all published "best practice" guidelines in an effort to influence the executive compensation debate and reform.[366] Corporate constituents may rely on such guidelines as a supplement to government regulation because there is a gap between what laws on the books require and good corporate governance.[367] Best practice guidelines as advocacy instruments also may influence and educate lawmakers. In many instances, lawmaker reforms simply mandate practices that have already been adopted by a significant segment of the corporate community.[368] Common executive compensation best practice recommendations include: compensation committee independence and diligence; training compensation committees; periodic assessments of compensation committee performance; compensation committee retention of experts, such as consultants and legal counsel; and board and shareholder disclosure.[369] Examples of more specific best practice recommendations include: pay-for-performance measures; stock ownership guidelines; mega-grants of stock options or restricted stock; repricing of options; performance vesting; holding periods; timing and dating stock options; and employment and change-in-control contracts.[370]

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364. Feddersen & Gilligan, *supra* note 7, at 150-51.

365. *See id.* at 168-69.

366. *See, e.g.*, ANNALISA BARRETT & PAULA TODD, NAT'L ASS'N OF CORPORATE DIRS., NACD BLUE RIBBON COMMISSION REPORT ON EXECUTIVE COMPENSATION AND THE ROLE OF THE COMPENSATION COMMITTEE (2003), http://www.directorsforum.org/resources/related_articles/NACD_BRC_Report.pdf [hereinafter NACD BLUE RIBBON COMMISSION REPORT]; TEACHERS INS. & ANNUITY ASS'N OF AM. HUMAN RES. COMM., EXECUTIVE COMPENSATION POLICY (2008), http://www.tiaa-cref.org/about/governance/docs/exec_comp_policy.pdf [hereinafter TIAA, EXECUTIVE COMPENSATION POLICY].

367. *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 CONN. L. REV. 915, 983 (2003) ("The gap between what Delaware law requires and what constitutes good corporate governance is enormous."); *see also* Brehm v. Eisner, 746 A.2d 244, 249 (Del. 2000) (distinguishing between falling short of best practices and legal culpability).

368. Cunningham, *supra* note 374, at 918.

369. *See* 2 CORPORATE GOVERNANCE: LAW AND PRACTICE, *supra* note 273, § 16.05.

370. *See id.*; *see also* COUNCIL ON FOREIGN RELATIONS, BUS. ROUNDTABLE, EXECUTIVE COMPENSATION: PRINCIPLES AND COMMENTARY (2007), http://www.businessroundtable.org/sites/default/files/ExecutiveCompensationPrinciples.pdf; CAL. PUB. EMPLOYEES' RET. SYS., CORE PRINCIPLES OF ACCOUNTABLE CORPORATE GOVERNANCE 12, 23-24 (2007), http://www.calpers-governance.org/principles/domestic/us/downloads/us-corpgov-principles.pdf; COUNCIL OF INSTITUTIONAL INVESTORS, THE COUNCIL OF INSTITUTIONAL

2. Credible Commitment and Brand Equity

Corporate constituencies must combine lawmaker claims of quality and impact with information about the credibility of such claims.[371] The degree of credible commitment among lawmakers varies. Similarly, the same degree of credible commitment is not available to all corporate constituencies. Credible commitment resembles what Darby and Karni termed "an informal service contract called the client relationship."[372] The "client relationship is an implicit understanding that the customer will return for future services so long as he does not detect fraud or low quality services."[373] In the corporate lawmaker context, credible commitment is an implicit understanding between lawmakers and one or more constituencies that the lawmaker will continue to respond to their constituent demands.[374] The lawmaker's need for or reliance on political capital instills confidence among powerful corporate constituencies.[375] Therefore, knowing the incentives of lawmakers reassures constituents despite their inability to discern impact.[376] In a more general sense, the Delaware and the federal corporate law regimes respectively resemble brands upon which corporate constituents make quality assessments.[377]

a. Delaware

Delaware's credible commitment to firms is substantial and its brand equity is strong.[378] "Delaware's ability to provide a unique branded customer experience explains its dominance and favor among large publicly traded firms."[379] "Delaware's investment in legal capital (i.e., judicial ex-

