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The Risks of Reward: The Role of Executive Compensation in Financial Crisis

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THE RISKS OF REWARD: THE ROLE OF EXECUTIVE COMPENSATION IN FINANCIAL CRISIS

Erica Beecher-Monas[†]

ABSTRACT	102
I. ONGOING FINANCIAL CRISIS	103
A. Stagnant Wages and Sky-rocketing Executive Compensation	103
B. The Theories of Pay for Performance and Optimal Contracting	106
C. The Role of Stock Options in Skyrocketing Pay	109
II. WHAT'S AT STAKE: THE RISKS OF UNBRIDLED REWARD	110
A. Firm Risk	111
B. Systemic Risk	115
III. SETTING EXECUTIVE COMPENSATION	117
A. Board Role	117
1. <i>Board Composition</i>	118
2. <i>Compensation Committees</i>	120
3. <i>Compensation Advisors</i>	122

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B. Board Dynamics.....	123
1. <i>Polarization</i>	124
2. <i>Relational Groups</i>	128
3. <i>Herding</i>	129
IV. EFFORTS AT REFORM	129
A. Sarbanes-Oxley.....	129
B. Say on Pay	130
C. Disclosure.....	131
D. Restricted Stock.....	133
E. Dodd-Frank Wall Street Reform and Consumer Protection Act	134
V. WHAT’S TO BE DONE?	135
A. Deferred Compensation	137
B. Tax Reform.....	138
C. Get Serious About the Business Judgment Rule	140
VI. CONCLUSION.....	143

ABSTRACT

This Article examines the role of unbridled executive pay in exacerbating what Keynes called the “animal spirits” of the market. It analyzes the ways in which theoretical bases of executive pay structures diverge from reality, and the stakes for the firm and society in skyrocketing pay practices unlinked to performance. Various regulatory efforts, including the executive pay provisions of the Dodd-Frank Act, are intended to better align pay with performance. This article discusses these provisions and analyzes them in light of behavioral economics. Curbing executive pay is vital to controlling risk and preventing economic collapse, but the dynamics of group behavior make solutions to the problem complex. This article acknowledges the complexity of interconnected financial systems, and concludes that the solution lies in a combination of removing perverse incentives in the tax system, encouraging the use of deferred compensation, and legal reform, together with increased vigilance on the part of regulators regarding the interconnectedness of our economy.

I. ONGOING FINANCIAL CRISIS

A. Stagnant Wages and Sky-rocketing Executive Compensation

AMERICAN workers' wages have been stagnant for decades. Over the same time period, executive pay in large, publicly held corporations has skyrocketed. Executive compensation in the United States has now reached well over 500 times that of hourly workers.¹ Excessive pay levels can affect not only shareholder wealth, by decreasing dividends and reducing earnings per share, it can also affect profitability by decreasing employee morale.² This huge disparity in pay levels between top executives and labor is not replicated in other industrialized nations; executive pay in Germany, for example, averages only eleven times that of workers'.³ It is not the disparity in pay alone that is so disturbing—movie stars and athletes also garner huge paychecks—but the disconnect between firm performance and executive pay.⁴ During the financial crisis, many of the firms with highly compensated executives were not only failing to perform, but were also either the recipients of taxpayer bailout funds from the Troubled Asset Relief Program (“TARP”) or the indirect beneficiaries of the bailout. Thus, the same wage-earners whose incomes had been stagnant for decades were called upon to rescue the profligate management of the “too-big-to-fail firms” that received their tax dollars. Somehow that seems, at the very least, unfair.

It also seems remarkably short-sighted. As Michael Lewis's thoughtful and entertaining book about the financial crisis *The Big Short* makes clear, this

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1. See, e.g., *CEOs and their Indian Rope Trip*, *ECONOMIST*, Dec. 11, 2004, at 61 (estimating the pay differential between CEOs and workers to be a factor of 500 in 2003); Carola Frydman & Raven Saks, *Executive Compensation: A New View From a Long-Term Perspective, 1936–2005*, FED. RES. BD. TECH. REP. NO. 2007-35 (2007), available at <http://federalreserve.gov/pubs/feds/2007/200735/200735abs.html> (growth of CEO pay relative to worker pay increased from 30:1 in 1970 to 120:1 by 2000).
 2. Omari S. Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 S.M.U. L. REV. 299, 335 (2009).
 3. Trevor Buck & Azura Shahrin, *The Translation of Corporate Governance Changes Across Cultures: The Case of Germany*, 36 J. INT'L BUS. STUD. 42, 48 (2005). There are signs, however, that with the large multinationals, EU firms may be heading in the U.S. direction. See, e.g., L. Reed Walton, *U.K. Pay Plans Criticized*, *RISKMETRICS* (Apr. 28, 2008, 11:47 AM), <http://blog.riskmetrics.com/2008/04/001159print.html> (noting opposition to executive pay practices at BP, GlaxoSmithKline and HSBC).
 4. See, e.g., Eric Dash, *Federal Report Faults Banks on Huge Bonuses*, *N.Y. TIMES*, July 23, 2010 (noting that “the federal authority on banker pay says that nearly 80% [of bonus pay doled out in 2008] was unmerited”).

imbalance has consequences.⁵ Among these consequences are a decreasing middle class and an increasing divide between rich and poor.⁶ Unable to maintain their standard of living (or pay for their homes, cars, and health care), and encouraged by easily obtained loans, Americans went into massive amounts of debt in the first decade of the twenty-first century, aided and abetted by policies—governmental and private—enabling such massive borrowing and engendering the subprime mortgage crisis from which we have yet to emerge.

Neither the financial crisis nor the government bailout halted the enormous executive pay packages. The departures of Stanley O'Neal from Merrill Lynch and Charles Prince from Citigroup with munificent separation packages (including the vesting of equity grants) are more emblematic of pay for failure than of pay for performance.⁷ After recognizing that its CEO, Kenneth Lewis, missed performance goals in 2007, Bank of America cut his bonus to \$8.5 million from the target bonus of \$18.5 million.⁸ That hardly seems like pay for performance. At Morgan Stanley, the CEO did not get a bonus, but the firm's overall compensation and benefits expenses rose 18% in 2007 despite a 6% decrease in revenue.⁹ On the eve of its government-sponsored (and funded) takeover by Bank of America, Merrill Lynch's board awarded \$3.6 billion in incentive bonuses.¹⁰ Citi paid \$5.33 billion in bonuses in 2008, despite losing \$27.7 billion and receiving \$45 billion in the bailout.¹¹ Bank of America, recipient of \$45 billion from TARP, paid out \$3.3 billion in bonuses.¹² These examples are merely the most salient of a widespread

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5. MICHAEL LEWIS, *THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE* (2010).
 6. See, e.g., JEFFREY D. SACHS, *COMMON WEALTH: ECONOMICS FOR A CROWDED PLANET* 261–262 (2008) (presenting demographic data on the divide between rich and poor).
 7. Despite the tanking of their firms, Price left Citigroup with about \$29.5 million, and O'Neal (whose departure from Merrill was deemed retirement) left with \$36.8 million in immediately vesting options, \$25 million in retirement benefits, and \$5 million in deferred compensation. Bimal Patel, *Credit Crisis and Corporate Governance Implications: Guidance for Proxy Season and Insight into Best Practices*, RISKMETRICS (Apr. 2008), <http://www.riskmetrics.com/system/files/private/CreditCrisisCorporateGovernance20080408.pdf>.
 8. Peter Edmonston, *Major Bank Cuts Bonuses of Executives*, N.Y. TIMES, Mar. 20, 2008, at C2. This figure does not include his \$1.5 million base salary, or \$3 million in options awards. *Id.*
 9. *Morgan Board Loses Support*, N.Y. TIMES, Apr. 5, 2008, at C8.
 10. *Judge Rejects Settlement Over Merrill Bonuses*, N.Y. TIMES DEALBOOK (Sept. 14, 2009, 12:33 PM), <http://dealbook.nytimes.com/2009/09/14/judge-rejects-settlement-over-merrill-bonuses>.
 11. Editorial, *Troubled Banks, Huge Bonuses*, N.Y. TIMES, Aug. 3, 2009, at A20.
 12. *Id.*

phenomenon: when a firm does well, its executives are rewarded handsomely; when the firm does poorly, the executives still make out very well.

The threat of financial regulation at last appears to have gotten the attention of corporate boards. In the past year, many firms, especially those that received government bailout funds, have cut executive pay. They were undoubtedly responding to interim TARP rules mandating a \$500,000 salary cap on the largest TARP recipients (with additional pay in long-term restricted stock),¹³ as well as to public outcry and political pressure. They may also have been responding to the Securities and Exchange Commission's increased disclosure requirements relating to executive compensation,¹⁴ and the new Dodd-Frank Wall Street Reform and Consumer Protection Act's ("Dodd-Frank") provisions requiring public corporations to give their shareholders a "say-on-pay" in the form of nonbinding recommendations to the board.¹⁵

The result has been somewhat mixed and it is too early to say whether the trend will continue. A survey of 200 top executives in large corporations revealed that the median CEO pay package declined by 13% to \$7.7 million in 2010, and the average pay decreased by 15% to \$9.5 million.¹⁶ This sent pay levels back to their 2004 levels, according to the study.¹⁷ The 2004 levels, however, were (and are) still wildly disproportionate to what hourly workers were making.

Moreover, this trend may be short-lived. Unless regulators are willing to give teeth to their pronouncements, these reductions in executive pay may become merely a temporary sop to public opinion. What is at stake is not just the survival of and well-being of individual firms, but, with increasingly large, interconnected firms, the health of the economy. This Article sets out the problem of systemic risk, and the danger posed by failing to link pay to performance in large corporations, especially those deemed "too big to fail."

13. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 111(b)(2), 122 Stat. 3765, 3776-77 (to be codified at 12 U.S.C. § 5221) (setting standards for executive compensation and corporate governance for firms that sell troubled assets to the government under the Act). *See also* Devin Leonard, *Executive Pay: A Special Report – Bargain Rates for a C.E.O.*, N.Y. TIMES, Apr. 3, 2010, at B1.

14. *See infra* notes 153-165 and accompanying text.

15. *See infra* notes 148-150 and accompanying text.

16. Leonard, *supra* note 13, at B7 (describing a study conducted by Equilar, a compensation research firm, of corporations with revenue of at least \$5.78 billion that had filed their proxy statements by March 26, 2010).

17. *Id.*

Part I examines the theoretical basis of executive pay structures, and discusses the ways in which theory and reality diverge. It then examines the stakes for the firm and society in skyrocketing pay practices unlinked to performance in Part II. Part III discusses board dynamics in the context of setting executive pay. Various regulatory efforts intended to better align pay with performance, including the executive pay provisions of the Dodd-Frank, are outlined in Part IV. Part V proposes and analyzes the most promising solutions to the problem. In Part VI, the Article concludes that curbing executive pay is vital to controlling risk and preventing economic collapse, but solutions to the problem are complex, and suggests a combination of removing perverse incentives in the tax system, encouraging the use of deferred compensation, and legal reform, together with increased vigilance on the part of regulators regarding the interconnectedness of our economy.

B. The Theories of Pay for Performance and Optimal Contracting

Two primary justifications are given by corporate boards for awarding huge executive pay packages. The first is that CEOs are being paid for performance, and that their pay packages act as an incentive to increase shareholder wealth.¹⁸ Linking pay to performance is a way to motivate executives to take risks that they might otherwise be inclined to avoid.¹⁹ Incentive pay is also believed to be essential to keep employees with significant discretion from shirking.²⁰

The second justification for the high rate of executive pay is that CEOs are worth it: they must be highly paid in order to attract and retain their talent.²¹ Stephen Bainbridge, for example, notes that film and athletic stars

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18. See Eduardo Porter, *More than Ever, It Pays to be the Top Executive*, N.Y. TIMES, May 25, 2007, at A1 (noting the claim that giving the top executive stock options links pay to performance and comparing the CEO to an entertainment superstar). See also John E. Core & Wayne R. Guay, *Is There a Case for Regulating Executive Pay in the Financial Services Industry?* 3–4 (Jan. 25, 2010) (working paper), available at <http://ssrn.com/abstract=1544104> (arguing that incentive pay is greater for U.S. CEOs than for those in any other country).
 19. The problem that managers would not take the risks necessary to improve shareholder value has been addressed as the problem of agency costs. 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, 312–30 (1976).
 20. See William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1557 (1982) (noting that “efficiency . . . requires managerial specialization and discretion, thereby creating opportunities for shirking”).
 21. See, e.g., Core & Guay, *supra* note 18, at 4 (noting that CEO pay at large firms has grown in tandem with the size and value of the firms).

are highly paid, but no one suggests that their pay should be regulated.²² Like these stars, there are few people in the employment pool qualified for CEO stardom.²³ According to this view, then, CEOs' outside pay packages are a function of their rare talent.

