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Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance

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TOO MUCH PAY, TOO MUCH DEFERENCE: BEHAVIORAL
CORPORATE FINANCE, CEOs, AND CORPORATE GOVERNANCE

Troy A. Paredes

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TOO MUCH PAY, TOO MUCH DEFERENCE: BEHAVIORAL CORPORATE FINANCE, CEOS, AND CORPORATE GOVERNANCE

TROY A. PAREDES*

ABSTRACT

In this Article, Professor Paredes considers the implications of behavioral corporate finance, and of CEO overconfidence especially, for corporate governance. To date, corporate governance has focused on solving conflicts of interest and on motivating managers to work hard—in other words, on traditional agency problems. Corporate governance has not emphasized the need to remedy the kind of “good-faith mismanagement” that results when CEOs are overconfident, although well-intentioned and hard-working.

In addition to detailing the effects of CEO overconfidence, Professor Paredes theorizes that CEO overconfidence is actually a product of corporate governance. First, Professor Paredes explains that high executive compensation gives positive feedback to a CEO and signals that the chief executive is a success. Studies show that positive feedback and recent success can result in overconfidence. Indeed, the very process of winning the tournament to become the top executive probably makes a CEO more confident. Stressing the possible link between CEO pay and CEO overconfidence offers a new behavioral approach to executive compensation that emphasizes the impact of executive pay on managerial psychology and decisionmaking. Second, a CEO-centric model of corporate governance is predominant in the United States as boards, subordinate officers, gatekeepers, judges, and shareholders defer to the chief executive, even in the post-Sarbanes-Oxley era. Professor Paredes suggests that CEOs can become overconfident as a result of the extensive corporate control concentrated in their hands and the fact that they are rarely seriously challenged.

Professor Paredes concludes by considering how to change corporate governance to manage CEO overconfidence. One possibility is

* Associate Professor of Law, Washington University School of Law. Special thanks are owed to Amitai Aviram, Larry Garvin, Mitu Gulati, Chris Guthrie, Adam Hirsch, Jonathan Klick, Russell Korobkin, Kim Krawiec, Don Langevoort, Tim Malloy, Greg Mitchell, Phil Tetlock, and other participants at the 2004 symposium on The Behavioral Analysis of Legal Institutions: Possibilities, Limitations, and New Directions held at the Florida State University College of Law. Useful comments were also received from participants at a workshop at Loyola Law School. Finally, I would like to thank Brian Anton, Chris Bracey, Bill Bratton, Kathleen Brickley, John Drobak, Lyman Johnson, Peter Joy, Scott Kieff, Pauline Kim, Ron King, Joe Lehrer, James O’Loughlin, and Joel Seligman for helpful comments and discussions that assisted in writing this Article. Rob Denney (law school class of 2004) and Alexandra Gilpin (law school class of 2005) did a great job providing invaluable research assistance. An earlier draft of this Article was circulated under the working title, *Too Much Pay, Too Much Deference: Is CEO Overconfidence the Product of Corporate Governance?* All mistakes, of course, are mine.

to appoint a “chief naysayer” to the board whose job is to be a devil’s advocate. This Article also explores the possibility of stiffening the fiduciary duty of care to account for CEO overconfidence and considers giving shareholders greater say over takeover decisions and greater ability to bring derivative actions. In sum, Professor Paredes argues that corporate governance should move beyond managerial motives to account more for human psychology and for how managers actually make business decisions.

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I. INTRODUCTION

Comcast Corporation’s stock traded down eight percent on the day the company publicly announced its unsolicited offer to acquire The Walt Disney Company for \$66 billion, including the assumption of debt.¹ As the market digested the deal in the days following its announcement, Comcast’s stock continued to fall, and the company ultimately shed over \$9 billion of shareholder value by the end of the week.² Maybe investors just needed time to appreciate the putative benefits of merging Disney’s content with Comcast’s distribution network.³ On the other hand, maybe investors were right to bid Com-

1. Peter Loftus & Janet Whitman, *Street Sleuth: Arbs Are Wary on a Comcast Play*, WALL ST. J., Feb. 12, 2004, at C3. On the announcement of Comcast’s bid, Disney’s stock shot up fifteen percent and ended up trading above the bid price by over three dollars a share. *Id.*

2. David Harding & Sam Rovit, *The Mega-Merger Mouse Trap*, WALL ST. J., Feb. 17, 2004, at B2.

3. For a good summary of events surrounding Comcast’s bid, see Bruce Orwall & Peter Grant, *Mouse Trap: Disney, Struggling to Regain Glory, Gets \$48.7 Billion Bid from Comcast*, WALL ST. J., Feb. 12, 2004, at A1.

cast's stock down after the Disney bid. Investors not only voted with their money by shying away from Comcast's shares, but they openly questioned the rationale for the deal and worried aloud that Comcast would overpay.⁴ Investors worried that Comcast's senior management was unrealistically optimistic about the prospects for a combined Comcast-Disney, given the operational and cultural integration challenges that any strategic mega-merger must overcome for the combination to succeed.⁵ Even if the deal could have been supported at Comcast's initial bid, a higher price for Disney might not have been sensible; yet investors knew that it might be hard for Comcast and its CEO, Brian Roberts, to walk away from the table once the bidding began.⁶

A vast literature shows that people tend to be overconfident. As De Bondt and Thaler have noted, "[p]erhaps the most robust finding in the psychology of judgment is that people are overconfident."⁷ People tend to be too optimistic about outcomes they believe they control and to take too much credit for success while blaming other factors for failure or underperformance. Not surprisingly, people tend to believe that they exert more control over results than they actually do, discounting the role of luck and chance.

It is not new to suggest that business executives, particularly CEOs, suffer from overconfidence—often referred to more pejoratively as executive “ego,” “hubris,” or “arrogance.” In fact, it is reasonable to believe that people in powerful and influential positions with track records of success—qualities that typify CEOs, especially of large public companies—might particularly be overconfident and prone to believe that they are in control. Such self-serving tendencies

Not only did investors have to get comfortable with the rationale for the deal—other high-profile deals premised on merging content and distribution include the AOL-Time Warner deal and General Electric's acquisition of Universal Vivendi's entertainment assets—but the market was also concerned about the potentially dilutive effect of issuing 0.78 shares of Comcast for each Disney share plus the constraints that assuming nearly \$12 billion of debt would impose on Comcast.

4. See, e.g., Peter Grant, *Edgy Holders Constrain Comcast*, WALL ST. J., Feb. 20, 2004, at C1; Robert A. Guth et al., *In Disney Fight, the 600-lb. Gorilla Just Might Sit It Out*, WALL ST. J., Mar. 5, 2004, at C1; Harding & Rovit, *supra* note 2.

5. For an interesting story on the unique Disney culture and the particular challenges it poses for any deal, see Bruce Orwell & Emily Nelson, *Small World: Hidden Wall Shields Disney's Kingdom: 80 Years of Culture*, WALL ST. J., Feb. 13, 2004, at A1.

6. Although Comcast ultimately dropped its bid, concern that the company would overpay was reasonable. Indeed, to assuage investor worries, CEO Roberts insisted that the company would not overpay for Disney. See, e.g., Bruce Orwell, *Eisner's Critics Keep Up Pressure at Walt Disney*, WALL ST. J., Mar. 10, 2004, at A3.

7. Werner F.M. De Bondt & Richard H. Thaler, *Financial Decision-Making in Markets and Firms: A Behavioral Perspective*, in 9 HANDBOOKS IN OPERATIONS RESEARCH AND MANAGEMENT SCIENCE: FINANCE 385-410 (R.A. Jarrow et al. eds., 1995).

might be amplified still further for so-called “celebrity” CEOs, who are regarded more for their charisma than their managerial skills.⁸

Although it is impossible to know whether Comcast CEO Brian Roberts suffered from overconfidence, investor skepticism of Comcast’s bid for Disney was well-founded. The idea that overconfidence might drive a manager to overpay when bidding for a company is traceable to Roll’s seminal work on the “hubris hypothesis” of corporate takeovers⁹ and to Thaler’s influential work on the “winner’s curse.”¹⁰ A rich body of subsequent empirical research has shown that acquisitions frequently destroy firm value when a bidder’s managers overvalue the deal and overestimate their ability to execute the deal successfully.¹¹ The other side of the acquisition coin also deserves mention. While a bidder’s shareholders have to worry about overpayment, a target company’s shareholders have to worry that the target board and its management team, even if loyal and not seeking to entrench themselves, will adopt defensive tactics to fend off an unsolicited bid because they are too confident in their business plan and in their ability to manage the company going forward.¹² Moreover, acceding to an unsolicited bid requires the target’s CEO and board to admit, at least on some level, that the bidder’s team has

8. See generally RAKESH KHURANA, *SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISMATIC CEOs* (2002) (discussing the charismatic CEO); HOWARD KURTZ, *THE FORTUNE TELLERS: INSIDE WALL STREET’S GAME OF MONEY, MEDIA, AND MANIPULATION* (2000); Diane L. Coult, *Putting Leaders on the Couch: A Conversation with Manfred F.R. Kets de Vries*, HARV. BUS. REV., Jan. 2004, at 64 (discussing CEO psychology and power); Michael Maccoby, *Narcissistic Leaders: The Incredible Pros, the Inevitable Cons*, HARV. BUS. REV., Jan.-Feb. 2000, at 68 (discussing CEO narcissism); Lynn R. Offermann, *When Followers Become Toxic*, HARV. BUS. REV., Jan. 2004, at 54 (describing how charismatic leaders are susceptible to flattery and ingratiation by others).

9. Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986).

10. RICHARD H. THALER, *THE WINNER’S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE* (1992) [hereinafter THALER, *WINNER’S CURSE*]; Richard H. Thaler, *Anomalies: The Winner’s Curse*, J. ECON. PERSP., Winter 1998, at 191 [hereinafter Thaler, *Anomalies*].

11. Acquisitions can also destroy firm value when management tries to build an empire or fails to exercise adequate diligence.

12. See, e.g., J.B. Heaton, *Managerial Optimism and Corporate Finance*, 31 FIN. MGMT. 33, 42-43 (2002) (explaining the decision of optimistic managers to fend off an unsolicited bid). For more on defensive tactics and the market for corporate control, see, for example, Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003); Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695 (1985); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target’s Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Troy A. Paredes, *The Firm and the Nature of Control: Toward a Theory of Takeover Law*, 29 J. CORP. L. 103 (2003); and Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: “Sacred Space” in Corporate Takeovers*, 80 TEX. L. REV. 261 (2001). In some sense, defensive tactics may be an antidote to bidder overconfidence.

a better strategy for the target and is better positioned to run the company.¹³ Such admissions do not come easy.¹⁴

The problem of CEO overconfidence, my focus in this Article and a central concern of the growing field of behavioral corporate finance, is generalizable and not limited to acquisitions.¹⁵ In fact, the problem of overconfidence is not limited to CEOs or firms but can affect all organizations. Overconfidence affects business decisions of all sorts by leading executives to overestimate a project's benefits, which then never materialize, and to understate a project's costs, which turn out to be higher than expected.¹⁶ Put differently, as a result of CEO overconfidence, companies are led to undertake and invest in projects that do not maximize firm value. An overconfident CEO will tend to take irrational risks, which can be modeled as investing in projects that have a negative expected net present value when considered more objectively.¹⁷ Corporate decisionmaking processes—in other words, corporate governance—should address such flawed decisionmaking, which not only destroys shareholder value but also harms all corporate constituencies and risks misallocating capital away from more productive uses. CEO overconfidence is a concern whether the purpose of corporations is to maximize shareholder value or to serve broader social goals.¹⁸

Nobody knows why people act and think the way they do. Behavioralism, which pushes beyond rational choice theory to take account of the psychology of decisionmaking, has been criticized as unsup-

13. Of course, this admission can be made less painful if target managers receive significant golden parachutes upon selling the company. See, e.g., Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 899 (2002).