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INVESTORS CORPORATE GOVERNANCE POLICIES 9-10, 13-18 (2008), http://www.cii.org/policies (follow "Download the full Council Corporate Governance Policy (PDF)" hyperlink); GEN. ELEC. CO., THE MANAGEMENT DEVELOPMENT AND COMPENSATION COMMITTEE KEY PRACTICES (2008), http://www.ge.com/company/governance/board/mngment_dev_key_practices07.pdf; INSTITUTIONAL S'HOLDER SERVS., ISS US CORPORATE GOVERNANCE POLICY: 2007 UPDATES 17-21 (2006), http://www.riskmetrics.com/sites/default/files/2007_US_Policy_update.pdf; NACD BLUE RIBBON COMMISSION REPORT, *supra* note 373; NYSE Euronext, Listed Company Manual § 303A (2008), http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/listed/1182508124422.html&displayPage=/lcm/lcm_section.html (follow "Section 3 Corporate Responsibility" hyperlink; then follow "303A.00 Corporate Governance Standards" hyperlink; then follow "303A.09 Corporate Governance Guidelines" hyperlink); TIAA, EXECUTIVE COMPENSATION POLICY, *supra* note 373.

371. *See* Anderson, *supra* note 94, at 44.

372. Darby & Karni, *supra* note 25, at 80.

373. *Id.*

374. Simmons, *supra* note 159, at 1178-79.

375. *See id.* at 1187-89.

376. *See id.* at 1147.

377. *See id.* at 1150. Credible commitment is an intangible element of a brand. "[T]he purchase of a branded product as the purchase of two bundled products—a tangible product (i.e., physical product) and an intangible product (e.g., psychological associations and perceptions related to what the Delaware brand represents, which may not relate to tangible features."). *Id.* at 1145.

378. *See id.* at 1139-43, 1178.

379. *Id.* at 1146; *see also* Darby & Karni, *supra* note 25, at 82 ("It is a worthwhile convenience to be able to place greater credit in a salesman's promise that a particular product has desirable qualities."). With standardization there is a tendency to reflect the status quo

pertise, case law, a specialized bar, and a business-like Division of Corporations), and its reliance on franchise taxes [as well as the absence of pluralistic interest group activity] instills confidence among firms [, especially managers and shareholders,] that Delaware will continue to respond to their demands."[380] Even where Delaware law may not be optimal for manager or shareholder interests, corporate constituents will continue to choose Delaware for its credible commitment and brand.

b. The Federal Government

Compared to Delaware, the federal government's credible commitment is weaker and more amorphous. Meanwhile, the federal brand is less defined and perhaps holds greater sway with certain shareholder and non-shareholder constituencies.[381] Interest group activity at the federal level is more pluralistic, and, consequently, the degree of credible commitment from lawmakers to a single constituency is less likely.[382] Thus, the federal government's credible commitment and brand equity among managers is weaker than Delaware's. In theory, the federal government should be more sensitive to non-shareholder sentiment. This added sensitivity, however, does not necessarily translate into tangible stakeholder-leaning reforms. Ironically, there is both corporate manager and non-shareholder skepticism concerning federal corporate reform.[383] The federal brand of corporate law, particularly the SEC, has suffered a serious blow in the wake of the financial market collapse and the exposure of unprecedented fraud on the investor community.[384] Instead of fulfilling its mandate to protect investors, the SEC is currently perceived as a "toothless watchdog."[385] This lack of faith in the federal government to effectuate change and provide protection may in part explain why even non-shareholder constituencies are targeting companies in a more direct fashion to address social inequity via executive compensation reform instead of simply lobbying the government alone.[386]

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or familiarity. One may choose an item because others recommend it or choose McDonald's over a local family restaurant because of familiarity. *See* Darby & Karni, *supra* note 25, at 82.

380. Simmons, *supra* note 159, at 1178. "Delaware's investment in legal capital signals to corporations that Delaware will continue to provide experienced and skilled judges and lawyers to assist corporations." *Id.* at 1178-79 (defining and discussing the impact of credible commitment on Delaware's dominance in the corporate charter market); *see also* Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1760 (2006).

381. *See* Simmons, *supra* note 159, at 1165, 1188-89 (comparing Delaware and the federal government).

382. *See id.* at 1188.

383. *See* VOGEL, *supra* note 184, at 9-10.