The argument that CEOs are being paid for their talent assumes an active market for corporate talent. This premise is questionable at best. CEOs are either promoted from (and retained) within the firm, or they are hired from the outside. Internal hiring is the predominant method.²⁴ When firms do turn to outsiders, it is generally in a crisis.²⁵ Promotions from within are likely to be the result of the incumbent CEO's choice, and present the problem of managerial influence over CEO pay. Hiring from outside under pressure to hire a charismatic CEO to turn the company around presents the problem of the board acting under insufficient information and with insufficient time, placing far too much emphasis on charisma rather than results.²⁶ Neither situation has the characteristics of an efficient market.

Both arguments—that CEOs are being paid for performance and that they are being paid for their talent—depend on the premise that boards actively negotiate with managers in the shareholders' interests, paying enough to attract talent and induce the CEO to remain with the firm, but avoiding

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22. Stephan M. Bainbridge, *Remarks on Say on Pay: An Unjustified Incurion on Director Authority* 1–2 (UCLA Sch. of Law, Law & Econ. Res. Paper Series, Paper No. 08-06, 2008), available at <http://ssrn.com/abstract=1101688>.
 23. See, e.g., David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587, 608 (2005) (observing that “[t]he number of candidates that a Fortune 500 firm would consider would be few”).
 24. Scott Thurm, *Directors Now Prefer Insiders in Search for CEOs*, WALL ST. J., May 2, 2007, at A2 (discussing study showing that in 2005 only 40% of CEOs hired by S&P 500 firms were outsiders, and that this dropped to 15% in 2006).
 25. See Charles M. Yablon, *Review Essay: Is the Market for CEOs Rational?*, 4 N.Y.U. J. L. & BUS. 89, 114 (2007) (noting that “the events precipitating the need for a new CEO are likely to have been traumatic . . . and [to have resulted in] a felt need to reassure shareholders and the investing public by placing a new confidence-inspiring CEO in place relatively quickly”).
 26. See RAKESH KHURANA, *SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOs* 188–90 (2002) (discussing the process of CEO hiring in which irrational choices for CEO are predicated on too little information, too early of a focus on a single candidate, and too great an emphasis on CEO charisma, giving the chosen candidate a huge amount of bargaining power). Outside candidates generally obtain higher compensation than internal candidates, perhaps because of the crisis context. See also Kevin Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 852–54 (2002) (arguing that data showing that outsiders command higher pay than insiders infers that board capture is fallacious).

inefficient terms and linking pay to performance to reduce agency costs.²⁷ With respect to an internal candidate, there may be unequal bargaining power because of the candidate's relationship with the incumbent CEO (who will have groomed and promoted the candidate, and therefore has a stake in seeing that the candidate is perceived—and paid—well). In the case of an external candidate, there may be unequal bargaining power because of the crisis precipitating the hiring. Once the initial pay package has been set, it is unlikely to decrease, since any decrease would be seen as a vote of no confidence, spurring CEO departure, and precipitating a new crisis.

Moreover, as behavioral studies of group interactions predict,²⁸ and as Bebchuk and Fried posited in their seminal work, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*,²⁹ the premise of arms-length bargaining is often illusory. All too frequently, CEOs have received substantial pay even when their firms were floundering. The comparison with athlete and film star pay is similarly inapt, since their pay packages are far more transparent than CEOs', and contain none of the hidden pay common in executive pay packages, such as post-retirement perks, deferred compensation arrangements, and retirement bonuses.³⁰

Finally, there is the question of what performance is being measured, and how well that relates to the overall well-being of the firm. The measure of performance is, in practice, defined almost entirely in terms of short-term (usually quarterly) stock price gains. Short-term incentives played an even larger role in setting executive compensation in the 2009 proxy season than they had previously.³¹ Long-term programs actually were reduced.³² This suggests that executive pay packages may distort firm policies and destroy firm value over the long term.

A singular focus on short-term stock price gains as the criterion for performance overlooks the importance of long-term investments in the firm, especially investment in labor. The inequalities in pay between the CEO and other workers (including middle managers) may decrease firm value by demoralizing the workforce and undercutting teamwork.³³ In addition, if

27. LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 2–3 (2004).

28. *See infra* Part III.B.

29. *Id.* at 3–4.

30. *Id.* at 5–6.

31. Gretchen Morgenson, *The Quick Buck Just Got Quicker*, N.Y. TIMES, Aug. 16, 2009, at BU1.

32. *Id.*

33. Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 712 (2005) (noting that “studies show that pay inequality can demoralize workforces and undercut collegiality and teamwork”).

workers do not make sufficient wages to buy the widgets produced by society's firms, the firms will suffer.³⁴ The deep economic crises of capitalism stem from insufficient demand for the goods the system could produce.³⁵

C. The Role of Stock Options in Skyrocketing Pay

Protests about the disconnect between executive pay and performance are not new. Responding to public outcry in 1993, Congress enacted Section 162(m) of the tax code, limiting corporate tax deductions for employee compensation to \$1 million in publicly owned corporations, unless the pay was linked to performance of the executive and the corporation.³⁶ This had two unintended side effects, both of which increased executive pay levels. First, as a practical matter, the \$1 million deductibility limit became the floor for executive pay.³⁷ Second, section 162(m) caused a sea-change in the use of conventional stock options in pay packages.³⁸

Congress made a blanket exception to the million dollar deductibility cap for stock options in section 162(m).³⁹ As a result, awarding a large percentage of compensation in stock options became the most common way for firms to make the link between pay and performance.⁴⁰ Although there has been some retrenchment on the usage of stock option grants—they have declined

34. See, e.g., DAVID SCHWEICKART, *AFTER CAPITALISM* 42 (2009) (explaining Keynes's theory that "the key to a healthy capitalist economy is effective demand").

35. *Id.*

36. I.R.C. § 162(m) (2006). See Meredith R. Conway, *Money for Nothing and the Stocks for Free: Taxing Executive Compensation*, 17 CORNELL J.L. & PUB. POL'Y 383, 397 (2008) (discussing the history of tax proposals designed to rein in executive pay).

37. See Ryan Miske, Note, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1675 (2004); Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 918 (2007) (citing studies showing that "unaffected firms also increased executive compensation").

38. Stock option grants in the U.S. went from 27% of CEO compensation in 1992 to over 60% by 2000. CONF. BD. COMM'N ON PUB. TRUST & PRIVATE ENTER., FINDINGS AND RECOMMENDATIONS, PART I: EXECUTIVE COMPENSATION 4 (2002), available at http://www.conference-board.org/pdf_free/SR-03-04.pdf.

39. Qualified compensation—remuneration paid pursuant to a plan that is based on objective performance goals, approved by an independent compensation committee and the shareholders—is not subject to the deductibility cap. I.R.C. § 162(m)(4)(C).

40. Conventional stock options—fixed, at the money options, exempted from the § 162(m) cap—are issued with a strike price at or above the fair market value on the date of the grant. Treas. Reg. § 1.162-27(e)(2)(vi)(A) (1996) (providing that in order to qualify under § 162(m), the compensation attributable to a stock option or stock appreciation right must be based solely on an increase in the value of the stock after the date of the grant).

from 98% usage among the 250 largest U.S. corporations in 1999 to 77% usage in 2009—stock options are still the most common form of incentive.⁴¹

Stock options are meant to align the interests of management with that of shareholders. Executives will only exercise the options if the market price of the stock when vested exceeds the exercise price; as a result, managers have an incentive to maximize shareholder value. But the fly in the ointment is that executives benefit whenever there is a rising market, not necessarily from their own efforts. Moreover, the ability of managers to choose the timing of their stock sales and sell large amounts of stock over a short period may encourage managers to attempt to manipulate the stock price before selling.⁴² In addition, adjusting pay downward for poor performance is a rare phenomenon.⁴³ In any event, a recent study concluded that there is little evidence that section 162(m) made executive pay any more performance-sensitive.⁴⁴

II. WHAT'S AT STAKE: THE RISKS OF UNBRIDLED REWARD

Executive pay is a complex issue because of the many incentives that are involved. Most obviously, firms seek to attract and retain talented leaders. To do this they need to pay a market rate, which they need to be able to ascertain. Firms also seek to reward CEOs for past performance and give them incentives to improve the firm's prospects (or increase shareholder value, as it is usually described). At the same time, betting the firm on risky endeavors is generally discouraged.

Each of these concepts is fraught with troubling definitional and operational problems. Ascertaining the market rate for executives of large

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41. FREDERICK W. COOK & CO., THE 2009 TOP 250 REPORT: LONG-TERM INCENTIVE GRANT PRACTICES FOR EXECUTIVES 5 (2009), available at http://www.fwcook.com/alert_letters/2009_Top-250-Report.pdf.
 42. See Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 455 (2008) (contending that existing legal rules and compensation arrangements do little to solve the problem of managerial incentives to manipulate stock prices and suggesting that boards adopt a policy of announcing a fixed gradual schedule for cashing out executive options, removing executives' control over the timing of equity sales).
 43. See, e.g., *In re Viacom, Inc. S'holder Derivative Litig.* No. 60527/05, 2006 N.Y. Misc. LEXIS 2891, at *24 (N.Y. Sup. Ct. June 23, 2006) (noting the rarity of downward adjustments in declining to dismiss shareholder claims that directors breached their fiduciary duty in approving \$160 million in compensation to three executives at a time when the company faced a \$17.5 billion loss).
 44. See Nancy L. Rose & Catherine Wolfram, *Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation*, 20 J. LAB. ECON. S138, S141 (2002) (discussing the effect of § 162(m) on CEO performance).

corporations is far from easy, especially since the disciplining market for corporate control has been virtually dismantled by anti-takeover legislation and court approval of defensive measures.⁴⁵ Paying for performance is also complicated by questions of how to define and measure performance, as well as the time over which performance is to be measured. What performance? Performance when?

In the period leading up to the financial crisis, both tax and accounting rules favored pay packages for executives that consisted primarily of immediately exercisable at-the-money options, taxable when exercised rather than when they were issued.⁴⁶ Compensation packages thus explicitly began to focus on stock prices.⁴⁷ This focus on short-term stock price as the criterion for performance gave rise to an increased temptation to manipulate earnings. It also discouraged investments in research and development, which typically take years to pay off.

Finally, there is the notion of risk. On the one hand, boards seek to incentivize CEOs to undertake risk so that shareholders will prosper. On the other hand, undertaking too much risk may sink the firm, a result that boards and shareholders certainly will want to avoid. When firms are intertwined (as the notion of “too big to fail” implies), too much risk taking may sink not only the firm, but the whole economy. Regulation is needed to ensure that these large intertwined firms internalize the costs of their actions.⁴⁸

A. Firm Risk

Originally conceived as a way to align managerial interests with those of their shareholders, paying executives with stock options may have the unintended consequence of pushing CEOs to undertake risks beyond what is optimal for their common shareholders. Empirically, CEOs are less prone to

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45. See REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW* 163–89 (2004) (contrasting the U.S., which gives the board broad authority to determine whether an offer will reach the shareholders, with the U.K., which limits managers ability to interfere with a takeover offer). The cyclical nature of the takeover market is also a factor, influenced by high costs and the availability of credit. See Walker, *supra* note 23, at 608–10 (discussing the cyclical nature of the takeover market).
 46. Jeffrey N. Gordon, *The Rise of Independent Directors in the U.S., 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 *STAN. L. REV.* 1465, 1530 (2007).
 47. *Id.* at 1532 (noting that “stock prices had become the bellweather performance measure”).
 48. See KENNETH R. FRENCH ET AL., *THE SQUAM LAKE REPORT: FIXING THE FINANCIAL SYSTEM* 80–81 (2010) (explaining that the possibility of bailouts means that stakeholders do not face the full cost of their failure, increasing the potential for systemic risk, and requiring capital market reform).

engage in risky transactions when their pay is unlinked to share performance.⁴⁹ Some risk is a good thing: if the executive does nothing risky, the firm is unlikely to prosper. Thus, by paying executives in stock or stock options, boards hope to make executives more willing to undertake value-enhancing transactions.⁵⁰ But option pay pushes beyond this, encouraging riskier transactions than shareholders would wish because the executive does not share in the downside risk from decreasing stock prices that shareholders face. (If the options are out of the money when exercisable, the executive will simply let them expire.) This means that CEOs paid in options will be more risk-preferring than their shareholders.⁵¹

An executive's in-the-money options (those with a market value strike price) will only pay off if the market value increases, otherwise they will be worthless. In considering a risky strategy that has even chances of increasing or decreasing asset value, the executive thus has the incentive to engage in the risky strategy, because only if the risky strategy succeeds will the options be worth anything.⁵² Failure to take the risk—even if the odds are uncertain—will only mean that the options expire worthless. Thus, there is little incentive not to take the risk.⁵³

The option holder is thereby insulated from the downside risk that shareholders experience.⁵⁴ As a result, executives may be willing to engage in strategies that increase the short-term value of the stock price regardless of the long-term results. In the current financial crisis, lax lending practices and over-exposure to derivatives appear to have been the risks of choice, but prior crises where the risky conduct was earnings manipulation (e.g., the

49. See, e.g., Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 262 (2010) (citing studies involving bank CEOs).

50. See Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q. J. ECON. 653, 653–56 (1998) (contending that the shift to equity-based compensation from 1980–99 correlated to executives' increased willingness to engage in internal restructuring, acquisitions, and other value enhancing transactions).