14. It is hard enough for a manager or director of the target to make such an admission to himself, let alone to make such an admission publicly by recommending the bid to target shareholders.

15. Investor overconfidence (as compared to managerial overconfidence) is a similar concern. See, e.g., Simon Gervais & Terrance Odean, *Learning to Be Overconfident*, 14 REV. FIN. STUD. 1 (2001); Richard Deaves et al., An Experimental Test of the Impact of Overconfidence and Gender on Trading Activity (Nov. 21, 2003) (unpublished manuscript), available at <http://ssrn.com/abstract=497284>. See generally Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 444 n.126 (collecting citations regarding overconfidence and behavioral finance).

16. Lovallo and Kahneman refer to managers who see business opportunities through “rose-colored glasses,” in effect “setting themselves up for failure.” Dan Lovallo & Daniel Kahneman, *Delusions of Success: How Optimism Undermines Executives' Decisions*, HARV. BUS. REV., July 2003, at 56, 57-58. For more on the consequences of CEO overconfidence, see *infra* Part II.B.

17. See, e.g., Heaton, *supra* note 12, at 43; Avishalom Tor & Max H. Bazerman, *Focusing Failures in Competitive Environments: Explaining Decision Errors in the Monty Hall Game, the Acquiring a Company Problem, and Multiparty Ultimatums*, 16 J. BEHAV. DECISION MAKING 353 (2003).

18. For more on the theory of the firm and the purpose of corporations, see Paredes, *supra* note 12, at 108-38.

ported by a general theory of human behavior and as simply observing that people deviate from perfect rationality but in uncertain ways. Critics of behavioralism contend that it is ultimately of little help in fashioning legal and regulatory regimes because its indeterminacy sheds little light on how to craft better rules of the game.¹⁹ We still have a great deal to learn about human psychology and its implications for the law, as well as for industrial organization and organizational behavior more generally. However, as Thaler put it, “[I]t is important to keep in mind that rationality is an assumption in economics, not a demonstrated fact.”²⁰

Although a number of factors might affect CEO behavior, such as CEO age, tenure, education, and socioeconomic background,²¹ I theorize that CEO overconfidence is in important ways a product of corporate governance. Corporate governance structure and practice in the United States is likely to lead to CEO overconfidence in two key

19. Korobkin captured the essence of the critics’ concern as follows:

To date, social scientists have been unable to provide a detailed understanding of the mechanics of heuristic reasoning sufficient for lawmakers to predict with a high degree of confidence the specific contexts in which heuristic reasoning will deviate from the predictions of [rational choice theory] in ways that will hinder the fulfillment of the law’s substantive goals. The available research concerning *which* heuristics are employed *when* remains largely a set of disparate empirical results, with each study serving as a small piece to a large puzzle with gaping holes.

RUSSELL KOROBKIN, THE PROBLEMS WITH HEURISTICS FOR LAW 12 (UCLA School of Law, Law & Econ. Research Paper No. 04-1, 2004) (footnote omitted), *available at* <http://ssrn.com/abstract=496462>. Richard Posner has been harsher, criticizing behavioralists for not having “an economic theory to set against rational-choice theory.” Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551, 1558 (1998).

20. Thaler, *Anomalies*, *supra* note 10, at 200. The facts on the ground, as demonstrated by a mounting body of empirical work, belie the assumption of rationality and the rational choice model of human behavior. Rather, people have limited cognitive abilities and have been shown to suffer from various cognitive biases that affect how they behave and make decisions. For more on irrationality and behavioral law and economics, see generally BEHAVIORAL LAW AND ECONOMICS (Cass R. Sunstein ed., 2000); HEURISTICS AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT (Thomas Gilovich et al. eds., 2002) [hereinafter HEURISTICS AND BIASES]; JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES (Daniel Kahneman et al. eds., 1982); CHOICES, VALUES, AND FRAMES (Daniel Kahneman & Amos Tversky eds., 2000); ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000); THE LAW AND ECONOMICS OF IRRATIONAL BEHAVIOR (Francesco Parisi & Vernon L. Smith eds., 2005); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998); and Russell Korobkin, *A Multi-Disciplinary Approach to Legal Scholarship: Economics, Behavioral Economics, and Evolutionary Psychology*, 41 JURIMETRICS 319 (2001). Not only are individuals boundedly rational and subject to various cognitive biases that affect decisionmaking, but individuals routinely make decisions based on imperfect information.

21. For studies of various characteristics that affect managerial decisionmaking, see, for example, Donald C. Hambrick & Phyllis A. Mason, *Upper Echelons: The Organization as a Reflection of Its Top Managers*, 9 ACAD. MGMT. REV. 193 (1984); Michael A. Hitt & Beverly B. Tyler, *Strategic Decision Models: Integrating Different Perspectives*, 12 STRATEGIC MGMT. J. 327 (1991); and David Norburn, *The Chief Executive: A Breed Apart*, 10 STRATEGIC MGMT. J. 1 (1989).

ways. The first relates to executive compensation. A large executive compensation package gives positive feedback to a CEO and signals that the chief executive is a success. Studies show that positive feedback and recent success build confidence.²² In this view, the very process of winning the tournament to become the top executive probably makes a CEO more confident. Indeed, highly confident individuals presumably self-select into the tournament to become CEO in the first place. The leading theoretical approaches to executive compensation—which generally break down into the so-called “optimal contracting approach” and the “managerial power approach”—try to explain the size and design of executive compensation,²³ while other approaches focus on whether the size of CEO pay is “just” or “fair” as compared to what the average worker receives. Stressing the possible link between CEO pay and CEO overconfidence offers a new “behavioral approach” to executive compensation that is more concerned with the psychological consequences of executive pay—namely, the risk of bad business decisions, particularly overinvestment, rooted in growing CEO confidence—than with the incentive effects or fairness concerns associated with how and how much CEOs are paid.

Large executive compensation packages are paid against the backdrop of a corporate governance system that is, to a large extent, characterized by deference to the CEO. Boards have been criticized, especially after the scandals at Enron, WorldCom, Tyco, Adelphia, and elsewhere, as being too quiescent and too willing to follow the CEO.²⁴ This is either because board members do not have the time, information, or expertise to challenge the CEO on business matters or because the directors lack independence and are therefore reluctant to stand up to the chief executive.²⁵ Emblematic of the separation of ownership and control,²⁶ shareholders do not have the legal authority to exercise direct authority over the business and only have the right to vote on a few matters, including electing the board of directors and approving a small number of fundamental corporate changes, such as mergers. The cost and practical difficulties of coordinating dispersed shareholders further frustrates shareholder voice. Although share-

22. See sources cited *infra* note 171.

23. For a thorough treatment of both approaches to executive pay, see Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

24. See, e.g., Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress*, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 495 (Nancy B. Rapoport & Bala G. Dharan eds., 2004). The boards at Enron, WorldCom, and Tyco became exemplars of board failings as scandals at the companies broke.

25. See *infra* Part III.B.3.

26. See generally ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932); Paredes, *supra* note 12, at 109-12 (discussing Berle and Means and the principal-agent model of the firm).

holders have been more active and have been speaking with a louder voice post-Enron, for the most part, public shareholders remain distant from actual corporate decisionmaking and are relegated to following the “Wall Street Rule,” selling their shares if they are not happy with the company’s direction and are dissatisfied with its performance.²⁷ In short, there is little opportunity for shareholders to challenge the CEO directly, and institutional investors, the most likely shareholder counterweight to the CEO, are often reluctant to exercise what influence they do have or to criticize management publicly.²⁸ Finally, under the business judgment rule, courts defer to the CEO, as well as to the rest of the management team and the board, when it comes to how the business is managed.²⁹ Judges recognize that they are ill-equipped to second-guess the substance of business decisions and are afraid of chilling businesses from taking risks by subjecting directors and officers to legal liability for breach of fiduciary duty when a business decision, made and executed in good faith, turns out badly.

This, then, leads to the second way CEO overconfidence might be the product of corporate governance. The scandals, beginning with Enron in 2001, reinforced a continuing concern that many people have: that the United States corporate governance system, especially as in place before the recent spate of reforms, contains inadequate checks and balances to stem managerial disloyalty and corruption.³⁰ My concern is different and centers not on disloyalty and corruption, but on good-faith business errors. My theory is that CEOs are emboldened and more confident as a result of the great deal of corporate control concentrated in their hands, as well as the fact that their business judgment is deferred to and their exercise of control is for the most part unchallenged. In sum, my hypothesis is that deference to the CEO can bolster CEO confidence.

This Article proceeds as follows. Part II lays out the general framework of analysis, giving a detailed account of CEO overconfidence and how it can lead to mismanagement, even when a CEO is

27. Although shareholders do not have direct control over the business, shareholders are asserting themselves more post-Enron, as evidenced by a rise in institutional investor activism and more aggressive use of the shareholder proposal process under the federal securities laws.

28. See, e.g., Robert C. Pozen, *Institutional Perspective on Shareholder Nominations of Corporate Directors*, 59 BUS. LAW. 95 (2003) (discussing why institutional investors may choose to sell their stock instead of participating more actively in corporate governance).

29. When addressing the courts or corporate law in this Article, I am referring to the Delaware bench and to Delaware corporate law, since Delaware is the dominant state in the United States when it comes to corporate law and public company incorporation.

30. For summaries of these reforms, see, for example, William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003); Paredes, *supra* note 24.

trying to run the firm well. Part III examines how CEO pay and the deference shown to CEOs can contribute to CEO overconfidence. Having examined the consequences and potential causes of CEO overconfidence, this Article continues in Part IV by considering how corporate governance could incorporate techniques for managing CEO overconfidence, chief among them being efforts to ensure that the CEO and the board of directors “consider the opposite,” that is, meaningfully consider arguments against some proposed course of action. One possibility is to appoint a “chief naysayer” whose job is to be a devil’s advocate, punching holes in proposals before the company commits to them.

Part IV also addresses what managerial overconfidence might mean for the law of fiduciary duty and the business judgment rule. In its present form, the business judgment rule insulates directors and officers from liability when they do not act in bad faith or disloyally and when the consideration of the challenged business decision is not grossly inadequate. In other words, poor business decisions that are undertaken in the honest belief that they are in the best interests of the corporation and its shareholders do not run afoul of fiduciary obligations. The risk posed by CEO overconfidence is that it results in just this type of “good-faith mismanagement” of the business. Part IV explores the possibility of extending the law of fiduciary duty to cover mismanagement that is rooted in managerial overconfidence,³¹ while mindful that greater judicial oversight risks undercutting the basic tenets of the business judgment rule. Instead of asserting themselves more into corporate decisionmaking, courts could simply encourage voluntary best practices designed to counteract CEO overconfidence. Courts could also afford shareholders a greater role, particularly when it comes to corporate control transactions and the right to bring derivative lawsuits.

The possibilities for reform explored in Part IV help develop a behavioral model of corporate governance and an agenda for further study. However, caution is warranted before corporate governance is revamped radically to address CEO overconfidence or other aspects of managerial psychology.

31. Notably, Vice Chancellor Strine of the Delaware Court of Chancery recently wrote an opinion in which he accounts for psychology in finding that members of a special litigation committee were not independent from the defendant-directors charged with breach of fiduciary duty. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003). *But see* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040 (Del. 2004) (arguably cutting back on Vice Chancellor Strine’s *Oracle* opinion). For an academic precursor to Vice Chancellor Strine’s reasoning in *Oracle*, see James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS., Summer 1985, at 83 (considering the implications of “structural bias” on directors).

First, although a growing number of studies support the claim that CEOs are overconfident, it is hard to measure the extent of CEO overconfidence. It is even more difficult to calculate the magnitude of the impact CEO overconfidence has on actual business decisions, particularly since what seems like overconfidence might be explained in terms of imperfect information or conflicts of interest. What specific deals, for example, would a CEO have passed over if he were not overconfident?