384. *See* Editorial, *Stanford Caught Out – At Long Last*, FIN. TIMES (USA), Feb. 21, 2009, at 6; Joanna Chung & Andrew Ward, *Obama Signals Change with Choice of Schapiro*, FIN. TIMES (USA), Dec. 19, 2008, at 3.

385. *See Stanford Caught Out*, *supra* note 384, at 6.

386. *See* VOGEL, *supra* note 184, at 226-27.

3. *Procedures as a Default Heuristic for Legitimacy*

Procedures are at the heart of the legitimacy of U.S. corporate governance reforms and the executive compensation debate. Some public choice theorists contend that "[t]he basic desire to give voters [or constituents] more control of the mechanism is not [necessarily] based on any false idea of how well the voters are informed."[387] Instead, the issue is "simply that the voters are the only people in the whole process [even if ignorant] who do not have an element of systematic bias in their decision process."[388] This approach is too simplistic. From this perspective, even if the average layperson is misinformed regarding the executive compensation issue, they are still actively pursuing their own perceived well-being. This perspective further assumes that if a primary goal of lawmakers is to promote the well-being of citizens, lawmakers should allow greater say and influence from the common man. This increase in participation may contribute to greater inefficiency or indeterminacy in regulatory outcomes, but it is also "likely to make the government more in accord with the preferences of the common man; i.e. it brings us a little closer to the objective of popular rule which is supposed to be what democracy is about."[389] This perspective, however, does not adequately account for credence characteristics and lawmaker opportunism, and is therefore misplaced in the corporate reform context. Participation alone is not sufficient. Informed participation is necessary to hold lawmakers accountable.

Even assuming there are laws and institutional structures reflecting democratic accountability, a serious question lingers concerning corporate constituent information asymmetries. Lawmakers, in their own self interest, may exploit these information asymmetries without risk of detection. The public's demand for democratic procedures and the seemingly earnest lawmaker response may not solve the issue but could serve as subterfuge masking the actual problem. Failure to address such information asymmetries can have perverse consequences. The executive compensation issue is a model illustration of this effect. The tenor of executive pay reform efforts may appear to enhance participation and promote democratic norms, but such participation may have little impact on setting a particular executive's pay or realigning the power dynamics within the firm. Solving executive compensation problems is not simply a matter of constituent input; rather, it involves constituents, equipped with sufficient information, making the most of their participation.

Equipped with limited knowledge concerning the impact of a particular reform, corporate constituencies by default look to procedures as a proxy for quality. The legitimacy of corporate reforms is often viewed through

387. Tullock, *supra* note 2, at 1043.
388. *Id.*
389. *Id.*

a procedural lens as opposed to a substantive one.[390] There is simply too much disagreement concerning the shape of substantive reforms. And extensive substantive reforms may prove too risky for lawmakers. Not surprisingly, the majority of executive compensation reforms are procedural.[391]

Multiple constituencies can coalesce around procedures that, irrespective of their tangible impact, symbolize elements of fairness. Shareholder voting mechanisms, independent committees, and disclosure requirements all reflect democratic procedures that the various corporate constituencies are familiar with in the governmental context. Transplanting the same democratic features and rhetoric in the corporate context provides reassurance to corporate constituencies who have asymmetric information.[392] Democratic procedures are much easier to understand than markets and the plethora of executive compensation elements and reform measures that are constantly evolving. Whereas there are procedural mechanisms to hold governmental power accountable to the general populace, such accountability procedures are often absent in the corporate context, especially beyond the shareholder constituency. As the past two decades of executive compensation reform reveal, the presence of these procedural features, despite their reassurance, does not eliminate rising executive compensation levels or abuses. Nonetheless, democratic procedures, such as shareholder say-on-pay and a contest between corporate constituents, may signal public legitimacy, but not necessarily investor legitimacy.[393]

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390. *See* Cary Coglianese, *Legitimacy and Corporate Governance*, 32 DEL. J. CORP. L. 159, 161 (2007) (asserting that "corporate governance is akin to procedural legitimacy").

391. *Id.* at 162.

392. *See* discussion *supra* Part IV.D.1.b.