51. Bebchuk & Spamann, *supra* note 49, at 263 (observing that the “holder of an option only cares about share price fluctuations above the strike price”).

52. *Id.* at 272 (providing the example of Bank of America, whose options—because its share price had dropped significantly during the financial crisis—were far out of the money favored very aggressive risk taking because “only very large stock price gains will yield a positive payoff . . . [and] small gains would not be able to pull up the stock price above the exercise price”).

53. While option pay unquestionably incentivizes short-term, risky behavior, there are still some incentives not to take undue risks, such as the prospect of executive job loss if the risk does not pan out. These risks, however, are minimized in light of the high pay levels (giving executives a measure of independence from salary) and the common existence of golden parachutes.

54. *Id.* at 264.

Enron and WorldCom debacles) also appear to have such short-term myopia at their core.⁵⁵

In sum, while shareholders would certainly encourage risk taking that, if successful, would drive up the price of their shares, this preference is constrained by the specter of downside losses. Option holders have no such constraints. They have little to lose (human capital and reputation count for something, but pale beside the prospect of upside gains) and everything to gain from the upside.

This means that for option holders like the CEO, if a risky strategy succeeds, she will benefit; if it fails (and the firm survives), very little happens to the executive's pay. Although directors acting on behalf of the shareholders ought to resist such managerial risk-taking, boards instead appear to consistently approve these actions.⁵⁶ While one might expect that publicizing this pay for failure would shame CEOs and the boards responsible for their pay packages into acting with more restraint, this has not been the case. During the financial crisis, firms simultaneously received taxpayer bailout money, paid huge executive compensation, and laid off workers.⁵⁷ Even the prospect of extraordinarily bad press did not deter these boards from approving large pay packages.

When CEO pay packages depend on short-term profits, the CEOs will understandably undertake risks to ensure that these short-term profits are realized.⁵⁸ If performance is being measured by scrutinizing quarterly earnings reports, the result will be excessive pressure to make those numbers

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55. See David I. Walker, *The Challenge of Improving the Long-Term Focus of Executive Pay*, 51 B.C. L. REV. 435, 439 (2010) (discussing the "reckless pursuit of short-term profits by corporate executives who will have cashed out before the long-term repercussions are felt").
56. Ivan E. Brick et al., *CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?*, 12 J. CORP. FIN. 403, 421 (2006).
57. Sarah Anderson et. al, *Executive Excess 2009: America's Bailout Barons*, INSTITUTE FOR POLICY STUDIES (Sept. 2, 2009), <http://www.ips-dc.org/files/439/EE09final.pdf> (noting that in 2008, while the CEOs of the top 20 firms receiving treasury funds averaged \$13.7M in personal compensation, the same top 20 bailout recipients laid off more than 160,000 employees).
58. See D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation*, 81 TUL. L. REV. 829, 857-58 (2007) (noting the divergence of interests between management, whose pay depends on hitting short-term performance objectives, and shareholders who may value a long-term accumulation of value in corporations). There may also be a conflict between short-term shareholders and buy-and-hold shareholders.

look good.⁵⁹ This provides incentives to pursue short-term gain at the expense of long-term benefits.

A short-term pay period focus means that the long-term consequences of risk-taking are often overlooked. For example, in a recent survey of 400 U.S. CFOs, 55% indicated that they would delay investments in order to meet quarterly earnings expectations, even at the expense of long-term value creation.⁶⁰ The claw-back provisions to performance-based executive pay, written into Sarbanes-Oxley Act in response to the previous financial crisis involving Enron and WorldCom (among others),⁶¹ should have warned compensation committees and executives about the dangers of a short-term perspective, but short-term practices appear to have continued unabated.⁶²

Moreover, this short-term focus on the part of executives and their boards of directors means that there is strong temptation to compensate for stock gains without taking even firm-wide risk adequately into account. It may take some time before the deleterious effects of failure to invest in research and development, for example, are felt in the corporation. By the time the corporation actually sees the effects in its bottom line, the research department may have been long dismantled. The pressure on executives to meet the quarterly earnings forecasts also contributes to this problem. If structured financing ventures are prevalent, for example, even if the CEO and the board have substantial doubts about the practice, CEOs have incentives to “ride a bubble until [just before] it bursts”⁶³—continuing to engage in risky structured financing transactions even if they have doubts about the soundness of the strategy—because otherwise they risk losing out on substantial short-term profits. The higher the compensation, and the more closely it is tied to the price of the firm’s stock, the greater the incentive to ride that bubble. And if the CEO fails to jump off in time, he always has his golden parachute.

As a result of this short-term focus on pay period rather than long-term results, and the heavy use of stock options in paying executives, the upside

59. See BEBCHUK & FRIED, *supra* note 27, at 125–26 (noting that executive contracts which now routinely reward CEOs for reporting increased earnings create incentives to inflate the numbers).

60. Simon C.Y. Wong, *Uses and Limits of Conventional Corporate Governance Instruments: Analysis and Guidance for Reform – Part One*, GLOBAL CORP. GOVERNANCE FORUM, Issue 14, at 7 (2010).

61. See *infra* notes 143–147.

62. See, e.g., ASPEN INSTITUTE, LONG TERM VALUE CREATION: GUIDING PRINCIPLES FOR CORPORATIONS AND INVESTORS 3–4 (2007), available at http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/Aspen_Principles_with_signers_April_09.pdf.

63. Richard A. Posner, *Are American CEOs Overpaid, and, if so, What if Anything Should be Done About It?*, 58 DUKE L.J. 1013, 1041 (2009).

potential for profits has become unlinked from the risk of loss. Linking pay to short-term gains through options appears to magnify the risks that executives are willing to take, since they are compensated for stock price increases, but unlike shareholders, are not punished for decreases in share price.⁶⁴ This also encourages the CEO to increase firm leverage in order to magnify potential returns on firm investments.⁶⁵ This kind of compensation structure may threaten the safety of the firm. As Richard Posner remarked, “a CEO cushioned against loss has an incentive to take high risks in order to maximize the expected value of his stock options.”⁶⁶ Moreover, in large, interconnected firms, compensation structures which encourage risk-taking may threaten the safety and soundness not only of the particular firm, but of the entire financial system.⁶⁷

B. Systemic Risk

As we have seen in the current financial crisis, far more is at stake than just the fate of a particular firm. When firms are “too big to fail,” their risk taking affects all of us. Too great or too little in the way of risk-taking incentives can affect the entire economy. With too few incentives for risk taking, the economy may stagnate, while incentives that are too great may result in collapse. Incentives for risk taking arise when “the sensitivity of payoffs on the downside is lower than the sensitivity of payoffs to the upside.”⁶⁸ Compensation structures that insulate executives from downside risk may encourage excessive risk taking, and thus pose a danger that reverberates throughout the economy.

64. That is, designing executive pay packages to reward short-term performance, coupled with the use of options as the form of compensation, increases the focus on short-term results, even though the options themselves may not vest for a year or two, because what counts for the executive is the exercise price. In the meantime, managers are able to off-load their risk by hedging prior to the exercise date.

65. *Id.*

66. *Id.* at 1027.

67. Jeffrey N. Gordon, “*Say on Pay*”: *Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 365 (2009) (noting that while Enron was brought down at least in part by misguided compensation strategies, that failure was internalized, while the failure of Lehman reverberated through the system).

68. Core & Guay, *supra* note 18, at 26 (explaining that “greater stock-based pay can potentially either mitigate or exacerbate any existing incentive alignment problems, depending on whether the executive had the right amount, too much, or too little equity incentives to begin”).

In addressing this problem with respect to financial institutions, Bebchuk and Spamann suggest paying executives with a broader segment of firm assets, such as preferred stock and outstanding bonds.⁶⁹ Bebchuk and Spamann limit their suggestion to banks because banks present a special cost due to the externalities (e.g., taxpayer bailouts) imposed on society, but these externalities are present whenever a firm is “too big to fail” (the bailout of General Motors comes to mind). Because firms today obtain their financing by directly accessing the capital markets, banks are no longer the sole source of systemic risk; increasingly important are capital market linkages.⁷⁰ The size of a firm’s exposure to other market participants correlates to the risk they pose to the economy.⁷¹

Schwarcz defines “systemic risk” as a chain of bad economic consequences (increases in the cost of capital or decreases in its availability) arising from a trigger event, such as market or institutional failure.⁷² He distinguishes systemic risk from what he terms “systematic risk,” periodic market downturns that affect most market participants and facilitate market equilibrium.⁷³ Other than the length and severity of the downturn, however, it is unclear what distinguishes the two. In any event, Schwarcz would agree that government intervention is necessary whenever there is a catastrophic potential threat to the economy.⁷⁴ Systemic risk cannot be mitigated by diversification, since it arises from a broad market failure.⁷⁵

The reason to regulate systemic risk, Schwarcz explains, is that it poses a “tragedy of the commons,” a situation in which market participants only have incentives to benefit themselves, rather than the economic system in which they participate.⁷⁶ A common environmental example of the tragedy of the commons is the problem of over-fishing the oceans. Each fisherman has an incentive to catch as much fish as possible for as long as possible, even though the fisherman knows that the oceans are being overfished—a result that, in the long term, causes everyone to suffer. When the benefits of

69. Bebchuk & Spamann, *supra* note 49, at 284 (noting that this would expose executives to “a broader fraction of the negative consequences of risks taken,” thereby reducing incentives for excessive risk-taking).

70. Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 200 (2008).

71. *Id.* at 204 (noting that “even ordinary operating companies can and sometimes do engage in aggressive or converging investment strategies similar to those used by hedge funds”).

72. *Id.* at 198–200 (citing the classic example of a bank run).

73. *Id.* at 204.

74. *Id.* at 198.

75. See Erik F. Gerding, *Code, Crash and Open Source: The Outsourcing of Financial Regulation to Risk Models and the Global Financial Crisis*, 84 WASH. L. REV. 127, 138–39 (2009) (discussing forms of risk).

76. Schwarcz, *supra* note 70, at 206.

exploiting a common resource (here, the market economy) accrue to select individuals while the downside risks are spread out among all market participants, those select individuals lack the necessary incentives to limit their activities. Similarly, even if risky decision-making may ultimately cause the firm (and the economy) to crater, the individual CEO still has incentives to grab while the grabbing is good.

Just as the fisherman has no incentive to catch fewer fish, since if he refrains others will catch the fish he let go, executives have no incentive to refrain from demanding (and boards from awarding) huge pay packages. This is well illustrated by the unseemly bonuses that were paid by TARP recipients. Commons problems need a regulatory solution. What that solution might be depends on the dynamics of the players involved: boards, CEOs, and shareholders.

III. SETTING EXECUTIVE COMPENSATION

Executive pay packages should be structured to provide incentives for executives to undertake an optimal amount of risk, both for the health of the firm and the health of the general economy. This is therefore one of the most important tasks of the board of directors. Given the importance of this endeavor, one might think that there would be an army of experts engaged in the task of generating statistical metrics and producing reams of research and empirical studies on this topic, and that debates over these factors would become a primary focus of boards seeking to set executive pay. One would be mistaken. There are few such studies, and they rarely enter the deliberations of the compensation committee.

Instead, boards tend to base the amount and structure of the pay package on what CEOs at comparably sized firms in the industry make. Moreover, since no board cares to admit that their CEO is in the lower half of the talent pool, the focus tends to be on what the upper half is making. Why is such an irrational process prevalent in boardrooms across the country? The structure of the board and board dynamics offer some insights.

A. Board Role

Corporate statutes universally provide that corporations are to be managed by or under the direction of the board of directors.⁷⁷ This is

77. See, e.g., DEL. CODE ANN. tit. 8, § 141 (2010). See also MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 140 (1976) (observing that despite

because directors are supposed to mitigate the risk caused by the separation of ownership and control, i.e., the risk that those in control will line their pockets at the expense of the investors, either by diverting funds or by shirking.⁷⁸ Because widely dispersed shareholder systems, such as those of the United States and the United Kingdom, face collective action problems when it comes to monitoring those in control, shareholders must delegate such monitoring to their representatives: the board of directors.⁷⁹ Shareholders should then be able to use their voting power to hold the directors accountable for making sure the corporation is run in the interests of shareholders.