Second, strategies for managing CEO overconfidence center on achieving a more balanced assessment of project payoffs by institutionalizing dissent or otherwise encouraging opposing viewpoints to ensure that risks are properly accounted for. A balanced appraisal of risk is important even in a rational actor model of managerial decisionmaking. However, when attention is focused on risk and on arguments against a project, CEOs and other managers might be dissuaded from taking even prudent risks and might become too tentative. An overconfident and decisive CEO might be better than a hesitant CEO who is reluctant to make decisions.

Third, many claim that CEOs are risk-averse, staking out a more cautious agenda for the firm than shareholders would prefer. In this view, CEOs purposely manage the business more conservatively to protect their firm-specific human capital (that is, their jobs). If CEOs are in fact risk-averse, CEO overconfidence might actually lead to a more optimal level of risk-taking by counterbalancing a CEO's risk aversion.

Finally, because we still have a great deal to learn about decisionmaking, any recommendations for reforming corporate governance based on our present understanding of managerial psychology are tentative.

In the past, corporate governance has emphasized solving agency problems rooted in the potential conflict of interest between directors and officers, on the one hand, and shareholders, on the other.³² Without question, the scandals at Enron and elsewhere show that it is important to continue improving both legal and nonlegal mechanisms that remedy conflict-of-interest problems by guarding against looting, fraud, and other forms of corporate corruption and disloyalty and by incentivizing managers, as well as boards, to maximize shareholder value. The added challenge for corporate governance is to move beyond managerial motives to account more for human psy-

32. See, e.g., Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

chology and how managers actually behave and make business decisions when they are well-intentioned and hard-working.³³ Although radical reform is not appropriate, measured steps toward implementing a behavioral approach to corporate governance should be considered.

II. ANALYTIC FRAMEWORK: AN OVERVIEW OF CORPORATE DECISIONMAKING

A. *A Brief Introduction to Corporate Decisionmaking*

It is inescapable in business that managers will make decisions that turn out poorly. Running a company requires taking risks and acting on the basis of imperfect information.³⁴ Waiting for certainty is not workable. Further, most companies face stiff competition. Sometimes a single tough competitor can squeeze a company, as compa-

33. For a sampling from the growing field of behavioral law and economics that focuses on corporate governance and securities regulation, see Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1 (2002); Lawrence A. Cunningham, *Behavioral Finance and Investor Governance*, 59 WASH. & LEE L. REV. 767 (2002); Lynne L. Dallas, *A Preliminary Inquiry into the Responsibility of Corporations and Their Officers and Directors for Corporate Climate: The Psychology of Enron's Demise*, 35 RUTGERS L.J. 1 (2003); James A. Fanto, *Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 BUFF. L. REV. 249 (2001) [hereinafter Fanto, *Braking the Momentum*]; James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L.J. 1333 (2001) [hereinafter Fanto, *Quasi-Rationality*]; James A. Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 OR. L. REV. 435 (2004) [hereinafter Fanto, *Whistleblowing*]; Kimberly D. Krawiec, *Accounting for Greed: Unraveling the Rogue Trader Mystery*, 79 OR. L. REV. 301 (2000); Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997) [hereinafter Langevoort, *Organized Illusions*]; Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135 (2002) [hereinafter Langevoort, *Taming the Animal*]; Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968 (2002) [hereinafter Langevoort, *Hyper-Competition*]; Paredes, *supra* note 15; Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397 (2002); Hillary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903 (2002); Robert B. Thompson, *Securities Regulation in an Electronic Age: The Impact of Cognitive Psychology*, 75 WASH. U. L.Q. 779 (1997); and 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 (2004) [hereinafter Langevoort, *Resetting the Thermostat*].

This Article fits in with contemporaneous work by Langevoort, in which Langevoort argues for enhanced internal reporting controls that are “dialed up” as the risk of self-serving managerial behavior increases. See Langevoort, *Resetting the Thermostat*, *supra*. Additionally, prior work by Hayward and Hambrick studied potential causes of CEO overconfidence in an effort to explain premiums in acquisitions. See Mathew L.A. Hayward & Donald C. Hambrick, *Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris*, 42 ADMIN. SCI. Q. 103 (1997).

34. For an interesting survey of managerial views of risk, many of which are discussed below, see James G. March & Zur Shapira, *Managerial Perspectives on Risk and Risk Taking*, 33 MGMT. SCI. 1404 (1987).

nies as diverse as Home Depot and Lowe's, on the one hand, and AMD and Intel, on the other, can attest.³⁵ Stated differently, ill-advised business decisions and business failures are common occurrences in a free-market system.

The agency model of managerial decisionmaking illuminates problems other than the inherent risk of business and the need for companies to withstand competitive pressures.³⁶ Simply, there is no reason to assume that managers are necessarily motivated to maximize shareholder value.³⁷ To the contrary, the central theme of the agency model is that when the interests of managers and shareholders diverge, managers, if unchecked, will place their own self-interests before the best interests of the corporation and its shareholders. Three brief examples, centering on overinvestment (that is, the undertaking of negative net present value projects), illustrate this concern.³⁸

First, even if a business decision is ill-advised on a net present value basis³⁹ but ultimately pays off, it can result in the promotion of the managers who were behind the project in the first place. Individuals might distinguish themselves as able and confident managers and accordingly advance in rank and pay within an organization as a result of the project's success and for having made a bold and decisive move.⁴⁰ Indeed, the process by which managers rise to the top of the corporate hierarchy is often described in terms of a "winner take all" tournament in which individuals who advance to the next round are likely to be those who take risks that pay off, whether as a result of skill, luck, or some combination of the two.⁴¹ Managers

35. A market may even be competitive without actual competitors if a dominant company faces meaningful potential competition.

36. For more on the agency model of the firm, see sources cited *supra* note 32. See also Paredes, *supra* note 12, at 109-12; Thompson & Smith, *supra* note 12, at 268-69.

37. In this Article, I adopt a shareholder primacy view of the firm and of positive corporate law. See Paredes, *supra* note 12, at 127-32 (defending shareholder primacy).

38. There is also an underinvestment risk. Managers may be too cautious in order to preserve their jobs. See *infra* notes 114 and 159 and accompanying text.

39. Conventional net present value calculations, in that they focus on cash flow as opposed to the "intangible" benefits of some course of action that quantitative models do not readily capture, might underestimate the value of a project and, therefore, might not be the best basis for making investment decisions.

40. Relatedly, managers may simply try to give the impression of being in control by making bold moves. For more on impression management strategies and what could be called the "politics" of decisionmaking, see, for example, James T. Tedeschi & Valerie Melburg, *Impression Management and Influence in the Organization*, in 3 RESEARCH IN THE SOCIOLOGY OF ORGANIZATIONS 31 (Samuel B. Bacharach & Edward J. Lawler eds., 1984); John J. Sosik et al., *Beneath the Mask: Examining the Relationship of Self-Presentation Attributes and Impression Management to Charismatic Leadership*, 13 LEADERSHIP Q. 217 (2002); and James Wade et al., *Golden Parachutes: CEOs and the Exercise of Social Influence*, 35 ADMIN. SCI. Q. 587 (1990). See also *infra* notes 225-28 and accompanying text.

41. For various discussions of tournament theory, see George P. Baker et al., *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593 (1988); Brian G.M. Main et al., *Top Executive Pay: Tournament or Teamwork?*, 11 J. LAB. ECON. 606 (1993); Charles A.

might also advance within the broader business community and the political and social circles in which they travel. In short, risk neutrality, let alone conservatism, typically is not a blueprint for personal success if one hopes to climb the corporate ranks. A manager who factors in the private benefits of taking risks is more likely to overinvest in negative net present value projects.

The second example is closely related to the first one. Instead of seeking to maximize profits and firm value, managers might seek to maximize the size of the company through acquisitions or other strategies for expanding into new geographic and product markets that will grow the company's revenues and assets, although not necessarily its profits.⁴² In the view of this well-known "empire-building hypothesis," managers are motivated to grow the business to boost their personal reputation, to entrench themselves, or to position themselves for future opportunities, even if the company's diversification and growth come at the expense of shareholder value.⁴³

Third, the psychic payoff of taking risks—namely, the excitement that accompanies undertaking a challenge and doing a big deal—might lead managers to engage in excessively risky business strategies.⁴⁴ One senior executive explained his affection for running a

O'Reilly III et al., *CEO Compensation as Tournament and Social Comparison: A Tale of Two Theories*, 33 ADMIN. SCI. Q. 257 (1988); Symposium, *The Wages of Stardom: Law and the Winner-Take-All Society*, 6 U. CHI. L. SCH. ROUNDTABLE 1 (1999); Randall S. Thomas, *Should Directors Reduce Executive Pay?*, 54 HASTINGS L.J. 437, 442-53 (2003); and Langevoort, *Resetting the Thermostat*, *supra* note 33, at 288-89, 297-304. See also *infra* notes 184-89 and accompanying text. For closely related work on the economics of superstars, see Sherwin Rosen, *The Economics of Superstars*, 71 AM. ECON. REV. 845 (1981). For a formal model showing that individuals who take risks are more likely to proceed to the next round of the tournament, see ANAND MOHAN GOEL & ANJAN V. THAKOR, RATIONALITY, OVERCONFIDENCE AND LEADERSHIP (Univ. of Mich. Bus. Sch., Working Paper No. 00-022, 2000), available at <http://ssrn.com/abstract=244999>. It is important to note that to the extent CEO overconfidence is adaptive, promoting overconfident managers who are willing to take risks may ultimately be in the best interests of the corporation. See *infra* notes 102-14 and accompanying text.

42. For more on such "empire building," see WILLIAM J. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH (rev. ed., Harcourt, Brace & World 1967) (1959); Christopher Avery et al., *Why Do Managers Undertake Acquisitions? An Analysis of Internal and External Rewards for Acquisitiveness*, 14 J.L. ECON. & ORG. 24 (1998); Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 627-28 (1989); John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1167-69, 1224-29, 1269-80 (1984) [hereinafter Coffee, *Regulating*]; John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 20-22 (1986); and Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

43. Jean-Marie Messier's failed attempt to turn his French water utility into a media company comes to mind. See, e.g., John Carreyrou, *Vivendi, Messier to Pay \$51 Million to Settle Charges*, WALL ST. J., Dec. 24, 2003, at A3; Daniel Henninger, *Wonder Land: Modern Culture Creates Its Own Escape Routes*, WALL ST. J., Jan. 17, 2003, at A10.

44. For a similar point in the context of "rogue traders," see Krawiec, *supra* note 33, at 314.

company as follows: “It’s the thrill of the hunt, the exhilaration of making deals.”⁴⁵ This does not necessarily equate with maximizing firm value.

Not only do managers have an incentive to take risks, but managers (with the possible exception of CEOs), as well as the directors who oversee them, have an incentive not to dissent when projects are proposed.⁴⁶ For example, a small minority of dissenters might simply be ignored or, worse yet from a dissenter’s perspective, rebuked—the “shoot-the-messenger” idea.⁴⁷ By dissenting, an individual might signal that he lacks confidence in himself or in the firm and its managers, and he might be seen by others as disloyal and not a team player.⁴⁸ Accordingly, an individual who is convinced that some project is ill-advised might nonetheless quiet his dissent and go along with the group in order to preserve his reputation and status in the firm. Further, many individuals might not want the burden of making the case for “no,” especially if it is likely to be rejected anyway.