393. *See* BENZ, *supra* note 86, at 4. David Vogel describes the value of democratic procedures:

> Indeed, much of the effect of private political pressures on business has been procedural rather than substantive. One of the most visible of these procedural changes has been in the composition of some of the corporate boards of directors. True, the addition of these new members has not resulted in any substantive change in corporate policies, but they are nevertheless important symbols of management's recognition of the legitimacy of a broadened constituency.

VOGEL, *supra* note 184, at 12. One can marshal a plausible argument that the overemphasis on executive pay may shift director focus from more pressing business matters. Vogel further states: "The most fundamental contribution of citizen pressures has been to link the corporation more closely with the vitality and turbulence of the democratic process. Ultimately, cit[i]zen protests have less to do with increasing corporate accountability than with preserving and strengthening democratic participation." *Id.* at 227.

VI. CONCLUSION AND IMPLICATIONS

A. The Analysis of Credence Characteristics Provides a Novel Assessment of Political Effects on Executive Compensation Reform and Corporate Reform in the Broader Context

The analysis of credence characteristics in the executive compensation reform context has implications for Wall Street, K Street, and Main Street. At the political level, executive compensation reforms are inextricably tied to agency costs and public accountability. The credence characteristics analysis requires looking beyond laws on the books and managerial appropriation to consider lawmaker motivations and corporate constituent information asymmetries. Just like a reform's impact is difficult to decipher, lawmaker intent is difficult to discern. This situation inevitably leaves crude mechanisms upon which corporate constituents must rely to discern the quality of executive compensation reform. In a positive sense, these mechanisms have the potential to reduce information asymmetries, promote informed participation, constrain lawmaker discretion, supplement lawmaker expertise, and bolster the legitimacy of the corporate governance regime. The downside, however, is that such mechanisms are imprecise and may reflect a particular bias or distortion. The credence characteristics of executive compensation reform underscore the important roles that third-party opinions (for example, executive search firms, compensation consultants, academics, and institutional investors) and intangible mechanisms (for example, credible commitment, branding, and symbolic procedures) play in U.S. corporate governance as a check on lawmaker opportunism and, in some cases, lawmaker incompetence.

Lawmaker incentives are a key underpinning of the credence characteristic analysis. Therefore, it is necessary to make the distinction between lawmaker opportunism involving the concealment of information concerning reforms and lawmaker incompetence involving poor information quality. In either scenario, the corporate constituent faces similar risks and costs, but the potential resolution differs. The reduction of lawmaker opportunism may not necessarily require more government resources, "but only a [lawmaker] decision to stop."[394] The mere threat of losing political capital may constrain lawmaker opportunism, provided the decision-making heuristics available to corporate constituents are reliable. These mechanisms, however, merely minimize the risk of lawmaker opportunism rather than eradicate it. Meanwhile, increasing "the level of [lawmaker] competence or quality of information involves [the additional] investment of real resources."[395] Therefore, combating lawmaker deficits in expertise requires more than third party mechanisms exposing lawmaker incompetence. It may also require significant govern-

394. Darby & Karni, *supra* note 25, at 83.
395. *Id.*

ment (that is, supply-side) expenditures. As indicated above, the available decision-making mechanisms are often imprecise and may suffer from bias. Although these mechanisms highlight lawmaker opportunism and incompetence, they may neither adequately discipline lawmakers nor enhance government expertise.

The analysis of the credence characteristics of executive compensation reform is only part of a larger conversation that might sensitize researchers to the impact of credence characteristics and political effects on corporate reform in a broader sense. Instead of proffering an in-depth analysis regarding the substantive merits of existing executive pay reforms or a clear vision of the optimal shape of such reforms, the preceding analysis illustrates the impact of political behavior (that is, lawmaker opportunism) on executive pay reforms. Without accounting for political impact on the shape of corporate reform, corporate constituents as well as legal commentators are, in essence, taking a blue pill that may ultimately displace the prospect of optimal reform. Credence characteristics, in the broader corporate reform context, highlight the need to discipline lawmaker behavior, enhance lawmaker competence, and address the informational asymmetries of corporate constituents.

B. The Credence Characteristics of Corporate Reform Allow for Incremental and Moderate Change Even in the Face of Crisis

Credence characteristics in the executive compensation context provide lawmakers with greater latitude to maintain political capital without making significant change. In other words, credence characteristics allow lawmakers to straddle the fence between political symbolism and conscientious resolution.