1. Board Composition

Over the last decade, boards have been getting smaller and more independent.⁸⁰ Most boards in large corporations now consist primarily of independent directors, that is, directors without direct financial or family ties to the corporation.⁸¹ Theoretically, this should be good news for shareholders, who could logically expect such small, independent boards to actively engage in arms-length bargaining on their behalf. Because inside directors are widely acknowledged to be co-optable by the management they are supposed to monitor—insiders' careers often depend on the good graces of the CEO—increasing the role of independent directors has been seen as the solution.⁸² In theory, independent boards will improve monitoring

this universal doctrine, “in the typical large, publicly held corporation the board does not ‘manage’ the corporation’s business . . . [but] that function is vested in the executives.”). In fact, Eisenberg found that boards of large corporations tended not to initiate decisions, and largely passively approved those initiated by management. *Id.*

78. See ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119–25 (1933) (describing the effects of separating ownership and control and discussing the ramifications of the ensuing agency problems).
79. See Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1804 (2006) (explaining that in large publicly held corporations, “shareholders have little incentive to exert effort to monitor management and actively intervene in corporate decisionmaking”).
80. See Yablon, *supra* note 25, at 104–05 (observing that “the dramatic increase in levels of CEO compensation” correlate with a period where there are more outside directors on the board, more boards have a majority of outside directors, “more instances where independent directors meet separately from the CEO,” and “there has been a substantial decrease in board size”).
81. NYSE Listing Rules require the majority of the board to be independent. NYSE, INC., LISTED CO. MANUAL § 303A.01 (2003).
82. See, e.g., Frank B. Cross & Robert A. Prentice, *Economies, Capital Markets, and Securities Laws* 11 (U. Tex. Sch. of Law, Law & Econ. Research Paper No. 73, 2006), available at

because they will be less willing to rubber stamp management policies and more willing to consider alternative courses of action. Given this trend toward more independent boards, why then has executive pay continued to rise in such a meteoric fashion? There are several explanations for this phenomenon.

First, shareholders actually have very little input into the process by which new members of the board are selected.⁸³ Far from being selected by shareholders, directors frequently are selected for consideration by the CEO.⁸⁴ Although the slate of directors is put forward by the nominating committee, the names on the slate are generally suggested by the CEO. The shareholders may vote for the directors, but unless there is a proxy fight, they do not have much real choice. Proxy fights are extremely rare. The number of nominations generally matches the number of open board positions.⁸⁵

Moreover, insiders often retain a strong influence even where the majority of the board is composed of outside directors.⁸⁶ For example, the CEO may be board chair set the agenda, provide the information that the board will use in its deliberations, and dominate deliberations. As of 2007, only 37% of S&P 500 companies had separate board chairs and CEOs, and only 11% had independent chairs.⁸⁷ Thus, while independent boards are meant to improve corporate governance through more active board monitoring, the question of whether this occurs in fact is subject to considerable debate.⁸⁸ With respect to executive pay, the corporate

<http://ssrn.com/abstract=908927> (noting that boards of directors “plainly have failed” at the task of monitoring managers).

83. See Lucian A. Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45 (2003) (noting that “[a]lthough shareholder power to replace directors is supposed to be an important element of our corporate governance system, it is largely a myth”).
84. See Cross & Prentice, *supra* note 82, at 11–12.
85. Jayne W. Barnard, *Shareholder Access to the Proxy Revisited*, 40 CATH. U. L. REV. 37, 38 (1990) (observing that shareholders “are neither permitted to play a meaningful role in the selection of directorial candidates, nor to choose among competitive candidates for scarce board positions”).
86. See James P. Walsh & James K. Seward, *On the Efficiency of Internal and External Corporate Control Mechanisms*, 15 ACAD. MGT. REV. 421, 434 (1990) (citing studies showing that “there does not yet seem to be consensus support (either theoretically or empirically) for the conventional wisdom that either an increased presence of outsiders on the board of directors or the increased ownership stakes by any shareholder group (including management) necessarily improve corporate performance”).
87. Patel, *supra* note 7, at 10.
88. See, e.g., Erica Beecher-Monas, *Marrying Diversity and Independence in the Boardroom: Just How Far Have You Come, Baby?*, 86 OR. L. REV. 373, 375 (2007) (discussing the debate over increasing director independence as a solution to monitoring problems).

governance solution to executive influence has been to set up independent compensation committees that deliberate in the absence of the CEO. Yet even when the CEO is absent from deliberations, the CEO will have enormous influence over the selection of his successor. In a crisis situation, where the CEO has departed, the successor's pay will still be determined in light of the departed CEO's pay; a new candidate will be unlikely to take anything less, and most likely will demand more.

Furthermore, most board members are the CEOs of other public companies.⁸⁹ As CEOs, their payment structures and levels are probably similar to those they are considering, and they also have boards that will set their pay. Because directors who are CEOs of other firms will have their own pay set in comparison to CEOs in similar firms, they are unlikely to view these comparable pay packages as exorbitant. In addition, compatibility is the key to invitations to serve on a board of directors.⁹⁰ This suggests that directors are likely to identify with the CEO. In effect, the relationship between the CEO and the directors is a cozy one in which they hire and retain each other.⁹¹ Absent a crisis, there are great pressures on the board to keep the CEO happy, and ever-increasing pay appears to accomplish that.

2. Compensation Committees

The use of independent compensation committees advised by executive compensation firms was supposed to solve the problem of board capture. New York Stock Exchange ("NYSE") listing rules now require that the compensation committee consist solely of independent directors.⁹² The underlying premise is that independent directors will be more willing (and able) to actively bargain over pay.

89. Michael B. Dorff, *Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 BUFF. L. REV. 811, 845 n.145 ("CEOs of other companies constitute some 63% of outside directors"); KORN/FERRY INT'L, 30TH ANNUAL BOARD OF DIRECTORS STUDY 10 (2003), available at <http://www.kornferry.com/Publication/3321> (finding that 83% of boards included a CEO or chief operating officer of another firm in 2002).

90. Stephen M. Bainbridge, *Why a Board – Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 37 (2002) ("invitations to the board are based heavily on matters like compatibility and 'fit'") (quoting Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 797 (2001)).

91. See Yablon, *supra* note 25, at 121 (noting that "CEOs and directors are each effectively responsible for hiring and retaining one another, the CEO through control of the board nomination process, the board through its hiring and firing power").

92. NYSE LISTED CO. MANUAL § 303A.06 (2009).

This may not be the solution to the problem of excessive pay, however. When it comes to setting CEO compensation, independent directors seem to make little difference; having a high level of independence appears (counter-intuitively) correlated with high executive compensation.⁹³ Golden parachutes are actually more prevalent in firms with independent boards.⁹⁴ Why this should be so is unclear, although there are several factors that may contribute to the problem. First, directors as well as executives are now routinely paid in option grants, and director pay levels appear to be correlated to executive pay.⁹⁵ Second, most independent directors are drawn from the ranks of CEOs in other corporations, so their view of the appropriate amount of compensation may be colored by self-interest. After all, they are undoubtedly aware that their own pay will be set by examining the median. Although shareholders theoretically can vote directors who fail to constrain executive pay out of office, the reality is that shareholder challenges to incumbent board members are very rare outside of hostile takeovers.⁹⁶ Third, polarization effects may increase any inherent biases shared by individuals in the group.

When setting compensation levels, a compensation committee usually benchmarks its executives against a peer group of executives from similarly sized firms.⁹⁷ Directors do not want to believe that their executive is substandard, so the pay will be at least the median of this group, and probably

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93. See Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 292–95 (2004) (noting that management’s ability to distort information will not be solved by the presence of independent directors on the board); Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 931 (1999) (noting empirical studies suggesting that high executive remuneration is correlated with high levels of board independence). At Enron, for example, the remuneration committee appeared to believe that its function was to pay Enron executives more than those at competing firms. S. PERMANENT SUBCOMM. OF INVESTIGATIONS OF THE COMM. ON GOV’T AFFAIRS, *THE ROLE OF THE BOARD OF DIRECTORS IN ENRON’S COLLAPSE*, S. REP. NO. 107–70, at 53–54 (2002).
94. See, e.g., Philip L. Cochran et al., *The Composition of Boards of Directors and Incidence of Golden Parachutes*, 28 ACAD. MGMT. J. 664, 668 (1985); Harbir Singh & Farid Harianto, *Management-Board Relationships, Takeover Risk, and the Adoption of Golden Parachutes*, 32 ACAD. MGMT. J. 7, 20 (1989).
95. See Ivan E. Brick et al., *supra* note 56, at 421 (presenting data suggesting directors have incentives to increase the level of executive pay to increase their own compensation).
96. See BEBCHUK & FRIED, *supra* note 27, at 25 (observing that between 1996 and 2002 electoral challenges to incumbents outside the hostile takeover context averaged about two per year in corporations with market capitalization greater than \$200M).
97. See Wong, *supra* note 60, at 15 (discussing the process of setting executive pay).

somewhat above it. The problem with this system is that it results in a constant ratcheting upwards of the pay levels for all executives.⁹⁸

3. Compensation Advisors

Compensation committees do not work in a vacuum. They have experts upon whom they may rely. The committees are usually advised by compensation consultants, who typically present a comparison study of pay for similarly situated CEOs. These experts may also be conflicted. Because the incumbent CEO often has considerable influence in hiring the expert, the expert has considerable interest in pleasing the CEO.⁹⁹ In addition to desiring repeat business from the compensation committee, executive compensation consulting firms often perform other, far more lucrative, services for the firm and thus may be inclined to produce figures pleasing the executive.¹⁰⁰

Most firms providing compensation consulting also perform many other services, and compensation consulting tends to generate only a small portion of their returns.¹⁰¹ For example, in 2006, executive compensation consulting firm Hewitt generated \$2 billion in other consulting revenues, and only \$850 million in executive compensation consulting.¹⁰² Sixty-three percent of the largest firms hiring compensation consultants also used the same consulting firm to perform other services.¹⁰³ MetLife and PepsiCo both used compensation consultants to provide other large-fee generating services, but nevertheless referred to the compensation consultants as “independent.”¹⁰⁴ Most of the firms whose consultants provided both compensation advice and other services failed to disclose this to their investors.¹⁰⁵

98. *Id.* (noting that this is a particular problem when larger firms are included in the peer group).

99. See BEBCHUK & FRIED, *supra* note 27, at 38 (explaining that compensation consultants are usually hired by human resource departments, with CEOs involved in the selection process).

100. Gretchen Morgenson, *Panel to Look at Conflicts in Consulting*, N.Y. TIMES, May 11, 2007, at C1 (noting that Congress issued subpoenas to executive compensation firms Hewitt Associates, Mercer Consulting, and Towers Perrin in relation to this concern).

101. Letter from James F. Reda, Managing Dir., James F. Reda & Assoc., to Nancy Morris, Sec’y, SEC 4 (Apr. 6, 2006), available at <http://www.sec.gov/rules/proposed/s70306/jfreda3948.pdf>.

102. Morgenson, *supra* note 100.

103. Gretchen Morgenson, *House Panel Finds Conflicts in Executive Pay Consulting*, N.Y. TIMES, Dec. 6, 2007, at C1 (discussing Congressional investigation into consulting conflicts).

104. *Id.*

105. *Id.*

B. Board Dynamics

Management of a corporation by or under the direction of a board of directors is a choice to manage through a group decision process.¹⁰⁶ There are good reasons for this choice of group decision-making. Group decisions are often superior to those of individuals.¹⁰⁷ As compared to individual memory, group memory is more accurate, detailed, and retains a greater volume of information.¹⁰⁸ Groups master new concepts better than individuals.¹⁰⁹ Abstract problem solving is often better in groups.¹¹⁰

Yet, not all group decisions are good ones. While group processes do assist decision-making in tasks which have a clear answer (because individual errors in assessing information tend to cancel each other out), group processes may skew the decision away from the optimal solution when there is no clear right answer. Deliberations over the proper form and level of executive pay packages rarely have clear right answers, and shared biases of group members about whether and how to use information may skew the decision-making process in these situations.¹¹¹ Interactive groups are especially subject to polarization effects, herding, and information cascades. This poses particular problems with respect to decisions about executive pay.