Additionally, “going along” is a relatively low-cost strategy. If a dissenter is proven wrong (for example, an acquisition the dissenter opposed turns out to be a success), then the scorn the individual received will appear justified, and the individual’s status in the firm

45. Barbara Martinez, “Mike T. Is Back!”: A REIT Highflyer Ejects, and Rediscovered the Dealmaker Within, WALL ST. J., Sept. 2, 1999, at A1; see also George Anders & Susan Warren, *Military Service: For Halliburton, Uncle Sam Brings Lumps, Steady Profits*, WALL ST. J., Jan. 19, 2004, at A1 (reporting that Vice President Cheney described a merger he negotiated while CEO of Halliburton as “one of the most exciting things I’ve been involved in” (internal quotation marks omitted)); Anita Sharpe, *Management: Unseen Force in the Shadow of Ted Turner*, WALL ST. J., May 31, 1995, at B1 (describing Ted Turner as “revel[ing] in the thrill of a chase and big deals”); Kopin Tan, *James Bond Meets Wall Street in Use of Deal Code Names: M&A Players Make Choices to Keep Plans a Secret, Indulge Their Obsessions*, WALL ST. J., Sept. 19, 2000, at C22 (referring to the “thrill of engineering a ground-breaking deal” for executives).

46. See *infra* Part III.B. The sorts of decisionmaking “cascades” contemplated below in Part III have been discussed most extensively in the legal literature by Kuran and Sunstein. See Timur Kuran & Cass R. Sunstein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683 (1999); see also CASS R. SUNSTEIN, CONFORMITY AND DISSENT (Univ. of Chi. Law Sch., John M. Olin Law & Econ. Working Paper No. 164 (2d series), Pub. Law & Legal Theory Working Paper No. 34, 2002), available at <http://ssrn.com/abstract=341880>.

47. For example, a dissenter may be given a smaller bonus or raise, may be overlooked for some promotion, may be cut out of the flow of information, may be kept off certain important projects, or may even be ousted from the firm.

48. Lovallo and Kahneman also discuss the “organizational pressures” to conform and to be optimistic:

Organizations also actively discourage pessimism, which is often interpreted as disloyalty. The bearers of bad news tend to become pariahs, shunned and ignored by other employees. When pessimistic opinions are suppressed, while optimistic ones are rewarded, an organization’s ability to think critically is undermined. The optimistic biases of individual employees become mutually reinforcing, and unrealistic views of the future are validated by the group.

Lovallo & Kahneman, *supra* note 16, at 60-61.

might continue to fall as his business judgment, as well as his loyalty and confidence, is called into question. On the other hand, if the business decision turns out badly, then any blame will be shared by the group supporting the project. Each individual will have at least some political and reputational cover within the firm because many others agreed with the ill-advised decision when it was made. There is safety in numbers and in making the same mistake as others.

Finally, an officer's or director's unwillingness to dissent, when motivated by self-interest and concerns for personal reputation, sounds in disloyalty. But sometimes a person conforms in good faith. Those with opposing viewpoints often convince themselves that the majority view is correct.⁴⁹ Plus, people are biased to avoid the cognitive dissonance that dissenting gives rise to.⁵⁰

Because of the challenges and costs shareholders face in coordinating and keeping adequately informed about the corporation's business and affairs, it is difficult for shareholders to monitor and discipline the kind of managerial conduct that the agency model of corporate decisionmaking contemplates.⁵¹ In other words, shareholders cannot be relied on to hold directors and officers accountable, although shareholders are more active today than historically as overseers of the board and management. Courts also hold directors and officers accountable, particularly by enforcing fiduciary obligations. However, to the extent that the challenged conduct is a business decision—such as the choice to move forward with a merger or to launch a new product line—as opposed to director or officer disloyalty, the challenged conduct will escape any hard look by the courts under the business judgment rule.⁵² Courts are much better at policing the kind of corrupt conduct that L. Dennis Kozlowski engaged in

49. A related point is that corporate decisionmakers may not fully appreciate the risk of some project because of poor information. Subordinates not only have an incentive to ensure that adverse information and caveats are filtered from what flows up to superiors, but subordinates themselves may be overly optimistic. In either case, the result is that senior managers responsible for making decisions may receive biased information that is overly optimistic. Indeed, by their nature, bottom-line assessments, upon which decisions are often based, are stripped of nuance. For a general discussion of the role of information flow in corporate decisionmaking, see Langevoort, *Organized Illusions*, *supra* note 33.

50. For more on cognitive dissonance, see, for example, Emily Pronin et al., *Understanding Misunderstanding: Social Psychological Perspectives*, in *HEURISTICS AND BIASES*, *supra* note 20, at 636, 637-38; and Nancy B. Rapoport, *Enron, Titanic, and the Perfect Storm*, 71 *FORDHAM L. REV.* 1373, 1385-91 (2003).

51. For more on the role of shareholders in corporate governance, see *infra* notes 309-22 and accompanying text. During the bull market of the 1990s, investors saw relatively little reason to police management and the board.

52. For more on judicial review of corporate conduct, see *infra* Part IV.C. Fraud will be subject to judicial review under the federal securities laws; here I am focusing on state corporate law and internal corporate affairs. For the leading treatise on the business judgment rule, see DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* (5th ed. 1998 & Supp. 2002).

at Tyco and Richard Scrushy engaged in at HealthSouth than at monitoring substantive business judgments. Recognizing the limitations of shareholders and courts as accountability mechanisms, the agency model relies on contracts (for example, incentive-based executive compensation) and markets (for example, an active market for corporate control and capital markets) to discipline managers to maximize firm value.⁵³

Corporate decisionmaking, of course, is more complicated than the foregoing suggests, although the discussion is adequate to illustrate the key goal that has informed much of corporate governance: the need to ensure an effective system of checks and balances that contains managers who are motivated to serve their own self-interests.

Managerial motives are not the only concern, however. Managerial psychology is just as important to managerial decisionmaking as the incentives underlying the agency model. The behavioral model of corporate decisionmaking—sometimes referred to as “behavioral corporate finance”—sets aside the assumption of rationality and takes account of human psychology by focusing on how a range of well-documented cognitive biases affect how executives make business decisions.⁵⁴ CEO overconfidence is of singular interest given the dominant position chief executives hold in firms, even after the recent spate of corporate governance reforms. Notably, unlike the agency model, behavioral corporate finance, to my knowledge, has not been an emphasis of corporate governance and has had no real impact on corporate law.

The essence of the overconfidence problem is that managers tend to overvalue projects and therefore to overinvest.⁵⁵ In other words, managers take excessive risks by investing in negative net present value projects, even when they are acting in good faith and trying to maximize shareholder value.⁵⁶ Not surprisingly, business decisions are likely to turn out poorly when managers err by overestimating a project’s benefits, which then never materialize, and underestimating its costs, which then come in higher than projected. This situa-

53. For more on the corporate governance role of contracts, markets, and non-law institutions, see, for example, Troy A. Paredes, *A Systems Approach to Corporate Governance Reform: Why Importing U.S. Corporate Law Isn't the Answer*, 45 WM. & MARY L. REV. 1055, 1075-1100 (2004); and Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233 (2002).

54. See, e.g., MALCOLM BAKER ET AL., BEHAVIORAL CORPORATE FINANCE: A SURVEY, (Nat'l Bureau of Econ. Research, Working Paper No. 10863, 2004), available at <http://nber.org/papers/w10863>. Strategies designed to bolster one's reputation or to bluff competitors, plus efforts to encourage others to support a project, also can explain seemingly overconfident managerial behavior. See, e.g., Lovallo & Kahneman, *supra* note 16, at 60-61.

55. See *infra* notes 59-75 and accompanying text.

56. See *supra* notes 15-18 and accompanying text.

tion is exacerbated because managers end up facing unrealistic expectations as a result of overly optimistic projections. An important second-order effect of overconfidence, then, is that managers might strain to satisfy investors' expectations, such as by taking even greater risks in hopes of a big payoff or by managing the business with an eye toward the next quarter instead of the long run, creating distortions and inefficiencies in how the business is run.⁵⁷ Some managers might simply manage earnings, if not engage in outright fraud, to avoid missing earnings or revenue targets.⁵⁸

The challenge is to craft corporate governance regimes that address not only traditional agency problems but also account for the psychology of well-meaning managers, a task I turn to in Part IV. But first, there is more to the nature and potential causes of CEO overconfidence that is worth exploring.

B. CEO Overconfidence

A vast literature⁵⁹ shows that people tend to be overconfident. People overestimate their abilities, believe that they know more than they in fact do, and suffer from an "illusion of control," believing that they exert more control over results than they actually do.⁶⁰ The psychology literature also shows that a closely related self-attribution

57. For general discussions of managing to the market, see Joseph Fuller & Michael C. Jensen, *Just Say No to Wall Street: Putting a Stop to the Earnings Game*, J. APPLIED CORP. FIN., Winter 2002, at 41 (explaining that managers sometimes use the consensus expectations of Wall Street as the starting point for the company's budgeting process); and John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, J. ACCT. & ECON. (forthcoming 2005) (manuscript available at <http://ssrn.com/abstract=491627>) (showing that executives are willing to sacrifice shareholder value and forgo positive net present value projects in order to meet earnings targets).

58. For more on earnings management, see, for example, John C. Coffee, Jr., *What Caused Enron? A Capsule Social and Economic History of the 1990s*, 89 CORNELL L. REV. 269 (2004); and Arthur Levitt, "The 'Numbers Game,'" Remarks at N.Y.U. Center for Law and Business. (Sept. 28, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt> (last visited Feb. 2, 2005).

59. The following discussion draws from an extensive literature on overconfidence, overoptimism, and self-attribution biases, as well the literature on commitment and confirmation biases. See, e.g., Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 28-30 (2003); Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, 51 VAND. L. REV. 1653, 1659-61 (1998); Asher Koriat et al., *Reasons for Confidence*, 6 J. EXPERIMENTAL PSYCHOL.: HUM. LEARNING & MEMORY 107 (1980); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1091-95 (2000); Sarah Lichtenstein & Baruch Fischhoff, *Do Those Who Know More Also Know More About How Much They Know?*, 20 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 159 (1977); Jeffrey J. Rachlinski, *Misunderstanding Ability, Misallocating Responsibility*, 68 BROOK. L. REV. 1055, 1080-82 (2003); see also *infra* note 100.

60. For good summaries of these tendencies, see, for example, Daniel Kahneman & Dan Lovallo, *Timid Choices and Bold Forecasts: A Cognitive Perspective on Risk Taking*, 39 MGMT. SCI. 17, 27 (1993); Lovallo & Kahneman, *supra* note 16, at 58-59; and March & Shapira, *supra* note 34, at 1410-11.

bias affects judgment. Individuals tend to take credit for success but to blame other factors for failure or underperformance.⁶¹ In other words, people are prone to mistake skill for luck. For example, a CEO might exaggerate the contribution of his vision and skill as a manager to his company's successful entry into a new market, especially if others have failed pursuing similar strategies; yet, if the venture turns out poorly, the CEO will likely blame other factors.⁶² Consistent with the sort of asymmetric interpretation of outcomes that self-attribution leads to, studies show that success leads to greater confidence, an idea I return to below when considering possible causes of CEO overconfidence.⁶³ The bottom line is that people tend to be overly optimistic about future events as they place too much faith in themselves and their ability to generate positive results.

Another side to the overconfidence coin is also worth noting. At the same time that individuals overestimate their own abilities, they have been shown to neglect their competitors' skills and to underestimate their competitors' strategic countermoves.⁶⁴ These so-called "blind spots" in a manager's evaluation of the competitive landscape might, in and of themselves, lead to overinvestment, such as excess entry into markets, overpayment in acquisitions, or imprudent capacity expansions.⁶⁵

61. For more on the self-attribution bias, see, for example, Kent Daniel et al., *Investor Psychology and Security Market Under- and Overreactions*, 53 J. FIN. 1839, 1844-45 (1998); and Gilles Hilary & Lior Menzly, *Does Past Success Lead Analysts to Become Overconfident?* 7 (Apr. 2, 2001) (unpublished manuscript, on file with author). The self-attribution bias might itself explain people's tendency to overestimate their abilities and their illusion of control, at least when people have had recent success. See *infra* notes 169-74 and accompanying text for more on the link between past success and overconfidence.