A number of legal commentators have expressed concern over corporate lawmakers' "crisis-mode" regulation or "knee-jerk" reform responses during periods of economic turmoil.[396] This concern, although relevant, is overstated in the executive compensation context.[397] Even during periods of economic turmoil, corporate lawmakers have considerable discretion to respond in a moderate fashion due to the credence characteristics of corporate reform. Corporate constituents, particularly those with information asymmetries, usually will not discern the quality or impact of the reform until after the period of economic crisis has

396. *See* Romano, *supra* note 177, at 1528 (explaining SOX's shortcomings as a product of crisis-mode legislation); *see also* Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 Duke L.J. 1, 7–8 (2005) (asserting that the duty of good faith evolved in the "*sturm und drang* in corporate governance" after the public scandals of WorldCom, Enron, and Tyco brought into question the current American corporate governance model).

397. Cunningham, *supra* note 367, at 923-41 (asserting that major scandals at Enron, WorldCom, Global Crossing, Qwest, and (to an extent) Congressional deference and non-support for stricter SEC rules during the boom period of the 1990s, led to an environment where lawmakers felt, at the very least, that they must symbolically undertake some major legislative action in the business sector).

passed and constituent outrage wanes, only to reappear again with the next economic downturn or cycle. Accordingly, corporate lawmakers will exercise their added discretion to act in a moderate or conservative fashion. Thus, executive compensation reform will continue to evolve incrementally without substantial shifts, despite corporate scandals and economic turmoil. Massive reforms are too risky. Substantial lawmaker movements could cause broad constituent backlash, expose ineptitude, and make lawmakers blameworthy. In fact, many executive compensation reforms simply formalize best practices already adopted by a significant portion of the corporate community. There is always a gap between what the law requires and what constitutes a well run company.[398] Corporate lawmakers are reluctant to upset the internal power relationships between shareholders and management, and instead will either: (i) outsource reform to the vagaries of the market and third-parties; or (ii) regulate business activity indirectly or outside of the traditional corporate law context (for example, tax, antitrust, and labor laws). Best practice codes are an example of the former alternative. The latter alternative of indirect regulation is more likely to be populist in substance. These situational factors promote conservatism among corporate lawmakers, who wish to avoid corporate manager backlash and responsibility for failed reform efforts.[399]

C. Executive Pay Reform Operates as a Blue Pill—A Mechanism for Lawmaker Diversion and Responsibility-Shifting

Corporate lawmaker opportunism partially explains the prominence of executive pay compared to other, arguably more pressing, corporate law issues—ownership-related decisions involving mergers, takeovers, and even certain operational decisions, such as asset divestitures, product development, and raising capital.[400] At most, excessive executive pay, at the firm level, is merely a symptom of the greater agency cost problem. On average, executive pay for the top five executives at Fortune 500 companies in 2006 constituted 1.82 percent of profits.[401] For large companies, the actual impact of executive compensation is minimal.[402]

The overemphasis on executive compensation functions as a blue pill or diversion from other pertinent socio-economic issues, like the mini-

398. *See* E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004?*, 153 U. Pa. L. Rev. 1399, 1411, 1506 (2005).

399. Within this scenario, lawmakers arguably favor the highest denominator of constituents—corporate management and institutional shareholders who experience fewer information constraints and possess a greater ability to detect lawmaker opportunism.

400. *See* Rosen, *supra* note 171, at 2932 (discussing how House Bill 1257 potentially diverts attention from more pressing business issues).

401. *See* Loewenstein, *supra* note 58, at 11 (acknowledging arguments that executive compensation has a small impact on company profits).

402. Jerry Goldberg, *The Fortunate 2500 of the Fortune 500*, http://www.jgfortunate2500list.com/home.html (follow the "see the 2007 List" hyperlink) (last visited Aug. 17, 2008).

mum wage, health insurance, retirement accounts, education, and social security, that are more relevant to ordinary Americans.[403] This diversion of populist outrage has negative consequences for populist corporate constituencies. By singling out and seeking to limit pay for a few executives at the top of the wealth pyramid, lawmakers may divert pressure from improving the plight of those at the bottom via increasing the minimum wage or other redistributive policies and interventions. Despite the theoretical emphasis on limiting the costs of managerial appropriation and executive pay, slack in compensation practices extends beyond the CEO to employees throughout an organization and merits evaluation.[404] But this particular aspect of compensation reform has received less attention from legal commentators as well as politicians. A reason for the enhanced focus on executive pay versus the pay of other employees is that executive pay involves greater potential for self-dealing.