106. Decisions of the board are made consensually. DEL. CODE ANN. tit. 8, § 141(b) (2009) (“The vote of the majority of directors present at a meeting at which a quorum is present shall be the act of the board of directors.”). A group is defined as “made up of individuals who see themselves and who are seen by others as a social entity, who are interdependent because of the tasks they perform as members of a group, who are embedded in one or more larger social systems (e.g. community, organization), and who perform tasks that affect others (such as customers or coworkers).” Richard A. Guzzo & Marcus W. Dickson, *Teams in Organizations: Recent Research on Performance and Effectiveness*, 47 ANN. REV. PSYCHOL. 307, 308–09 (1996).

107. For a review of studies showing that groups consistently outperform their average member, see Bainbridge, *supra* note 90, at 12–19.

108. David A. Vollrath et al., *Memory Performance by Decision-Making Groups and Individuals*, 43 ORG. BEHAV. & HUMAN DECISION PROCESSES 289, 298 (1989).

109. Gayle W. Hill, *Group Versus Individual Performance: Are N+1 Heads Better than One?*, 91 PSYCHOL. BULL. 517, 520–22 (1982) (reviewing empirical literature). Some of the groups in the concept mastering tasks did not outperform their best members, however. *Id.*

110. *Id.* at 524.

111. See Daniel Gigone & Reid Hastie, *Proper Analysis of the Accuracy of Group Judgments*, 121 PSYCHOL. BULL. 149, 159 (1997) (explaining that the group performance will be at the level of the average members).

1. Polarization

One unexpected tendency of group decisions is that groups often polarize;¹¹² that is, group decisions tend to coalesce around an extreme position rather than around the middle of the individually held antecedent positions.¹¹³ This suggests that even if the individual members of a compensation committee would prefer a more modest pay package, if the group has a predilection toward higher pay levels, that will be the decision. This phenomenon is more acute when the group is homogeneous, as it tends to be at the upper echelon of corporate management, because if group members share a particular bias, polarization may magnify its impact.¹¹⁴

Directors tend to be drawn from the same social and educational backgrounds. Economic ties between board members are prohibited by the rules on director independence, but social ties such as these are pervasive. Shared biases are common when the group members have strong social ties. The effects of polarization are magnified in groups with strong social ties because such cohesive groups tend to have access to limited argument pools and suppress dissent.¹¹⁵ Because of the phenomenon of group polarization, risk aversion and risk preference may both be magnified in group decisions.¹¹⁶ This is known as the “risky shift.”¹¹⁷

112. See, e.g., Daniel J. Isenberg, *Group Polarization: A Critical Review and Meta-Analysis*, 50 J. PERSONALITY & SOC. PSYCHOL. 1141, 1141 (1986) (noting that group polarization occurs when “an initial tendency of individual group members toward a given direction is enhanced following group discussions”). For a discussion of group polarization in the context of audit committee deliberations, see Erica Beecher-Monas, *Corporate Governance in the Wake of Enron: An Examination of the Audit Committee Solution to Corporate Fraud*, 55 ADMIN. L. REV. 357, 377–80 (2003).

113. See Cass R. Sunstein, Essay, *Deliberative Trouble? Why Groups Go to Extremes*, 110 YALE L.J. 71, 85–86 (2000) (“The effect of deliberation is both to decrease variance among group members, as individual differences diminish, and also to produce convergence on a relatively more extreme point among predeliberation judgments.”).

114. Isenberg, *supra* note 112, at 1141.

115. See JOHN C. TURNER ET AL., REDISCOVERING THE SOCIAL GROUP : A SELF-CATEGORIZATION THEORY 159–62 (1987); Dominic Abrams et al., *Knowing What to Think by Knowing Who You Are: Self-Categorization and the Nature of Norm Formation, Conformity and Group Polarization*, 29 BRIT. J. SOC. PSYCHOL. 97, 113–16 (1990); Russell Spears et al., *De-Individuation and Group Polarization in Computer Mediated Communication*, 29 BRIT. J. SOC. PSYCHOL. 121, 122–31 (1990).

116. See Paul E. Jones & Peter H. M. P. Roelofsma, *The Potential for Social Contextual and Group Biases in Team Decision-making: Biases, Conditions & Psychological Mechanisms*, 43 ERGONOMICS 1129, 1144 (2000) (noting that two special cases of group polarization are “risky shift,” when the group becomes more risk seeking, and “cautious shift,” when the group becomes more risk averse than the average tendencies of the individual members).

117. *Id.*

In addition, collective processes tend to magnify systematic errors.¹¹⁸ These systematic errors include phenomena such as overconfidence, self-interest, and cognitive dissonance.¹¹⁹ These errors may also skew group decision-making, particularly if the group is homogeneous. Thus, while random errors of individuals should be cancelled out by other individuals' random errors in a group process, this does not occur if the errors are skewed in the same direction. This suggests that the prevalence of CEOs on corporate boards may shift the group toward a higher pay level.

Confirmation bias research suggests that people tend to believe that their initial judgment is correct, and to ignore information that might call it into question.¹²⁰ Cognitive dissonance theory suggests that people tend to take further actions that justify and reinforce decisions that they have already made.¹²¹ For example, gamblers and voters are more confident after placing

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118. See Norbert L. Kerr et al., *Bias in Judgment: Comparing Individuals and Groups*, 103 *PSYCHOL. REV.* 687, 713–14 (1996) (noting that although the law of large numbers suggests that random errors will cancel each other out in collective decisions, systematic errors will be magnified).
119. The tendency to view information in a manner that will bolster our own position has been studied in many contexts. See, e.g., Linda Babcock & George Loewenstein, *Explaining Bargaining Impasse: The Role of Self-Serving Biases*, 11 *J. ECON. PERSP.* 109, 112–17 (1997) (finding that mock settlement participants tend to view the same materials differently depending on whether they had been assigned to the role of plaintiff or defendant, and even where there are real consequences, such as in salary negotiations between teachers' unions and school boards, this tendency is observable); Kimberly A. Wade-Benzoni et al., *Egocentric Interpretations of Fairness in Asymmetric, Environmental Social Dilemmas: Explaining Harvesting Behavior and the Role of Communication*, 67 *ORG. BEHAV. & HUM. DEC. PROCESSES* 111, 113 (1996) (finding evidence of egocentric biases in interpreting fairness in the fishing industry). For a discussion of information selection biases in the context of communications regulation, see generally Derek E. Bambauer, *Shopping Badly: Cognitive Biases, Communications, and the Fallacy of the Marketplace of Ideas*, 77 *U. COLO. L. REV.* 649, 673–92 (2006) (discussing information distorting biases).
120. See Hart Blanton et al., *Overconfidence as Dissonance Reduction*, 37 *J. EXPT'L SOC. PSYCHOL.* 373, 373 (2001) (citing studies asking people to evaluate their ability in solving laboratory problems and showing that "people think that they can solve problems that they cannot, think that they have made progress toward correct solutions when they have not, and think that they have drawn correct conclusions when they have not").
121. See generally LEON FESTINGER, *A THEORY OF COGNITIVE DISSONANCE* (1957). Festinger's theory provoked a great deal of controversy, but the empirical basis for it appears to have survived the controversy. See, e.g., Robyn M. Dawes, *Behavioral Decision Making and Judgment*, in *THE HANDBOOK OF SOCIAL PSYCHOLOGY* 497, 557–61, 561 (Daniel T. Gilbert et al. eds., 4th ed. 1998) (detailing the controversy and concluding that "cognitive dissonance theory is resilient").

their bets or votes than they were before.¹²² This research may explain the similarity of pay package structures, as well as the widespread reliance on comparison studies in place of more probing empirical studies in setting pay levels.

In addition, the social environment of board deliberations may increase overconfidence because people acting within small social networks have been found to demonstrate greater levels of overconfidence.¹²³ Compensation committees are essentially small social networks: they are characterized by having three to fifteen members (a characteristic boards of directors share), with someone in a central, coordinating position (the chair, who on boards of directors is typically the CEO), and weak contact with outsiders (at least during the decision process). These features of their interaction may thus help to explain why boards are generally confident that they have hired the top talent and therefore should pay top dollar for it.

Rather than fracturing the group into opposing views, polarization is a consensual shift further in the direction of the group's initial tendency.¹²⁴ For polarization to occur, there must be an initial leaning of the group in a particular direction.¹²⁵ This kind of predilection is more common if the group is homogeneous. For example, when there is an underlying norm endorsing management positions, individuals would attempt to signal that they shared the group attitude.¹²⁶ This results in a kind of competition, but since no one can be sure exactly what the average is, the value moves in the direction favored by the group norm. This effect has been observed in studies where

122. See Blanton et al., *supra* note 120, at 374 (arguing that “overconfidence reflects the motive to maintain a view of the self as a knowledgeable perceiver who makes sound judgments”).

123. See Joshua Klayman et al., *Overconfidence: It Depends on How, What, and Whom You Ask*, 79 *ORG. BEHAV. & HUM. DEC. PROCESSES* 216, 243 (1999) (citing research finding an overall bias toward overconfidence, particularly in small social networks).

124. James H. Liu & Bibb Latane, *Extremization of Attitudes: Does Thought and Discussion-Induced Polarization Cumulate?*, 20 *BASIC & APP. SOC. PSYCHOL.* 103, 103 (1998) (noting the difference between popular conceptions of polarization and social scientists' conceptions of polarization).

125. See Noah E. Friedkin, *Choice Shift and Group Polarization*, 64 *AM. SOC. REV.* 856, 857–59 (1999) (explaining the concept of group polarization in terms of a choice shift, which occurs “when, after a group's interaction on an issue, the mean final opinion of group members differs from the members' mean initial opinion . . . in the opposite direction of the initial inclination of the group”).

126. See ROBERT S. BARON, NORBERT KERR & NORMAN MILLER, *GROUP PROCESS, GROUP DECISION, GROUP ACTION* 73–79 (1992) (discussing the process of polarization); Robert S. Baron & Gard Roper, *Reaffirmation of Social Comparison Views of Choice Shifts: Averaging and Extremity Effects in an Autokinetic Situation*, 33 *J. PERSONALITY & SOC. PSYCHOL.* 521, 528–30 (1976) (finding that members strive to show adherence to group norms).

the group categorized itself as either risk taking or cautious: group decisions were observed to polarize in the risky direction by stereotypically risk-seeking groups, and in the cautious direction by self-perceived cautious groups, although both risky and cautious individuals tended to shift away from their individual predilections.¹²⁷

One explanation for group polarization is that groups have an internal culture that prefers some values over others.¹²⁸ This too is more likely if the group is homogeneous. During discussions, group members attempt to signal their adherence to these group norms, but because they do not know ahead of time the level of group adherence to these norms, the result is a competition that shifts the initial preferences to a more extreme level.¹²⁹ This means that if group members share a particular bias, group dynamics may intensify its impact.¹³⁰ People wish to be perceived favorably by the group, so they adjust their expressed opinions in line with their image of the group position—an image already polarized because of its prototypical nature.¹³¹

Another explanation for the polarization effect is that the initial declaration of the individual's position was more moderate than the position the individual really held.¹³² As the individual realizes the group position is more extreme, the individual is freed to express these more extreme views.¹³³ In this explanation, there is not really a shift in underlying attitudes, but merely an increased willingness to express previously held views. Both this and the prior explanation are social comparison theories, and suggest that group polarization occurs when high status members of the group hold more extreme views than the mean.¹³⁴ Thus, in the context of a compensation committee, a CEO with a predilection for a particular view may shift the group decision in that direction.

127. John C. Turner et al., *Referent Informational Influence and Group Polarization*, 28 BRIT. J. SOC. PSYCHOL. 135, 143 (1989) (noting that “defining the shared characteristics of the group in advance will ensure that arguments/positions/ members in line with the stereotype will tend to be perceived as more representative of the group as a whole and hence more persuasive and valued”).

128. See Baron & Roper, *supra* note 126.

129. See Glenn S. Sanders & Robert S. Baron, *Is Social Comparison Irrelevant for Producing Choice Shifts?*, 13 J. EXPT'L. SOC. PSYCHOL. 303, 304 (1977).

130. *Id.*

131. JOHN C. TURNER ET AL., *REDISCOVERING THE SOCIAL GROUP: A SELF-CATEGORIZATION THEORY* 156 (1987).

132. See Isenberg, *supra* note 112, at 1142.

133. *Id.*

134. George R. Goethals & Mark P. Zanna, *The Role of Social Comparison in Choice Shifts*, 37 J. PERSONALITY & SOC. PSYCHOL. 1469, 1474–75 (1979).