62. Studies of annual reports have found evidence of such self-serving tendencies among managers, although the findings might reflect a form of impression management, in addition to cognitive bias. See James R. Bettman & Barton A. Weitz, *Attributions in the Board Room: Causal Reasoning in Corporate Annual Reports*, 28 ADMIN. SCI. Q. 165 (1983); Stephen E. Clapham & Charles R. Schwenk, *Self-Serving Attributions, Managerial Cognition, and Company Performance*, 12 STRATEGIC MGMT. J. 219 (1991); Gerald R. Salancik & James R. Meindl, *Corporate Attributions as Strategic Illusions of Management Control*, 29 ADMIN. SCI. Q. 238 (1984); Barry M. Staw et al., *The Justification of Organizational Performance*, 28 ADMIN. SCI. Q. 582 (1983). In general, it is difficult to distinguish self-attribution as a cognitive bias from self-attribution as an impression management strategy.

63. See *infra* notes 169-74 and accompanying text.

64. Colin Camerer & Dan Lovallo, *Overconfidence and Excess Entry: An Experimental Approach*, 89 AM. ECON. REV. 306 (1999) (discussing "reference group neglect").

65. See, e.g., Edward J. Zajac & Max H. Bazerman, *Blind Spots in Industry and Competitor Analysis: Implications of Interfirm (Mis)Perceptions for Strategic Decisions*, 16 ACAD. MGMT. REV. 37 (1991) (explaining competitive "blind spots" and their implications for corporate decisionmaking); see also Camerer & Lovallo, *supra* note 64 (showing that "reference group neglect" can lead to excess entry); Langevoort, *Organized Illusions*, *supra* note 33, at 140-41 (discussing Zajac and Bazerman's explanations for suboptimal corporate decisions); Tor & Bazerman, *supra* note 17, at 370 (explaining that failing to fully consider indirect effects, such as the decisions of others, can lead to "decisions with negative expected values").

The commitment bias exacerbates the consequences of overconfidence.⁶⁶ People are prone to commit increasingly to a course of action once a decision has been made. The irrational escalation of commitment leads to what may be thought of as a sort of path dependence in decisionmaking, or throwing good money after bad. Relatedly, people are biased toward searching for and welcoming evidence that confirms their choice, while resisting and explaining away disconfirming evidence that recommends some different course of action.⁶⁷ Thus, individuals are often slow to realize that they are pursuing an ill-advised strategy. These unconscious commitment and confirmation biases supplement the purposeful determination with which a person might continue to pursue a project in order to avoid having to concede a mistake and to save face.⁶⁸ A CEO has a strong incentive to engage in this sort of strategic overcommitment to protect his reputation, particularly if the CEO otherwise would have to backtrack publicly from a particular decision or overall business strategy.⁶⁹

The combination of the cognitive tendencies described above leads to what Langevoort has called the “optimism-commitment whipsaw.”⁷⁰ First, because of overconfidence, managers make bad business decisions, at least in terms of expected payoffs. CEOs and other executives who are overconfident are more likely to go forward with what amounts to bad business decisions because they accentuate the benefits of some course of action while downplaying the costs and uncertainties.⁷¹ As March and Shapira put it, “[M]anagers accept risks, in part, because they do not expect that they will have to bear

66. For more on overcommitment, see, for example, Barry M. Staw, *Rationality and Justification in Organizational Life*, in 2 RESEARCH IN ORGANIZATIONAL BEHAVIOR 45 (Barry M. Staw & L.L. Cummings eds., 1980); Pamela R. Haunschild et al., *Managerial Overcommitment in Corporate Acquisition Processes*, 5 ORG. SCI. 528 (1994); and Barry M. Staw & Jerry Ross, *Knowing when to Pull the Plug*, HARV. BUS. REV., Mar.-Apr. 1987, at 68.

67. See, e.g., Choi & Pritchard, *supra* note 59, at 30-33 (discussing the confirmation bias); Hillel J. Einhorn & Robin M. Hogarth, *Confidence in Judgment: Persistence of the Illusion of Validity*, 85 PSYCHOL. REV. 395 (1978) (also discussing confirmation bias); J. Edward Russo & Paul J.H. Schoemaker, *Managing Overconfidence*, SLOAN MGMT. REV., Winter 1992, at 7, 12 (also discussing confirmation bias); see also Langevoort, *Organized Illusions*, *supra* note 33, at 142-43 (“The management literature strongly suggests that once executives have committed to a course of action, their subsequent survey of information is strongly biased to bolster their choice Bolstering evidence is actively sought, while disconfirming information is subconsciously resisted.”).

68. An impression management explanation of overcommitment sounds in agency problems and not cognitive bias.

69. See Haunschild et al., *supra* note 66, at 532 (discussing how the desire to “save face” can create commitment to acquisitions).

70. Langevoort, *Organized Illusions*, *supra* note 33, at 147, 167.

71. Of course, the tipping point between an adaptive, healthy level of confidence and excessive overconfidence is not easily defined. For more on the balance between the pros and cons of confidence and narcissism more generally, see MICHAEL MACCOBY, *THE PRODUCTIVE NARCISSIST: THE PROMISE AND PERIL OF VISIONARY LEADERSHIP* (2003). See also *infra* notes 102-14 and accompanying text (discussing benefits of CEO overconfidence).

them.”⁷² After the decision to undertake a project is made, a manager becomes overcommitted to it. The very process of making a decision escalates commitment to it, thereby making it more difficult to unwind a bad decision or to change course midstream. Amplifying this “whipsaw” effect, once a CEO makes a decision, the endowment effect and loss aversion may further escalate his commitment, at least insofar as the chief executive views the derailing of the project as a loss.⁷³

In 2000, at the peak of the Internet boom, VeriSign, Inc., paid \$20 billion to acquire Network Solutions, Inc. Three years later, VeriSign sold its Network Solutions business for \$100 million.⁷⁴ There is no way to know for sure what role cognitive bias played in the VeriSign-Network Solutions deal. However, it is at least worth having the transactions in mind when considering the destruction of shareholder value that CEO overconfidence can lead to.⁷⁵

Enough business decisions turn out poorly—such as the consistent overpayment in acquisitions⁷⁶—that CEOs might be expected to learn from their mistakes, as well as from the repeated mistakes of their counterparts at other companies.⁷⁷ However, such lessons seem to be lost on many, maybe most, CEOs. Studies show that certain types of

72. March & Shapira, *supra* note 34, at 1411 (discussing managerial belief in the ability to control risks, thereby distinguishing taking “good” risks from “gambling”); *see also* Camerer & Lovallo, *supra* note 64, at 315 (“Overconfidence predicts that agents will be relatively insensitive to risk; indeed, when risk is high their overconfidence might lead them to *prefer* riskier contracts because they think they can beat the odds.”); Lovallo & Kahneman, *supra* note 16, at 59 (explaining that managers’ “self-confidence can lead them to assume that they’ll be able to avoid or easily overcome potential problems in executing a project”).

73. For more on the endowment effect, see generally Russell Korobkin, *The Endowment Effect and Legal Analysis*, 97 NW. U. L. REV. 1227 (2003).

74. Nick Wingfield, *VeriSign to Sell Most Operations in Web Addresses to Equity Firm*, WALL ST. J., Oct. 17, 2003, at B2.

75. As a counterexample, consider Microsoft’s restraint in refusing to bid against Comcast for Disney, as some speculated Microsoft might. Bill Gates is reported to have said: “You won’t see us buying a movie studio or some big communications asset or those kinds of things. What we know is software.” Guth et al., *supra* note 4 (internal quotation marks omitted).

76. *See, e.g.*, ULRIKE MALMENDIER & GEOFFREY TATE, WHO MAKES ACQUISITIONS? CEO OVERCONFIDENCE AND THE MARKET’S REACTION (Nat’l Bureau of Econ. Research, Working Paper No. 10813, 2004) [hereinafter MALMENDIER & TATE, WHO MAKES ACQUISITIONS?], available at <http://nber.org/papers/w10813>; Haunschild et al., *supra* note 66; Hayward & Hambrick, *supra* note 33; Pekka Hietala et al., *What Is the Price of Hubris? Using Takeover Battles to Infer Overpayments and Synergies*, 32 FIN. MGMT. 5 (2003); Ulrike Malmendier & Geoffrey Tate, *CEO Overconfidence and Corporate Investment*, J. FIN. (forthcoming) [hereinafter Malmendier & Tate, *CEO Overconfidence*] (manuscript available at http://www.afajof.org/afaforthcoming/MalmendierTate_fulldocument.pdf); Roll, *supra* note 9.

77. For similar discussions regarding the persistence of cognitive biases in the face of market discipline, see, for example, Black, *supra* note 42, at 630-32; and Langevoort, *Organized Illusions*, *supra* note 33, at 148-56.

clear feedback can debias overconfidence, at least to some extent.⁷⁸ But for the most part, learning from experience cannot be relied on to remedy CEO overconfidence. In short, the feedback indicating that a CEO is prone to err is usually too noisy and too delayed to send a sufficiently clear signal. As Zajac and Bazerman have explained, the kind of “accurate and timely feedback” that is necessary to improve judgment

is rarely available [to managers] because (1) outcomes are commonly delayed and not easily attributable to a particular action, (2) variability in the environment degrades the reliability of feedback, (3) there is often no information about what the outcome would have been if another decision had been made, and (4) many important decisions are unique and therefore provide little opportunity for learning.⁷⁹

For example, plenty of factors other than a bad business decision—such as rising interest rates, an economic downturn, turf battles among key management members, bad lawyers, or an unforeseen regulatory change—can plausibly be blamed for a bad business outcome, when in fact the principal culprit is a bad business decision or its poor execution. In addition, it can take years before a business decision is identified as a failure. Furthermore, because business is inherently risky, some good business decisions will inevitably turn out badly (and some bad business decisions will turn out well). Accordingly, managers may be able to deflect business failures as simply the “cost of doing business.”⁸⁰ Additionally, the prospect of learning from experience occurs against the backdrop of overconfidence. It is possible that chief executives have convinced themselves that their own talents will enable them to avoid the pitfalls that have affected

78. See, e.g., Kahneman & Lovallo, *supra* note 60, at 18 (explaining that learning can occur “when closely similar problems are frequently encountered, especially if the outcomes of decisions are quickly known and provide unequivocal feedback”).

79. Zajac & Bazerman, *supra* note 65, at 42 (citing Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. S251, S274-75 (1986)); see also Sheryl B. Ball et al., *An Evaluation of Learning in the Bilateral Winner's Curse*, 48 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 1 (1991) (study showing failure of subjects to learn in bidding context); Russo & Schoemaker, *supra* note 67, at 10 (“Overconfidence persists in spite of experience because we often fail to learn from experience.”); Yoella Bereby-Meyer & Brit Grosskopf, *Overcoming the Winner's Curse: An Adaptive Learning Perspective* (Aug. 8, 2002) (unpublished manuscript) (studying the importance of “noise-free feedback” for learning and negotiating), available at <http://ssrn.com/abstract=324201>.

80. Lovallo and Kahneman expressed a similar point in explaining the conventional economic (as opposed to cognitive) understanding of business failure:

According to standard economic theory, the high failure rates are simple to explain: The frequency of poor outcomes is an unavoidable result of companies taking rational risks in uncertain situations. Entrepreneurs and managers know and accept the odds because the rewards of success are sufficiently enticing. In the long run, the gains from a few successes will outweigh the losses from many failures.

Lovallo & Kahneman, *supra* note 16, at 58.

other companies⁸¹ and that the lessons of others' experiences do not apply to them.