Another interesting question is whether corporate managers should be overly concerned about the emphasis on executive pay. Perhaps not. Certainly no director or CEO enjoys public embarrassment like the shaming Michael Eisner received before the Delaware courts.[405] However, the political salience of executive pay may also divert populist outrage and, to a degree, shareholder attention away from other corporate governance issues that are more problematic for managers (for example, altering internal power relationships or the balance between state and federal law). As illustrated above, executive compensation reform is often moderate and will not upset the internal affairs of the corporation nor displace business judgment. Therefore, managers should not be overly distressed about the focus on executive pay because it averts more substantial intrusions that upset existing power relationships.[406]

D. The Positive Side of Politics?: Averting Future Backlash and Inefficiency

Notwithstanding the costs of lawmaker opportunism, there are potential positive benefits associated with incorporating political effects into the discussion of executive compensation reform and, in broader terms, corporate governance reform. Politics has the ability to disrupt markets, but it also has the power to mediate economic turmoil. In order to avert a greater backlash generated by economic shocks, "inefficient legal structures may arise and survive, despite the fact that they could not withstand a normal efficiency critique."[407] Strategic inefficiency may, on balance,

403. *See* The Matrix, *supra* note 1.

404. *See generally* Rosen, *supra* note 171 (discussing the exclusion of high-salaried employees from executive compensation reform).

405. *See In re* The Walt Disney Co. Derivative Litig., 907 A.2d 693, 760-63 (Del. Ch. 2005).

406. *See* Roe, *supra* note 190, at 217; *see also* discussion *infra* Part IV.C.2. Advisory say-on-pay votes are perhaps an example.

407. *See* Roe, *supra* note 190, at 217 ("The prospect of backlash—or of strategically tempering otherwise efficient rules and institutions to finesse away a more destructive backlash—complicates a law and economics inquiry.").

be a net positive.[408] Thus, in order to prevent greater future inefficiency, lawmakers may create moderately inefficient rules, for example, executive compensation reforms.[409] The political value of strategic inefficiency is not diminished by the fact that one cannot measure with any degree of precision the amount of political backlash averted or the necessary amount of political accommodation.[410] Whereas the general tendency is to ascribe negative value to interest group dynamics and politics, the interaction of inefficiency with backlash may reflect a brighter side.[411] Lawmaker pursuit of self-interest may actually benefit shareholder and non-shareholder constituencies alike.[412]

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408. Mark Roe discusses the operation of strategic inefficiency in the face of backlash:

> The dampening rules may enhance a system's adaptivity and stability, preserving the core efficiency tendencies of capitalism, private property, and competitive markets, by conceding a few economically unwise but politically astute regulations here and there. One could believe a set of legal institutions to be inefficient one by one—antitakeover rules, slow chapter 11 reorganizations, Glass-Steagall, old-style antitrust, and a list to which we could all add—and still one cannot conclude that the whole set is inefficient, because the inefficient fringe may preserve that efficient core of private property, mobility, and competition. Hence we see the difficulty for law and economics scholarship, even today in the United States, and even without the alien and improbable risk of fundamental revolutionary political turmoil.

Id. at 237-38.

409. *Id.* at 239 ("To create the public good of political tranquility, a system may sometimes choose technically suboptimal production. . . .").

410. *See id.* at 240.

411. *See id.* at 240-41.

412. *See id.* at 238 n.40 (expressing doubt over whether executive compensation fits this pattern because excessive CEO pay might simply be an agency cost, not a necessary feature to firm productivity). The Obama administration's recent executive pay rhetoric and reforms can be viewed as an attempt to minimize public outrage and generate broader support for the unprecedented $787 billion dollar economic stimulus package. *See Bank Bonuses: Sound and Fury*, THE ECONOMIST, Feb. 14, 2009, at 14.