2. Relational Groups

Groups not only need to accomplish projects—such as monitoring management—but they also must keep the group working cohesively together.¹³⁵ Thus, in understanding how group decisions are made, it is important to examine a number of functions: the accomplishment of group projects, satisfaction of member needs, and maintaining the group as an ongoing system.¹³⁶ Relational teams, like boards of directors, develop strong internal relationships and engage with each other repeatedly. This is the type of situation that evolutionary game theory suggests produces cooperative strategies, which may devolve into collusion.¹³⁷

Groups experience enormous pressure to maintain cohesiveness.¹³⁸ As a result of this pressure, even independent boards may fail to realistically assess alternative courses of action, such as alternative levels and structures of executive pay.¹³⁹ The decision the group ultimately reaches is not properly characterized as a collective decision resulting from many independent judgments because people in a small group influence each other's judgments. Decisions of small groups are thus more volatile and extreme than those of the individual members. Consensus becomes more important than dissent because dissent threatens the group's cohesion. The effects of polarization can thus be expected to be even more pronounced for homogeneous boards that interact over many years.

135. See Joseph E. McGrath & Linda Argote, *Group Processes in Organizational Contexts*, in BLACKWELL'S HANDBOOK OF SOCIAL PSYCHOLOGY: GROUP PROCESSES 603, 608 (M. Hogg & R.S. Tindale eds., 2000).

136. See *id.*

137. See Erica Beecher-Monas, *Enron, Epistemology, and Accountability: Regulating in a Global Economy*, 37 IND. L. REV. 141, 157–80 (2003) (discussing implications of game theory for corporate governance); Kenneth L. Bettenhausen, *Five Years of Groups Research: What We Have Learned and What Needs to Be Addressed*, 17 J. MGMT. 345, 361–65 (1991) (summarizing empirical studies on group cohesion processes).

138. See Bebchuk & Fried, *supra* note 27, at 32 (noting that boards experience “a strong emphasis on politeness and courtesy and an avoidance of direct conflict and confrontation”) (quoting KHURANA, *supra* note 26, at 84).

139. See Samuel N. Fraidin, *Duty of Care Jurisprudence: Comparing Judicial Intuition and Social Psychology Research*, 38 U. C. DAVIS L. REV. 1, 51–52 (2004) (observing that although trust and cohesiveness are held in high esteem, dissent is actually associated with more thorough consideration of evidence and careful decisionmaking).

3. Herding

Herding is when people ignore their own information, and instead follow the crowd in making decisions.¹⁴⁰ One explanation for the failure of compensation consultants to provide more sophisticated information about the types of pay structures that will most benefit shareholders is that they are merely following others in their field, proposing the least controversial, most acceptable, structures because everyone else is doing it.¹⁴¹ Herding may also explain pay levels and boards' preference for traditional stock options in structuring pay packages over other possible structures.

IV. EFFORTS AT REFORM

Executive pay has been the focus of reform efforts for quite some time. The exemption for stock options from the million dollar cap in pay under the tax code is just one example.¹⁴² Curiously, executive pay keeps rising despite these various efforts.

A. Sarbanes-Oxley

Sarbanes-Oxley,¹⁴³ which set out a plethora of new rules regarding corporate governance reforms in the wake of the Enron and WorldCom scandals, focused mainly on accounting conflicts and director independence.¹⁴⁴ It addressed the issue of executive pay primarily through its provision regarding claw-backs of bonuses and incentive pay in the event of financial restatements resulting from misconduct.¹⁴⁵ Section 304 requires the CEO and CFO to repay any bonus, incentive, or equity-based compensation received during the twelve months after the filing of the misleading financial

140. See generally Peter H. Huang, *Herd Behavior in Designer Genes*, 34 WAKE FOREST L. REV. 639, 645–53 (1999) (reviewing theories of herd behavior).

141. See Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2048 (2007) (noting that “consultants may tout the latest trend in compensation because they are part of a social cascade themselves”).

142. See *supra* text accompanying notes 36–44.

143. The Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 2002 U.S.C.C.A.N. (116 Stat.) 745 (codified as amended in scattered sections of 11, 15, 28, and 29 U.S.C.).

144. As it turns out, however, when it comes to setting CEO compensation, director independence seems to make little difference. See Erica Beecher-Monas, *supra* note 88, at 388 (noting that—counter-intuitively—high levels of independence correlate with high executive compensation).

145. Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2011).

statement, or any profits from the sale of stock within the twelve month period.¹⁴⁶ Although the restatement must be due to misconduct in order to trigger the claw-back, the statute does not specify whose misconduct or the extent of misconduct necessary to activate the provision. It is similarly unclear how one would measure the amount of claw-back due to the firm. In any event, this provision has rarely been enforced.¹⁴⁷

B. Say on Pay

Executive pay has increasingly become the subject of shareholder proposals. These proposals most frequently appear as “say on pay” proposals, which ask for a non-binding advisory vote on pay packages, or “pay for performance” proposals, which ask for a greater relationship between executive pay and overall shareholder return.¹⁴⁸ The purpose of “say on pay” is to make boards more accountable for the pay packages that they award top executives. Dodd-Frank has made “say on pay” mandatory, with an advisory shareholder vote on whether to approve the disclosed executive compensation package to be held at least every three years.¹⁴⁹ Every six years, the shareholders must be given an opportunity to vote on whether the interval between the “say on pay” votes should be one, two or three years.¹⁵⁰ The U.K. has mandated its own version of “say on pay,” and the result has been a number of negative votes.¹⁵¹ Yet, the U.K. has not seen any corresponding decrease in executive pay.¹⁵²

146. *Id.*

147. See Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 376–77 (2009) (observing that the claw-back provisions have been largely ignored, citing evidence that, as of 2009, the SEC has brought only two claw-back enforcement actions under Sarbanes-Oxley).

148. See Sean M. Donahue, *Executive Compensation: The New Executive Compensation Disclosure Rules Do Not Result in Complete Disclosure*, 13 FORDHAM J. CORP. & FIN. L. 59, 68 (2008) (discussing shareholder proposals during the 2006 and 2007 proxy seasons).

149. Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–1900 (to be codified at 15 U.S.C. § 78n-1).

150. *Id.*

151. See, e.g., Core & Guay, *supra* note 18, at 23 n.8 (citing as examples of negative votes on pay Royal Dutch Shell, PLC, Royal Bank of Scotland Group, Bellway PLC, and Provident Financial PLC, but noting that the level and growth of CEO pay does not appear to have changed as a result).

152. Gordon, *supra* note 67, at 344 (observing that U.K. rates of CEO pay increased by double digits in recent years).

C. Disclosure

Disclosure of executive and director pay has been mandatory for over seventy years.¹⁵³ In 2006, the SEC's amended disclosure rules purported to make the disclosure of executive compensation more transparent.¹⁵⁴ Beginning in the 2007 proxy season, these rules were intended to revise compensation tables and narrative disclosure into three sections: (1) a summary compensation table, (2) equity-based interests relating to compensation, and (3) retirement or other post-employment compensation.¹⁵⁵ The new rules were intended to improve shareholders' ability to compare compensation across companies and within the firm, and to increase comprehension with enhanced narrative disclosure.¹⁵⁶ The underlying premise is that informed shareholders can exit, place proposals to consider shareholder approval for pay packages on proxy statements, or campaign to "vote no" or "withhold the vote."

In July 2009, the SEC proposed new amendments to its executive compensation disclosure rules.¹⁵⁷ Narrative in the Compensation Discussion and Analysis (CD&A) section is now supposed to explain the material factors underlying compensation policies in its explanation of the data in the compensation tables.¹⁵⁸ These disclosures must address the firm's compensation objectives, an identification of every element of compensation, and an explanation of why the firm chose each element, how it determined the amount, and how each element fits into the firm's overall compensation objectives. Post-employment compensation (such as pension plans and deferred compensation), policies relating to timing of option grants and the

153. Both Schedule A of the Securities Act of 1933, 15 U.S.C. § 77aa (2011), and § 12(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78l (2011), require disclosure of director and officer compensation. See Leigh Johnson et al., *Preparing Proxy Statements Under the SEC's New Rules Regarding Executive and Director Compensation Disclosures*, 7 U.C. DAVIS BUS. L.J. 373, 376–78 (2007) (discussing the history of executive compensation disclosure).

154. Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 54,302A, Investment Company Act Release No. 27,444A, 71 Fed. Reg. 53,157 (Sept. 8, 2006).

155. *Id.* at 53,160–61.

156. *Id.* at 53,160.

157. See Proxy Disclosure and Solicitation Enhancements, Securities Act Release No. 9052, Exchange Act Release No. 60,280, Investment Company Act Release No. 28,817, 74 Fed. Reg. 35,075 (July 17, 2009).

158. See *id.* at 35,077–79. Because the CD&A is filed with the SEC, it is subject to liability under the Securities Exchange Act, and is covered by the CEO/CFO certification required under Sarbanes-Oxley.

determination of exercise prices, and the role of executives in the compensation decision process must all be addressed.

Whether the new rules actually improved transparency is debatable.¹⁵⁹ The “plain language” requirements appear to have been interpreted to mean “more language” rather than clear language; the discussion and analysis section of proxy statements now averages twenty to thirty pages.¹⁶⁰ Charts that were supposed to clarify for comparison purposes appear muddled with footnotes from one chart cross-referencing another, with some footnotes running twelve pages or more. The instructions themselves take fifty-three pages of prose. Sometimes more disclosure is not better disclosure.¹⁶¹

Notwithstanding this prolixity, key information remains absent: target performance levels do not have to be revealed if the firm can claim the disclosure would result in competitive harm.¹⁶² According to the Corporate Library, more than two-thirds of companies in the 2008 proxy season avoided disclosure and listed fuzzy performance targets.¹⁶³

In addition, the revamped disclosure did not require sufficient disclosure of executive cumulative ownership positions, in particular, the sensitivity of CEO wealth to changes in firm performance.¹⁶⁴ Current share ownership disclosure is also not required.¹⁶⁵

The Dodd-Frank Act attempted to cure these last two deficiencies by amending § 14 of the Securities Exchange Act to require annual disclosure of information showing the relationship between executive compensation

159. Claudia M. Deutsch, *A Brighter Spotlight, Yet the Pay Rises*, N.Y. TIMES, Apr. 6, 2008, at BU1 (remarking that the 2008 proxy season was typified by “a blizzard of words and numbers that did more to obscure their processes than to illuminate them . . . [while the] true links between pay and performance remained scarce”).

160. See, e.g., Johnson & Johnson, Proxy Statement (Form DEF 14A) 21–52 (Mar. 12, 2008).

161. See John Schwartz, *Transparency, Lost in the Fog*, N.Y. TIMES, Apr. 8, 2007, at 3 (observing that under the new disclosure rules, “[t]here is so much information that you can’t see the forest for the non-tax qualified deferred compensation”).

162. Executive Compensation and Related Person Disclosure, SEC Release No. 33-8655, 71 Fed. Reg. 53,166 (Jan. 27, 2006); see Letter from Ann Yerger, Exec. Dir., Council of Inst. Investors, to Nancy M. Morris, Sec’y, SEC 35 (Mar. 29, 2006), available at http://www.cii.org/UserFiles/file/testimony/06-05_07%20stock%20options%20JM%20subcom%20investigations.pdf.

163. Deutsch, *supra* note 159 (noting that at most 30% of these “were really competitively sensitive”). Representative Barney Frank suggested that a way around the competitive harm concerns would be to require disclosure after the performance has been measured, but this comment was not adopted. See Letter from Barney Frank, Member of House Comm. on Fin. Serv., to Christopher Cox, Chair, SEC 2 (Apr. 10, 2006), available at <http://democrats.financialservices.house.gov/SECexceccomprulecommentletter.pdf>.

164. See Gordon, *supra* note 67, at 331.

165. *Id.* at 331 n.31.

actually paid and financial performance, taking into account changes in value of shares, dividends and distributions.¹⁶⁶ The required disclosure now also includes disclosure of the median annual compensation of all employees except the CEO; the annual compensation of the CEO; and the ratio of the two.¹⁶⁷ Any hedging activity by the CEO must also be reported.¹⁶⁸

D. Restricted Stock

One proposal for better aligning shareholder interests with management has been to increase the use of restricted stock.¹⁶⁹ TARP requires that firms receiving bailout funds pay their executives in restricted stock that does not fully vest until after the government has been repaid.¹⁷⁰ This may better align shareholder interests with those of management, thus addressing the problem of firm risk, but it still ignores the problem of systemic risk.¹⁷¹

Bhaghat and Romano propose to address the problem of systemic risk by paying the bulk of CEO compensation in restricted stock that does not vest until two to four years after employment ends.¹⁷² The advantage of Bhaghat and Romano's proposal is that it aligns executives' interests with the long-term prospects of the firm, since they will be unable to take advantage of short-term fluctuations in share price. However, as the authors themselves acknowledge, more will have to be done to align employees' incentives with long-term performance; for example, paying executives in restricted stock did not prevent the massive losses at Merrill Lynch.¹⁷³ Moreover, Bhaghat and Romano appear agnostic on the mix between incentive and non-incentive

166. Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010, Pub. L. No. 111-203, § 953, 124 Stat. 1376, 1903–04 (codified at 15 U.S.C. § 78n).