Even when the signal is relatively clear that a poor decision has been made, the self-attribution bias predicts that CEOs will explain it away. Consider how frequently a chief executive is heard explaining away a sharp decline in his company's stock price upon the announcement of some major transaction, such as an acquisition, instead of taking the market's reaction for what it often is—strong feedback that the deal might not make sense for the company.⁸²

Managers who do take responsibility for having made a bad decision are unlikely to attribute it to cognitive bias. Therefore, any steps that are taken to improve corporate decisionmaking are unlikely to involve strategies for rooting out overconfidence, overcommitment, or other psychological factors affecting managerial judgment. To the extent that the response is simply to try harder the next time a decision is made, studies show that managers might do even worse.⁸³

Even if a manager did in fact learn from experience and attribute his mistakes to overconfidence, it is unclear how much his actual behavior would change. As indicated earlier and as discussed more below, individuals have an incentive to exhibit self-confidence, to act decisively, and to remain committed to a decision in order to bolster both their personal reputation as well as their firm's reputation within the industry and with investors.⁸⁴ Moreover, when a manager believes he is in a final period (that is, that he will be ousted from his job unless he has a major success), he may reasonably conclude that he has little to lose by taking a big risk or by continuing with a project in the face of adverse information.⁸⁵ The manager may be no worse off by gambling on some excessively risky project instead of adopting a more rational approach or by escalating his commitment to a project instead of terminating it and cutting the company's losses.

81. Recent success bolsters confidence. *See infra* notes 169-74 and accompanying text.

82. CEOs regularly argue that the market undervalues their stock. Such a belief, if honestly held and not simply puffery, can create distortions in how the business is financed by encouraging stock buybacks or the financing of operations out of free cash flow or debt (as opposed to equity). *Cf.* Malmendier & Tate, *CEO Overconfidence*, *supra* note 76.

83. *See infra* notes 323-26 and accompanying text (discussing the adverse consequences of greater accountability).

84. *See supra* notes 46-50 and accompanying text and *infra* notes 102-14 and accompanying text.

85. For a related discussion of the incentives to engage in fraud in final periods, see, for example, Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691; and Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 705-09 (1999).

Whether or not learning debiases managerial overconfidence, market pressures might check it.⁸⁶ Market pressures—whether in the form of product market competition, the competition for capital, an active market for corporate control, or an active market for management—can discipline managers to run their businesses more effectively. In this view, managers who continue to act irrationally will be chased from the market, perhaps along with their firms. The business will be acquired, for example, or its cost structure will be too high to compete effectively. At a minimum, the CEO might be removed.⁸⁷

The extent to which markets can constrain overconfidence, however, is limited. First, a company usually has to underperform for a prolonged period of time before the CEO is replaced, although studies have found that boards are quicker to replace the CEO in the post-Enron era.⁸⁸ A Booz Allen Hamilton study of CEO turnover at the world's 2500 largest public companies (as measured by market capitalization) found that the forced turnover rate due to poor performance was only 3.0% in 2003 for North American (U.S. and Canadian) firms, slightly less than the 3.2% forced turnover rate for poor performance for the entire period 1997-2003.⁸⁹

Even if a management turnover eventually occurs, substantial firm value can be destroyed leading up to that point, to the detriment of shareholders and other corporate constituencies. When a chief executive is finally replaced, there are no assurances that the new CEO will be more effective, including when it comes to questions of cognitive bias. In an interesting study of the CEO market, Khurana suggested that ego and hubris might especially affect the types of charismatic CEOs who are often hired as “corporate saviors” to turn a

86. See Black, *supra* note 42, at 630-32 (discussing the disciplining effect of markets); Langevoort, *Organized Illusions*, *supra* note 33, at 148 (discussing the possibility that market forces can “weed out” inefficient firms). See generally James P. Walsh & James K. Seward, *On the Efficiency of Internal and External Corporate Control Mechanisms*, 15 ACAD. MGMT. REV. 421 (explaining the relationship among various mechanisms that discipline managers).

87. Whatever the criticisms of stock options and other forms of equity compensation, an executive with stock in his company has a particularly strong incentive to run the company well. One problem, however, is that a manager can improve his company's stock performance by improving the company's fundamentals or by “cooking the books.” See *infra* notes 154-56 and accompanying text. For an excellent discussion of equity-based pay, see Brian J. Hall, *Six Challenges in Designing Equity-Based Pay*, J. APPLIED CORP. FIN., Spring 2003, at 21 [hereinafter Hall, *Equity-Based Pay*]; and Brian J. Hall, *What You Need to Know About Stock Options*, HARV. BUS. REV., Mar.-Apr. 2000, at 121.

88. See, e.g., *Making Companies Work*, ECONOMIST, Oct. 25, 2003, at 14-15; Patrick McGeehan, *Study Finds Number of Chiefs Forced to Leave Jobs Is Up*, N.Y. TIMES, May 12, 2003, at C5; Mark R. Huson et al., *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 56 J. FIN. 2265 (2001); Chuck Lucier et al., *CEO Succession 2003: The Perils of “Good” Governance*, STRATEGY + BUSINESS, Summer 2004, at 1. For possible explanations of board reluctance to remove the CEO, see *infra* Part III.B.3.

89. See Lucier et al., *supra* note 88, at 8.

company around.⁹⁰ Further, such corporate saviors, Khurana found, are routinely given particularly far-reaching discretion over the business.⁹¹

Capital market discipline ultimately is tied to a company's financing needs—that is, to how frequently a company borrows or issues stock. When an underperforming company raises money, it will do so on less favorable terms than if the business were more profitable.⁹² However, the reality is that many companies need to raise capital infrequently. Further, even a poorly performing company will almost always be able to raise funds if needed, so capital market discipline is only so tough. Many companies can simply fund operations out of cash on hand and future cash flows, which further erodes the discipline of capital markets.⁹³ It is worth noting, though, that although a company may have no plans to raise significant capital in the future, significant prior borrowings might mitigate the effects of CEO overconfidence. Debt service obligations and the need to comply with debt covenants might constrain managers by denying them the free cash flow or operational flexibility required to engage in certain transactions, at least without first obtaining creditor approval. A high dividend payout can have a similar effect as high leverage.⁹⁴

Third, boards of directors can adopt defensive tactics to fend off a hostile bidder, thereby undercutting the disciplining effects of an active takeover market and enabling the board and the management team to entrench themselves.⁹⁵ Nor is running a proxy contest a realistic option for effecting a change in control because of the cost of running a proxy contest and the practical difficulties galvanizing shareholders to support nominees to challenge the incumbent directors the CEO favors.⁹⁶ More generally, it is difficult to unwind the decisions of a prior management team, even after a change in control. Assets can be sold, businesses can be spun off, missed opportunities can be pursued, debt can be restructured, and a new corporate strategy can be charted. But such transactions take time, and the transaction costs can be substantial. A considerable amount of firm value

90. KHURANA, *supra* note 8.

91. *Id.* at 179-85.

92. For example, the company will issue shares at a lower price, pay a higher interest rate, agree to more restrictive covenants, or have to borrow on a secured as opposed to unsecured basis.

93. Microsoft is at one end of the spectrum with cash and short-term investments on hand of \$56 billion at the end of the first quarter of 2004. See Robert A. Guth, *Microsoft Posts 39% Earnings Drop: Legal Costs Hurt Results, but Revenue Climbed 17%, Aided by Strong PC Sales*, WALL ST. J., Apr. 23, 2004, at A3.

94. See *infra* note 320.

95. See *infra* notes 309-14 and accompanying text.

96. A recent study by Bebchuk found fewer than eighty proxy contests for control over who would manage the company during the period 1996-2002. See Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45-46 (2003).

may have already been destroyed, putting the company in a sizable hole that is hard to climb out of; and there are no assurances that the corporation's new business plan or the specific projects it undertakes will be successful. At bottom, the market for corporate control, in practice as opposed to in theory, affords relatively few opportunities to "arbitrage" managerial overconfidence.⁹⁷

Finally, market pressures are thought to reduce conventional agency problems because various markets punish managers who do not maximize shareholder value. Yet, it is questionable whether bringing similar discipline to bear on managers in the form of, for example, hostile takeovers or competitive product markets can effectively mitigate the effects of cognitive bias. Arresting the effects of overconfidence, let alone actually debiasing CEOs, is not primarily a question of aligning incentives and motivating CEOs to work hard.⁹⁸ Indeed, behavioral corporate finance presupposes that managers are hard-working and well-intentioned. More to the point, studies have shown that greater accountability can actually exacerbate cognitive biases, in which case more competition may actually worsen the CEO overconfidence problem.⁹⁹

An extensive body of theoretical and empirical research, with roots in Roll's work on the "hubris hypothesis" of corporate takeovers and Thaler's work on the "winner's curse" in auctions, has demonstrated the existence of managerial overconfidence and its impact on corporate decisionmaking.¹⁰⁰ As I discuss more below, there is reason

97. See, e.g., SIMON GERVAIS ET AL., OVERCONFIDENCE, INVESTMENT POLICY, AND EXECUTIVE STOCK OPTIONS 5-6 (Rodney L. White Ctr. for Fin. Research, Working Paper No. 15-02, 2003) (describing takeovers as a form of "arbitrage" of managerial irrationality), available at <http://ssrn.com/abstract=361200>.

98. For more on managing overconfidence, see *infra* Part IV.

99. See *infra* notes 323-26 and accompanying text.

100. See, e.g., SIMON GERVAIS & ITAY GOLDSTEIN, OVERCONFIDENCE AND TEAM COORDINATION (Rodney L. White Ctr. for Fin. Research, Working Paper No. 08-04, 2004) (showing that overconfidence can serve a coordination function in that it can improve team performance by motivating individual effort, which in turn offsets the free-rider problem and encourages other team members to be more productive), available at <http://finance.wharton.upenn.edu/~rlwctr/papers/0408.pdf> (last visited Feb. 2, 2005); GERVAIS ET AL., *supra* note 97 (modeling CEO decisionmaking and showing that overconfidence and optimism align the interests of otherwise risk-averse managers with the interests of shareholders, thereby increasing firm value and reducing the need for stock options to align managerial and shareholder incentives); GOEL & THAKOR, *supra* note 41 (showing that: (1) managers are likely to take greater risks when competing to become CEO; (2) overconfident managers are more likely to become CEO; and (3) overconfident CEOs might increase shareholder value as compared to their more rational counterparts); MALMENDIER & TATE, WHO MAKES ACQUISITIONS?, *supra* note 76 (empirical study of the impact of CEO overconfidence, as measured by the length of time a CEO holds options, on merger and acquisition activity); THALER, WINNER'S CURSE, *supra* note 10 (explaining the winner's curse in common value auctions as a function of asymmetric information); Ball et al., *supra* note 79 (experimental study showing that feedback after bids does not eliminate the winner's curse); Roland Benabou & Jean Tirole, *Self-Confidence and Personal Motivation*, 117 Q.J. ECON. 871, 872 (2002) (studying "the demand and the supply sides of self-confidence" in

to think that CEOs particularly suffer from overconfidence, in part because more confident individuals are more likely to reach the top post at a company and in part because a person's track record of success and accretion of control, both leading up to and after becoming the chief executive, are likely to reinforce his self-confidence.¹⁰¹