167. *Id.*

168. *Id.* at § 955, 124 Stat. at 1904–05.

169. Victor Fleischer, *Two Quick Workarounds on Executive Pay Caps*, CONGLOMERATE BLOG (Feb. 4, 2009), <http://www.theconglomerate.org/2009/02/two-quick-work-arounds-on-executive-pay.html>.

170. 12 U.S.C. § 5221(b)(3)(D)(i)(I) (2009). *See also* Fleischer, *supra* note 169 (noting that the effect on executive behavior of restricted stock vesting after the government is paid back is similar to the effect of a stock option).

171. *See* discussion *supra* Part II.

172. Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long Term*, 26 YALE J. ON REG. 359, 359 (2009).

173. Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Simplicity, Transparency, and Committing to the Long Term* 18 (Yale Law Sch. John M. Olin Ctr. for Stud. in Law, Econ., & Pub. Pol'y, Research Paper No. 393, 2009), available at <http://ssrn.com/abstract=1506742>.

pay, thus inviting firms to circumvent their proposal.¹⁷⁴ An even more important downside to their proposal is that the level of compensation would have to increase in order to compensate the executive for having to hold an undiversified and illiquid portfolio.¹⁷⁵ If the growing disparity in income levels between the labor force and chief executive is a destabilizing problem,¹⁷⁶ as well as a problem for long-term performance of the firm, paying executives in restricted stock at these necessarily higher levels will only exacerbate these problems. Moreover, as Walker notes, achieving the proper balance between bet-the-company risk-taking and executive risk aversion through regulation may be extremely difficult.¹⁷⁷

E. Dodd-Frank Wall Street Reform and Consumer Protection Act

Dodd-Frank has several provisions relating to executive pay. In addition to the revamped disclosure rules,¹⁷⁸ and the advisory “say on pay” votes that must be held at least every three years,¹⁷⁹ the issuer must also disclose golden parachute arrangements in any proxy solicitations for change of control transactions.¹⁸⁰ Such arrangements must also be subject to an advisory shareholder vote, unless already voted on by the shareholders. These shareholder votes are strictly advisory, however, and do not bind the board of directors or the issuer.¹⁸¹

174. See Bhagat & Romano, *supra* note 173 at 361. Although firms would have to give up their § 162(m) deduction if they did this, many firms appear willing to forego the deduction for top executives. See Steven Balsam & Qin J. Yin, *Explaining Firm Willingness to Forfeit Tax Deductions Under Internal Revenue Code Section 162(m): The Million Dollar Cap*, 24 J. ACCT. & PUB. POL’Y 300, 321–23 (2005) (discussing their finding that 40% of firms forfeited deductions).

175. Bhagat and Romano would solve the diversification and liquidity problems in three ways: first, by increasing the amount of restricted stock and options; second, by increasing the salary deduction to \$2 million; and third, by allowing executives to sell shares to the extent needed to pay taxes incurred for receiving restricted stocks and options in excess of the per-year limit. Bhagat & Romano, *supra* note 173, at 367–69.

176. *But see* FRENCH ET AL., *supra* note 48, at 76 (expressing doubt about whether “high levels of compensation are inherently destabilizing to individual firms or to the overall financial system”).

177. Walker, *supra* note 55, at 447.

178. See *supra* notes 157–165 and accompanying text.

179. See *supra* note 149 and accompanying text.

180. Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010, Pub. L. No. 111-203, § 951(b), 124 Stat. 1376, 1899–1900 (to be codified at 15 U.S.C. § 78n-1) (in any merger, acquisition, consolidation or sale of all or substantially all of the assets, the proxy solicitation must disclose the aggregate total of all compensation, present, deferred or contingent, and the conditions for payment).

181. *Id.* at § 951(c), 124 Stat. at 1900.

Compensation committees are now required for listing on a national exchange, and they must be comprised of independent directors.¹⁸² The relevant factors for director independence include sources of compensation, consulting or advisory fees paid by the issuer, and affiliation with the issuer or its subsidiaries.¹⁸³ Consultants or legal advisors to the compensation committee must be similarly independent. Moreover, the compensation committee must disclose whether it obtained the advice of a consultant, and if it had uncovered and addressed any conflict of interest.¹⁸⁴ The new legislation makes it a listing requirement to develop and implement a policy providing for disclosure of incentive compensation.¹⁸⁵

Claw-backs are also provided for the recovery of any compensation erroneously awarded due to an accounting restatement resulting from material noncompliance with financial reporting requirements.¹⁸⁶ These claw-back provisions appear more expansive than those under Sarbanes-Oxley, which required misconduct and were seldom enforced.¹⁸⁷ Although these claw-back provisions appear to be broader than those enacted by Sarbanes-Oxley, in that they require only material noncompliance rather than misconduct, the drawbacks in enforcing such provisions remain.

V. WHAT'S TO BE DONE?

There are good reasons to be concerned about the level of executive pay at large corporations. The disparity between CEO and worker pay erodes the middle class and encourages excess debt to keep the engine of consumption running.¹⁸⁸ Super compensation creates conflicts of interest between the firm and its executives.¹⁸⁹ Yet government intervention in executive pay has not been particularly successful in curbing exorbitant pay levels. The attempt to link pay to performance by capping deductibility at a million dollars resulted in huge pay increases in the form of (theoretically performance linked) stock

182. *Id.* at § 952, 124 Stat. at 1900–03 (amending the Securities Exchange Act by inserting § 10C).

183. *Id.*

184. *Id.*

185. *Id.* at §§ 953–54, 124 Stat. at 1903–04.

186. *Id.* at § 954, 124 Stat. at 1904 (amending the Securities Exchange Act by inserting § 10D)

187. *See supra* notes 143–147 and accompanying text.

188. *See supra* notes 34–35 and accompanying text.

189. *See* Steven L. Schwarcz, *Understanding the Subprime Financial Crisis*, 60 S. C. L. REV. 549, 562–63 (2009) (noting that financial independence implies a potential divergence of individual and firm interests).

options.¹⁹⁰ Attempts to limit deductibility of golden parachutes not only failed to discourage golden parachutes, but resulted in firms extending severance pay to any termination without cause, not just during change of control transactions.¹⁹¹

The problem with many of the solutions to the executive compensation conundrum, such as “say on pay,” is that while these provisions may curb the most outrageous pay packages, they do not affect incentives to take excessive risks. Even if executive pay is adjusted to better align shareholder and management interests by issuing restricted stock or other forms of pay with longer-term horizons, shareholders may prefer a higher level of risk taking than is optimal for other stakeholders in the firm, or for society as a whole. Similarly, increasing the independence and role of compensation committees may increase the accountability of directors for the pay packages they award, but in practice, this does little because of the dynamics of group decision-making. Some financial firms have attempted to take risk into account when measuring performance.¹⁹² The risk that these firms measured, however, was risk to the particular firm, rather than systemic risk.

Disclosure similarly fails to solve the problem of exorbitant pay insufficiently linked to performance. Here there are three problems. First, disclosure is not informative enough. Beyond disclosing the level of executive pay, disclosure should focus on the risk incentives of the pay package.¹⁹³ Disclosure rules should require disclosures regarding sensitivity of CEO wealth to performance measures such as stock price and earnings,

190. See *supra* notes 36-44 and accompanying text.

191. FRENCH ET AL., *supra* note 48, at 79 (“firms discovered that they could circumvent the new taxes on golden parachute payments by extending the payments to all terminations without cause”). The tax provisions at issue are I.R.C. § 280G (golden parachute payments are not deductible for the payor) and I.R.C. § 4999 (imposing a twenty percent excise tax on golden parachutes).

192. These firms used “value at risk” (VAR), which is a quantitative model that risk managers use to quantify a firm’s (or a trader’s) risk position, measured as a dollar figure. Joe Nocera, *Risk Mismanagement*, N.Y. TIMES, Jan. 4, 2009, at MM. The problem with such models is that they are based on assumptions that may not be accurate. For example, in valuing mortgage backed securities, the model used home price escalation assumptions formed at the height of the housing bubble. *Id.* Moreover, VAR measures only the short-term; it does not measure liquidity risk. *Id.* Plus, it can be gamed because it ignores miniscule risks of loss (no matter how large the unlikely loss may ultimately be). For example, the model was used by bankers to ignore the risk associated with credit default swaps, which had constant small gains and only rare losses. These losses turned out to be huge. *Id.*

193. See Core & Guay, *supra* note 18, at 28 (noting that “existing disclosures do not allow one to easily determine the overall sensitivity of executive compensation to firm performance”).

similar to disclosures required for the risks underlying financial instruments.¹⁹⁴ Second, better aligning shareholder and managerial interests does not solve the tragedy of the commons problem that directors and shareholders have little incentive to limit systemic risk.¹⁹⁵ Third, disclosure may have the unintended effect of ratcheting executive pay upward and may give rise to more opaque forms of compensation.¹⁹⁶

Relying on claw-backs as a reform measure is similarly fraught with difficulty. The problem with claw-backs is that measuring the effect of misstatements on bonus payouts can be quite complicated because accounting measures are often multi-year, and an earnings overstatement in one year will result in a reversal in a future period.¹⁹⁷ Moreover, determining whether a misstatement was material may require costly litigation.

Because of the commons problem, there is a role for government regulation in ensuring that firms do not engage in pay practices that increase systemic risk. The steps undertaken by Dodd-Frank are important first steps in engaging the problem. But more could, and should, be done

A. Deferred Compensation

The Squam Lake Report, written by fifteen leading economists in response to the emerging financial crisis, recommends deferring a significant percentage of CEO compensation, in cash, for several years.¹⁹⁸ Because the compensation would be forfeited if the government had to provide capital injections like those of TARP or other unusual guarantees of a firm's debt, it would act as a form of insurance.¹⁹⁹ These economists suggest that twenty percent of an executive's compensation should be held back for five years, and would ultimately be turned over to the executive only if the firm had neither declared bankruptcy nor received extraordinary government support

194. *Id.*

195. *See infra* Part II.B.

196. *See* Walker, *supra* note 23 at 658 (noting that “enhanced disclosure is a double-edged sword” that may lead to “less efficient, but more opaque compensation” and also to “compensation ratcheting upwards as firms benchmark compensation against each other”).

197. *See* Core & Guay, *supra* note 18, at 21 n.6 (discussing the difficulty of enforcing claw-back provisions).

198. *See* FRENCH ET AL., *supra* note 48, at 81–84.

199. *Id.* at 83.

during that time.²⁰⁰ The report advises that the deferred compensation should not be accelerated for resignation, but it is silent about termination.²⁰¹

Something along these lines is already practiced by the Swiss bank, UBS, which pays its executives' annual bonus into an escrow account, with payouts restricted to a third of the bonus each year.²⁰² Bonuses are added yearly, and the account balance is reduced if the business unit or the firm experiences a loss.²⁰³ This account is held for three years after the executive's termination.²⁰⁴ Similarly, firms issuing stock options or restricted stock to their top executives could do so with the provision of a pre-determined fixed schedule for cashing out.²⁰⁵ The advantage here would be that removing executives' control over the timing of equity sales discourages insider manipulation.²⁰⁶ The downside is that because deferred compensation decreases the executive's liquidity and diversification, executive pay levels may be forced upward.²⁰⁷

B. Tax Reform

The abject failure of § 162(m), as well as § 280G's golden parachute provisions,²⁰⁸ to halt the ballooning of executive pay counsel against attacking the problem of executive pay through corporate taxation strategies. Section 162(m), moreover, not only failed to curb excessive pay, but also created perverse incentives by discouraging index options and restricted stock, while encouraging nondiscretionary bonus formulas that encourage accounting manipulation.²⁰⁹

By all accounts, § 162(m) has failed to link pay to performance. If it has achieved neither of its objectives, neither limiting the rise of executive pay nor linking pay to performance, why not repeal it? Congress should simply abandon the deductibility limitations, and permit corporations to structure

200. *Id.* at 82–83.

201. *Id.* at 83.

202. *Compensation Report: UBS's New Compensation Model*, UBS (Nov. 17, 2008), <http://www.ubs.com/compensationreport> (summarizing UBS's compensation practices).

203. *Id.*

204. *Id.*

205. See Fried, *supra* note 42, at 455 (suggesting that institutional investors should urge firms to adopt a “hands-off” policy with a fixed and gradual schedule of payouts).

206. *Id.*

207. See *supra* text accompanying note 175.

208. See *supra* note 191.

209. See Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 926 (2007) (noting “the perverse incentives” created by § 162(m)).

their pay packages in whatever way makes most sense for the firm. This does nothing to limit executive pay, but then, neither has § 162(m).