It is important, however, not to paint too dark of a picture of CEO overconfidence. The lopsided view that has been depicted so far needs to be balanced, because there is a bright side to CEO confidence, even overconfidence.¹⁰² Managerial overconfidence may be

terms of "a consumption value, a signaling value, and a motivation value"); Antonio Bernardo & Ivo Welch, *On the Evolution of Overconfidence and Entrepreneurs*, 10 J. ECON. & MGMT. STRATEGY 301 (2001) (studying the persistence of overconfidence among entrepreneurs in terms of their tendency to overrely on their private information); Marianne Bertrand & Antoinette Schoar, *Managing with Style: The Effect of Managers on Firm Policies*, 118 Q.J. Econ. 1169 (2003) (empirical study of the effect of managerial "styles" on corporate decisionmaking, including investment policy, financial policy, and organizational strategy); Camerer & Lovallo, *supra* note 64 (experimental study showing overconfidence leading to excess market entry); Haunschild et al., *supra* note 66 (experimental study of overcommitment to acquisitions showing that commitment increases with (1) personal responsibility for the acquisition decision, (2) competition for the target, and (3) public knowledge of the decision to acquire the target); Hayward & Hambrick, *supra* note 33 (empirical study showing that acquisition premiums increase with hubris); Heaton, *supra* note 12 (modeling two effects of CEO optimism: (1) optimistic managers may forgo positive net present value projects because they believe that the market undervalues the company's securities, and (2) optimistic managers may undertake negative net present value projects that they in good faith believe are in the best interests of shareholders); Hietala et al., *supra* note 76 (modeling bidder payment in an effort to disentangle overpayment (that is, hubris) from other sources of value change that might lead to a higher bid, such as synergies and private managerial benefits); Kahneman & Lovallo, *supra* note 60, at 24-29 (distinguishing between an "inside view" of a problem and an "outside view" in explaining various causes and consequences of optimistic biases in organizations); Roderick M. Kramer, *The Harder They Fall*, HARV. BUS. REV., Oct. 2003, at 58 (discussing how overconfidence and ego can lead to a CEO's fall); Lovallo & Kahneman, *supra* note 16, at 58 (explaining how a more objective "outside view" can act as a "reality check" that counteracts managerial overconfidence); David M. Messick & Max H. Bazerman, *Ethical Leadership and the Psychology of Decision Making*, SLOAN MGMT. REV., Winter 1996, at 9 (studying the link between overconfidence and unethical managerial conduct); David de Meza & Clive Southey, *The Borrower's Curse: Optimism, Finance and Entrepreneurship*, 106 ECON. J. 375 (1996) (explaining that new entrants tend to be overly optimistic); Roll, *supra* note 9 (explaining overpayment in acquisitions as a function of managerial hubris); Zajac & Bazerman, *supra* note 65 (explaining that "blind spots" can explain excessive capacity expansion, excessive entry, and the winner's curse); Malmendier & Tate, *CEO Overconfidence*, *supra* note 76 (empirical study showing that the investment decisions of overconfident CEOs are substantially more responsive to cash flow because overconfident CEOs tend to believe that the market undervalues their securities).

101. For a discussion of the relationship between prior success and confidence, see *infra* notes 169-74 and accompanying text. Kramer has offered one of the most thoughtful accounts to date of how the heady effects of being CEO can lead to reckless leadership and to one's ultimate downfall. See Kramer, *supra* note 100.

102. Although not my focus here, commentators have identified important psychological benefits associated with self-confidence. Overconfidence may result as people try to shore up their self-esteem and overall psychological well-being. Egotism and narcissism can be psychologically healthy, in other words, by boosting a person's sense of self-worth. For more on the ego-protecting and anxiety-easing consequences of self-confidence and self-attribution, see generally Andrew D. Brown, *Narcissism, Identity, and Legitimacy*, 22

adaptive and ultimately serve the long-run best interests of the corporation. The managerial clarity, commitment, and charisma that arise from CEO confidence might best be realized when the CEO is overconfident, as opposed to rationally so.¹⁰³ A rationally confident and committed CEO might be too tentative and deliberate.

First, managers need to be decisive, and they must be willing and able to act boldly and quickly when necessary. Sometimes having the confidence to make a clear-cut decision is more important than trying to get it exactly right, particularly given the inherent uncertainty of business.¹⁰⁴ Furthermore, in many instances, a business decision is all or nothing; it is infeasible to undertake many projects part-way or on a “go slow” incremental basis, and timing is often crucial.¹⁰⁵ An especially confident leader can be particularly important to implementing a substantial overhaul of the business or turning around a distressed company.¹⁰⁶ Having acted, a manager must be committed to see things through; he cannot be tentative in executing the plan or quick to cave to challenges and setbacks.

Moreover, doing nothing, as opposed to taking what might be a gamble, has its own risks. Consider a firm where the overconfidence of its managers is kept in check. The prediction is that the firm will avoid excessively risky projects with a negative expected payoff, but the business will also have fewer big payoffs. At the same time, at least some of the firm’s competitors will be more aggressive. For some of these competitors, the willingness to take greater risks will pay off, even if only because of luck as opposed to a superior man-

ACAD. MGMT. REV. 643 (1997); Lisa Farwell & Ruth Wohlwend-Lloyd, *Narcissistic Processes: Optimistic Expectations, Favorable Self-Evaluations, and Self-Enhancing Attributions*, 66 J. PERSONALITY 65 (1998); Ellen R. Ladd et al., *Narcissism and Causal Attribution*, 80 PSYCHOL. REP. 171 (1997); Maccoby, *supra* note 8, at 69; and Langevoort, *Organized Illusions*, *supra* note 33, at 139 nn.129 & 131 (citing related literature).

103. Cf. Bernardo & Welch, *supra* note 100, at 325 (noting the view that “when trying to deceive others that they are of higher ability, individuals’ credibility is enhanced if they are themselves convinced of this higher ability”).

104. See Langevoort, *Organized Illusions*, *supra* note 33, at 153 (explaining that the benefit of a determined focus is that it can “avoid the informational paralysis that often comes from seeing and thus dwelling on too many risks or opportunities” and that “[h]igh levels of self-esteem and self-efficacy are associated with aggressiveness, perseverance, and optimal risk-taking”).

105. Of course, opportunities often exist to undertake projects, such as rolling out a new product, on a pilot-project basis. More subtly, instead of bringing some transaction within the firm, a company could undertake it through contract, recalling the firm/market boundary that Coase stressed in his work on the theory of the firm. See R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937), reprinted in R.H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 33 (1988). By way of example, consider a joint venture between two companies as opposed to a merger or acquisition.

106. For a related study of the search for charismatic “corporate saviors,” see KHURANA, *supra* note 8.

agement team.¹⁰⁷ Being “right” on an expected basis might not be enough to compete effectively against firms who in fact “win big” on a few projects.¹⁰⁸

The upshot is that when a manager is hesitant to take what might be seen as irrational risks, his company faces the prospect of being surpassed by more aggressive, hard-charging competitors who are willing to take chances to ensure that they remain ahead of the pack. Put bluntly, overconfidence can give managers the guts to take the risks and to make the business changes that are necessary for a company to remain competitive, even if it sometimes means taking too much risk. It is especially important for companies to remain aggressive and innovative, and to avoid resting on their past accomplishments, given the increasingly global marketplace and the rapid rate of technological change.¹⁰⁹

Additionally, a CEO who exhibits self-confidence and commitment to a course of action can boost morale and motivate others in the firm to pull hard in the same direction, whether it is integrating a target following an acquisition, entering a new line of business, or embarking on a visionary R&D effort. Outwardly self-confident and charismatic managers can also create a “tone at the top” that instills self-confidence in others at the company, thereby encouraging them to be more innovative and entrepreneurial and to take prudent risks that they might have otherwise shied away from.¹¹⁰

107. Cf. Thaler, *Anomalies*, *supra* note 10, at 200 (explaining that if you reduce your bid to avoid the winner’s curse, “you will avoid paying too much . . . but you will also win very few auctions. In fact, you may decide not to bid at all! Unless you want to switch businesses, this solution is obviously unsatisfactory”); *infra* notes 184-87 and accompanying text (explaining that managers who take risks are more likely to become CEOs).

108. The law of large numbers does not apply to small numbers.

109. For influential studies that stress the need for companies to innovate and to eschew complacency to succeed over the long run, see CLAYTON M. CHRISTENSEN, *THE INNOVATOR’S DILEMMA: WHEN NEW TECHNOLOGIES CAUSE GREAT FIRMS TO FAIL* (1997); and CLAYTON M. CHRISTENSEN & MICHAEL E. RAYNOR, *THE INNOVATOR’S SOLUTION: CREATING AND SUSTAINING SUCCESSFUL GROWTH* (2003). These studies emphasize the need for established companies, such as Microsoft, AT&T, and IBM, to continue to create disruptive technologies to outcompete upstart competitors.

110. Maccoby put it this way:

Why do we go along for the ride with narcissistic leaders? Because the upside is enormous. . . . When narcissists win, they win big. Narcissists create a vision to change the world; they are bold risk takers who think and act independently, pursuing their vision with great passion and perseverance. This is exactly the kind of leader we expect to take us to places we’ve never been before, to build empires out of nothing.

MACCOBY, *supra* note 71, at xiv.

There is a risk, however, that individuals will become too competitive and, as a result, too aggressive and willing to push the envelope too far—in terms of taking excessive business risks, as well as possibly engaging in fraud or illegal conduct—as they compete for promotions, bonuses, and organizational prestige. See, e.g., Langevoort, *Hyper-Competition*, *supra* note 33. Enron has been identified as fostering such a “hyper-competitive” culture, with Enron’s CFO, Andrew Fastow, the culture’s embodiment. There

Third, by projecting confidence, managers can send an important signal to competitors. A show of confidence is often interpreted as signaling a person's competence, commitment, and willingness to compete aggressively.¹¹¹ A reputation of competence and commitment is an important asset that can stave off competition, making it easier for a company to enter a new market with fewer rivals or to avoid a heated bidding contest in acquiring a target. Managers not only lose face when they back off from some business decision, but the market may see the management team as tentative, inviting greater competition. Plus, investors may lack confidence in a management team that seems unsure of itself. The problem is that talk is often cheap; a manager is expected to puff and to manage others' impressions of him and his company.¹¹² Accordingly, a CEO's reputation as an able and determined competitor will be more credible if he has a track record of being cutthroat, even to the point of being irrational.¹¹³

To generalize the point, when repeated play is expected in a competitive environment, the value of a particular course of conduct is not fully captured by focusing on its net cash flow, as it might be if the company were facing a one-off decision. Rather, the capitalized value of the reputational assets a management team builds when confidence and commitment are credibly projected should be taken into account when evaluating whether an undertaking is prudent or, more precisely, has a positive net present value.¹¹⁴

is also a risk that individuals will be too loyal to the CEO. The CEO might be so charismatic and convincing that others too readily follow him at the expense of important corporate governance checks and balances, which are undercut when the CEO goes unchallenged or is shielded from bad news.

111. See, e.g., Brown, *supra* note 102 (summarizing literature regarding reputation and signaling); see also Russo & Schoemaker, *supra* note 67, at 16.

112. Thus, the market should discount any signal sent by a CEO who is outwardly unflappable and decisive in discussing his vision for the company and the lengths to which the company will go to execute its business plan.

113. When a firm closes a deal, it not only acquires tangible assets or penetrates a new market, but it can also acquire the intangible benefits of a bolstered reputation. Any negative payoff today from overpaying in an acquisition, for example, might be outweighed by future gains the company enjoys if its dogged—perhaps irrational—determination defuses future competition. For a case study of the 1985 takeover battle between McCaw and Bell-South for Lin that illustrates this point, see Troy Paredes & Paul Robinson, *Sizing Up the Competition: Getting Paid to Play and Other Bidding Strategies in Takeovers*, STAN. J.L. BUS. & FIN., Autumn 1999, at 72.

114. For more on credible commitments, escalation, and signaling, see generally PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* 126-65 (1992).

Commentators have noted that managers, in part because of their inability to diversify their firm-specific human capital, might protect their positions by managing the business more conservatively than shareholders would prefer. Accordingly, an additional benefit of CEO overconfidence might be that it offsets managerial risk aversion. See, e.g., GERVAIS ET AL., *supra* note 97 (showing that CEO overconfidence and optimism can ameliorate conflicts of interest between risk-averse managers and shareholders); GOEL & THAKOR, *supra* note 41, at 29 ("CEO overconfidence turns out to be a virtue for risk-neutral sharehold-

It is important to stress that, unlike agency theory, the behavioral model of managerial decisionmaking assumes that managers are loyal and act in what they honestly believe to be the best interests of the corporation and its shareholders.¹¹⁵ The behavioral model might particularly resonate as an explanation of managerial mistakes with those who believe that most CEOs act in good faith and are well-intentioned.