Alternatively, the tax code could be revised to prohibit corporate deductions for the pay of a firm's top (say, five) executives. Deductions, after all, are commonly described as a matter of "legislative grace."²¹⁰ The reasoning that former President Clinton employed in justifying § 162(m) was that "the tax code should no longer subsidize excessive pay of chief executives and other high executives."²¹¹ That rationale applies equally to abandoning the deductions altogether.

One question is why corporations do not simply opt to forfeit the deductions. The obvious reason is that the company's overall tax liability will be greater, yet the amount at stake for the corporation will typically be too small for the cap on deductions to have much effect.²¹² Another reason may be the SEC disclosure rules, which require disclosure of the impact of § 162(m) on firm compensation policies.²¹³ Firms may fear shareholder outrage if they disclose that they have decided not to utilize this deduction. This fear, however, does not prevent nearly forty percent of firms from foregoing the deduction altogether.²¹⁴

Even if this proposal was adopted, revoking the deductions for executive pay only gets the federal government out of the business of structuring pay packages. It does not address the problem of the increasing disparity in income levels between the people at the top of the corporate hierarchy and the other employees. The disclosure of the gap between pay levels required by Dodd-Frank may help in this regard by shaming firms. However, it is unlikely that this will have any more effect than the public outrage over executive bonuses after the bailout. Rather than count on shaming to have an effect, why not focus on taxing the individuals reaping the exorbitant rewards? I am not suggesting a "CEO tax" similar to the one Britain levied

210. See David I. Walker, *Suitable for Framing: Business Deductions in a Net Income Tax System*, 52 WM. & MARY L. REV. (forthcoming Mar. 2011), available at www.bu.edu.law/faculty/scholarship/workingpapers/2010.html.

211. David E. Rosenbaum, *Business Leaders Urged By Clinton to Back Tax Plan*, N.Y. TIMES, Feb. 12, 1993, at A1.

212. The average Fortune 500 firm pays its top executives around 1.8% of its profits, so the actual effect of the deductibility cap is minimal. See Simmons, *supra* note 2, at 363.

213. Executive Compensation Disclosure; Securityholder Lists and Mailing Requests, Securities Act Release No. 7032, 55 SEC Docket 1352, 1355 (Nov. 22, 1993) (requiring proxy statement disclosure of "the registrant's policy with respect to qualifying compensation paid to its executive officers for deductibility under Section 162(m)").

214. Balsam & Yin, *supra* note 174.

on its bankers' bonuses,²¹⁵ but a progressive tax. A progressive tax which taxed a significantly higher percentage of income for those at the top two percent of the wealth pyramid would at least stabilize the system. Rather than attempting to curb pay levels indirectly through deduction caps, a progressive income tax would do far more toward leveling the social inequality that is the crux of the concern. Raising taxes is never a popular political option, but such a tax would nevertheless be far more effective than capping pay or capping deductions.

C. Get Serious About the Business Judgment Rule

Courts rarely overturn executive pay decisions, finding that complex business decisions like executive pay are particularly unsuitable for judicial review.²¹⁶ Courts protect boards' executive pay decisions through the business judgment rule.²¹⁷ In order for the business judgment rule to apply, however, the board must actually exercise its independent judgment and adhere to processes that help assure that they have carefully considered the matter carefully (e.g., employing independent consultants to advise the board).²¹⁸ Yet, in the litigation surrounding the severance package paid to Disney's former President, the courts recognized that the board was severely dysfunctional, but opted to lecture the directors rather than find them liable.²¹⁹

In the final opinion of the *Disney* case, the Delaware Supreme Court held that the business judgment rule protected the board's decision to terminate

215. See generally Paul Wilcott, *Gone with the Windfall*, N.Y. TIMES, Dec. 12, 2009, at WK10 (reporting on Britain's 50% windfall tax to be paid by banks on bankers' discretionary bonuses above \$40,000).

216. See, e.g., *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 838 (7th Cir. 1999) (opining that "judges are not competent to decide what business executives are worth"). Courts almost never overturn executive pay decisions at publicly held companies. Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 81-82 (1992) (collecting data).

217. For an explanation of the business judgment rule, see FRANKLIN A. GEVURTZ, CORPORATION LAW 286 (2d ed. 2010) ("The idea underlying the business judgment 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.").

218. See *In re Viacom Inc. S'holder Derivative Litig.*, 2006 N.Y. Misc. LEXIS 2891 at *22 (N.Y. App. Div. June 23, 2006) (declining to dismiss on finding the independence of the compensation committee questionable).

219. *Brehm v. Eisney (In re Walt Disney Co. Derivative Litig.)*, 907 A.2d 693, 697 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

Disney's president, Michael Ovitz, without cause,²²⁰ as well as the board's initial approval of his pay package, which included severance provisions that resulted in a \$130 million payout for fourteen months of work.²²¹ Although the court ultimately declined to hold the directors liable for breach of fiduciary duties or corporate waste, it noted that the compensation committee approved the terms of Ovitz's employment (including his pay package) after deliberating only an hour, during which time it also considered four unrelated matters.²²² Moreover, it was Michael Eisner, Disney's CEO, and a close friend of Ovitz, who negotiated the terms of employment. The board did not have the agreement or even complete information about the terms of the pay package before them when they deliberated.²²³ The compensation committee nonetheless unanimously approved the general terms of the agreement.²²⁴ Among the terms of the employment agreement was a severance provision that provided that termination for any reason other than gross negligence or malfeasance would result in substantial severance payments.²²⁵ In a later meeting, the compensation committee met to discuss issues relating to stock options, and ratified the entire employment agreement.²²⁶

When it became apparent that Ovitz was not working out, it was Eisner who made the decision to fire Ovitz without cause.²²⁷ The Disney board "had never met in order to vote on, or even discuss, the termination at a full session, and few if any directors did an independent investigation of whether Ovitz could be terminated for cause."²²⁸ Neither the Compensation Committee nor any other committee of the board met to vote on or discuss whether Ovitz could be terminated for cause.²²⁹

220. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d at 70.

221. *Id.* at 73.

222. *Id.* at 40. See also *In re Walt Disney Co. Derivative Litig.*, 907 A.2d at 708.

223. Nor were all the terms of Ovitz's pay revealed to the members of the Compensation Committee. Notably absent were the purchase of Ovitz's private jet for \$187,000 over the appraised value, the purchase of Ovitz's BMW at purchase price rather than depreciation value, and any specific list of perquisites. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d at 709 n.85.

224. *Id.* at 708–09.

225. The no-fault termination payment would consist of Ovitz's remaining salary, \$7.5 million per year for un-accrued bonuses, immediate vesting of options, and a \$10 million cash-out payment. *Id.* at 709. As it turned out, Ovitz's termination cost Disney \$130 million for his fourteen months in office. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d at 35.

226. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d at 710.

227. *Id.* at 731

228. *Id.* at 736.

229. *Id.*

Chancellor Chandler described the severance payments as “breathtaking.”²³⁰ Indeed, he noted that “many lessons of what not to do can be learned from defendants’ conduct here.”²³¹ He described the board as “supine” and “passive,”²³² and remarked on “Eisner’s success at surrounding himself with non-employee directors who would have sycophantic tendencies.”²³³ Although the board’s conduct “fell significantly short of the best practices of ideal corporate governance,” the lower court nevertheless declined to abrogate the business judgment rule.²³⁴

The lower court thus recognized directorial misconduct and structural bias, yet nevertheless felt constrained to merely lecture on the inappropriateness of the directors’ conduct while absolving the directors of liability for breach of duty of care, good faith, or corporate waste. On appeal, the Supreme Court rested its conclusion on its analysis of whether the CEO was permitted to terminate Ovitz without authorization of the board, and focused this analysis on the firm’s certificate of incorporation and by-laws.²³⁵ The certificate provided that the company’s officers “shall hold their offices for such terms and shall carry out such duties as are determined solely by the Board of Directors, subject to the right of the Board of Directors to remove any officer or officers at any time with or without cause.”²³⁶ Because the certificate does not repeat the term “solely” with respect to the board’s removal right, the court turned to the Disney by-laws.²³⁷ After concluding that the Disney by-laws were ambiguous, however, the court upheld the chancellor’s interpretation that the by-laws gave concurrent power to the board and the CEO on the basis of extrinsic evidence that “the Board unanimously believed that Eisner, as Chairman and CEO, possessed the power to terminate Ovitz.”²³⁸

230. *Id.* at 698.

231. *Id.* at 760.

232. *Id.* at 760 n.487.

233. *Id.* at 760, 760 n.488 (commenting that “Eisner stacked his . . . board of directors with friends and other acquaintances”).

234. *Id.* at 697.

235. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d at 69–70.

236. *Id.* at 68.

237. *Id.* at 69. For an article castigating the court’s analysis of Disney’s governing documents, see Marc I. Steinberg & Matthew D. Bivona, *Disney Goes Goofy: Agency, Delegation, and Corporate Governance*, 60 HASTINGS L.J. 201, 208 (2008) (contending that “the court made a fundamental flaw in its analysis” because, if the certificate vested exclusive removal power in the board, the by-laws could not make it concurrent).

238. *In re Walt Disney Co. Derivative Litig.*, 906 A.2d at 69. The Disney by-laws provided that the Board Chairman/ CEO “shall, subject to the provisions of the Bylaws and the control of the Board of Directors, have general and active management, direction, and supervision over the business of the Corporation and over its Officers.” *Id.* at 68. The court

Even under the court's interpretation, however, concurrent power is not unilateral power.²³⁹ The board never met to discuss whether Ovitz could be terminated for cause. The business judgment rule does not protect abdication of directorial responsibilities. A more courageous court would have noted the absence of procedures, the lack of independence, the utter failure to exercise judgment, and held that the business judgment rule does not apply to these circumstances. Without a considered business judgment, there is nothing deserving of protection.

Corporations are supposed to be managed by the board of directors for a reason. Theoretically, the group decision-making of the board, where there is open group deliberation, where a range of alternatives is considered, and competing ideas vetted, is superior to individual decision-making. If, instead of engaging in informed, deliberative decision-making, the board simply defers to the CEO, there is little reason to protect their decisions. Court deference to such decisions is an unwarranted abdication of judicial decision-making. Absent a record of the deliberative process for a decision, the court has no basis for invoking the rule's protection.

VI. CONCLUSION

The regulation of systemic risk is the centerpiece of the Dodd-Frank Act, which imposes reforms on any firm deemed to be of systemic significance, whether currently regulated as a bank, insurance company, or largely unregulated, as long as its size, leverage and interconnectedness pose a threat to financial stability should it fail. Its requirements that firms disclose the relationship of pay to performance, CEO hedging activity, and the ratio between CEO and median worker pay, demonstrate a salutary focus on the

acknowledged that this language neither vested power to terminate exclusively in the board nor gave express concurrent power to both the board and the CEO. *Id.* at 69. Thus, the Court found the by-laws ambiguous and therefore held that it was permissible for the Chancellor to turn to extrinsic evidence in interpretation. *Id.*

239. The Chancery Court commented that "a reasonably prudent CEO . . . would not have acted in as unilateral a manner as did Eisner when essentially committing the corporation to hire a second-in-command, appoint that person to the board, and provide him with one of the largest and richest employment contracts ever enjoyed by a non-CEO." *In re Walt Disney Co. Derivative Litig.*, 907 A.2d at 761–62. Chancellor Chandler further remarked that "[b]y virtue of his Machiavellian (and imperial) nature as CEO, and his control over Ovitz's hiring in particular, Eisner to a large extent is responsible for the failings in process that infected and handicapped the board's decisionmaking abilities." *Id.* at 760. Both courts nevertheless failed to recognize, however, that under its own jurisprudence, a supine board is undeserving of business judgment rule protection.

structure of pay packages in these firms. “Say on pay” votes may be largely toothless, but they at least provide the directors with feedback on their pay decisions.

At the same time, Dodd Frank’s claw-back provisions, though more enforceable than those of the Sarbanes-Oxley Act, are not sufficiently deterrent for executives willing to undertake excessive risk. Deferred compensation would be a preferable option. Moreover, there are still distorting influences left in place. At a minimum, § 162(m)’s deduction for stock option pay should be repealed. An even better route would be to completely discontinue the government’s subsidy of executive pay by repealing the corporate deduction for the top few executives. If income inequality is truly a concern, abandoning this subsidy and implementing a progressive tax aimed at highly compensated executives would appear to be a better redistribution solution. Finally, courts need to take the business judgment rule seriously. Although courts cannot be expected to structure pay packages for directors, they can examine the process by which decisions on executive pay are made. A board’s failure to engage in a process of informed deliberation should not be protected by the courts.