III. DOES CORPORATE GOVERNANCE CAUSE OVERCONFIDENCE?

Now that we have a better sense of how overconfidence can influence managerial decisionmaking, a more elusive question is raised: What might cause CEO overconfidence? It is likely that individuals who vie for the top job are highly confident to start with. My hypothesis, though, which remains to be tested empirically, is that CEO overconfidence is itself a product of corporate governance.

A. *Too Much Pay*

1. *The Conventional Story*

Executive compensation is one of the most controversial topics in corporate governance.¹¹⁶ The corporate opportunity doctrine and the

ers . . . because it helps overcome to some extent the risk aversion of managers and thus closes the 'preference gap' between shareholders and managers.”)

115. Others have also stressed this distinction between the agency and behavioral models. See, e.g., MALMENDIER & TATE, WHO MAKES ACQUISITIONS?, *supra* note 76, at 3, 29; Hayward & Hambrick, *supra* note 33, at 123-24; Heaton, *supra* note 12, at 33-35, 43-44; Hietala et al., *supra* note 76, at 26-27; Malmendier & Tate, *CEO Overconfidence*, *supra* note 76 (manuscript at 5-6). Jensen has tried to reconcile the models' differences when it comes to the tendency of people to act other than in their own self-interest, describing such irrationality as a sort of “internal” conflict of interest, as “people face agency problems in the form of conflicts with themselves.” See Michael C. Jensen, *Self-Interest, Altruism, Incentives, and Agency Theory*, in CORPORATE GOVERNANCE AT THE CROSSROADS 124, 129 n.8 (Donald H. Chew, Jr. & Stuart L. Gillan eds., 2005) (citing Richard H. Thaler & H.M. Shefrin, *An Economic Theory of Self-Control*, 89 J. POL. ECON. 392 (1981)).

116. For comprehensive analyses of executive compensation from which the following draws, see STEVEN BALSAM, AN INTRODUCTION TO EXECUTIVE COMPENSATION (2002); LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004); MICHAEL C. JENSEN ET AL., REMUNERATION: WHERE WE'VE BEEN, HOW WE GOT TO HERE, WHAT ARE THE PROBLEMS, AND HOW TO FIX THEM (Harvard Bus. Sch., NOM Research Paper No. 04-28, European Corporate Governance Inst., Fin. Working Paper No. 44/2004, 2004), available at <http://ssrn.com/abstract=561305>; Luis R. Gomez-Mejia, *Executive Compensation: A Reassessment and a Future Research Agenda*, in 12 RESEARCH IN PERSONNEL AND HUMAN RESOURCES MANAGEMENT 161 (Gerald R. Ferris ed., 1994); Luis Gomez-Mejia & Robert M. Wiseman, *Reframing Executive Compensation: An Assessment and Outlook*, 23 J. MGMT. 291 (1997); and Kevin J. Murphy, *Executive Compensation*, in 3B HANDBOOK OF LABOR ECONOMICS 2485 (Orley Ashenfelter & David Card eds., 1999). See also Brian J. Hall, *Executive Pay Research*, at <http://www.people.hbs.edu/bhall/ec> (providing an index of working papers and articles on executive pay) (last visited Feb. 27, 2005).

demand requirement, for example, do not attract interest the way a \$15 million CEO compensation package does, particularly when paid out during a slumping stock market or an economic downturn marked by job loss. Only “cooking the books” or hostile takeovers come close to grabbing attention the way executive pay does.

At the risk of oversimplifying, one may divide the normative executive compensation debate into two principal camps. The first camp contends that CEOs should receive a portion of the firm value they create in order to incentivize them to maximize firm value. If the firm is profitable and growing, shareholders, along with other corporate constituencies, are said to benefit, and the CEO should participate in the gains.¹¹⁷ The second camp responds that huge executive compensation packages often amount to little more than corporate looting.¹¹⁸ At the very least, huge CEO pay, it is argued, reflects a board that is shirking its responsibility by not exercising due care in overseeing and negotiating executive pay. Proponents of this second view can lean on *In re Walt Disney Co. Derivative Litigation*,¹¹⁹ in which Chancellor Chandler of the Delaware Chancery Court found that the alleged facts indicated that the Disney directors, in approving what amounted to a pay package exceeding \$140 million for Michael Ovitz, even though he served only about a year as the company’s president, “failed to exercise any business judgment and failed to make *any* good faith attempt to fulfill their fiduciary duties to Disney and its stockholders.”¹²⁰ Even the members of this camp who recognize the benefits of aligning the interests of managers with the interests of shareholders reason that a CEO works no harder or smarter when he is paid \$15 million (let alone \$50 million) as opposed to, say, \$1.5 million. Politics, of course, influence the debate, particularly after the headline-grabbing scandals at Enron, WorldCom, Tyco, Adelphia, the New York Stock Exchange, and elsewhere.

Against this normative backdrop, academic work on executive compensation tries to explain the why, when, how, and how much of executive pay—in other words, its size and design.¹²¹ Two leading ex-

117. Of course, if a corporation becomes more profitable by cutting costs, certain corporate constituencies, such as employees, could suffer, at least in the short run.

118. In terms of looting, it is worth considering that an overconfident CEO, with an inflated sense of himself and his worth to the firm, might not see a huge compensation package, even one loaded with perks of all sorts, as looting in the way that an outsider might. The CEO might honestly believe that he is worth his pay and entitled to it. At a minimum, accounting for a CEO’s genuine sense of entitlement could cloud a fiduciary duty or corporate corruption case alleging excessive executive pay.

119. 825 A.2d 275 (Del. Ch. 2003).

120. *Id.* at 278.

121. See, e.g., Gomez-Mejia & Wiseman, *supra* note 116 (explaining that the basic issues of executive pay are “(1) what are the *criteria* used in determining pay and employment . . . (2) what are the *consequences to the incumbent* (e.g., the level of pay and the risk

planations are the so-called “optimal contracting approach” and the “managerial power approach.”¹²² I can be brief in describing these approaches, since these models of executive pay have been discussed at length elsewhere and since my present intent is not to critique or evaluate these approaches, although I note that I think there is truth to both.

In the optimal contracting view, compensation packages are designed to reduce agency problems that arise when there is a conflict of interest between managers and shareholders and when ownership and control are separated. The challenge of executive pay is to devise payment practices that encourage managers to maximize firm value, recognizing managers’ tendency to act in their own self-interests. The primary focus is on creating the right link between executive pay and corporate performance. In emphasizing the need to create the right incentives for managers, adherents to this view worry more about the “how” than the “how much” of executive pay.¹²³ Although imperfect, stock options are perhaps the best-known contracting technique for linking executive pay and corporate performance.¹²⁴ There have, in fact, been a number of notable changes to stock options—such as minimum holding periods for shares received upon exercise and so-called premium-priced options—in response to the stark criticism of stock options following the wave of scandals beginning with Enron.¹²⁵ Still other companies, such as Microsoft, have switched to granting restricted stock to executives and employees.¹²⁶ The redesign of options and the switch to restricted stock is the very kind of executive compensation innovation that the optimal contracting approach anticipates.

The managerial power approach is an alternative model of executive compensation. Bebchuk, Fried, and Walker offer the most com-

of pay); and (3) what *mechanism* . . . is used to link compensation criteria to the compensation consequences”).

122. See Bebchuk et al., *supra* note 23, at 753.

123. See Michael C. Jensen & Kevin J. Murphy, *CEO Incentives: It’s Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138.

The optimal contracting view of executive compensation could account not only for the incentive effects but also for the behavioral implications of executive pay described in Part III.A.2.

124. For more on the pros and cons of stock options, see Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, J. ECON. PERSP., Summer 2003, at 49; and Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847 (2002).

125. See, e.g., Ken Brown & Joann S. Lublin, *Overhaul for Stock Options: Business Group Backs Tougher Rules*, WALL ST. J., Sept. 17, 2002, at C13; William M. Bulkeley, *IBM to Trim Use, Value of Options in Compensation*, WALL ST. J., Feb. 25, 2004, at B3.

126. See, e.g., Robert A. Guth & Joann S. Lublin, *Tarnished Gold: Microsoft Ushers Out Era of Options*, WALL ST. J., July 9, 2003, at A1.

plete development of the model.¹²⁷ They have summarized the model this way:

Analysis from this perspective focuses on the ability of executives to influence their own compensation schemes. According to the [managerial power] approach, compensation arrangements approved by boards often deviate from optimal contracting because directors are captured or subject to influence by management, sympathetic to management, or simply ineffectual in overseeing compensation. As a result . . . executives can receive pay in excess of the level that would be optimal for shareholders; this excess pay constitutes rents.¹²⁸

Put differently, executive compensation is itself part of the agency problem that preoccupies corporate governance, because managers use their power to extract for themselves value that would otherwise accrue to shareholders or perhaps to other corporate constituencies.¹²⁹ As examples of this sort of managerial rent extraction, Bebchuk, Fried, and Walker point to option repricing and the widespread use of at-the-money options, both of which, they say, are hard to explain from an optimal contracting perspective, as is the sheer size of some executive compensation packages.¹³⁰ It is doubtful, for example, that a CEO needs to receive options worth tens, and in some cases hundreds, of millions of dollars to be properly motivated. The managerial power approach attempts to use rent extraction to explain features of executive pay packages that the optimal contracting approach has a difficult time justifying.¹³¹

One more highlight of the managerial power approach is worth noting. Even if boards do not meaningfully check executive compensation, the market might. According to the model's proponents, executives are concerned about their reputations, as well as their jobs, and therefore have an incentive to avoid payment packages that trigger outrage by the general public and by investors, especially influential institutional investors, such as public pension funds.¹³² Just

127. See MARIANNE BERTRAND & SENDHIL MULLAINATHAN, DO CEOs SET THEIR OWN PAY? THE ONES WITHOUT PRINCIPALS DO (Nat'l Bureau of Econ. Research, Working Paper No. 7604, 2000), available at <http://nber.org/papers/w7604>; Bebchuk et al., *supra* note 23; see also Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, J. ECON. PERSP., Summer 2003, at 71.

128. Bebchuk et al., *supra* note 23, at 754.

129. See Bebchuk & Fried, *supra* note 127. But see Murphy, *supra* note 124, at 854-55 (explaining that it might be more appropriate to view high executive pay in terms of effective CEO bargaining as opposed to managerial rent extraction).

130. See Bebchuk et al., *supra* note 23, at 795-846 (discussing examples of managerial rent extraction).

131. *Id.*

132. See *id.* at 786-88; see also Murphy, *supra* note 124, at 855-57 (summarizing the history of outrage over CEO pay). For an excellent article on shaming, see David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811 (2001).

ask former New York Stock Exchange (NYSE) Chairman and CEO Richard Grasso, who stepped down from his post at the NYSE as a result of the outrage over his compensation package,¹³³ and former General Electric Chairman and CEO Jack Welch, who, after retiring, restructured his retirement package in the face of the public's outcry over what it saw as an outlandish exit package for him.¹³⁴ Executives also presumably want to avoid spurring the outrage of lawmakers, judges, and prosecutors. As of this writing, for example, Grasso is embroiled in litigation with New York Attorney General Eliot Spitzer over Grasso's NYSE pay.¹³⁵ Executive pay has even received new attention from the Delaware judiciary, raising questions about the future applicability of the business judgment rule when it comes to CEO pay.¹³⁶

One way for executives to skirt outrage is to receive less pay. This is the essence of the "outrage constraint" that Bebchuk, Fried, and Walker discuss. Another option for skirting scrutiny, which Bebchuk and his colleagues stress, is that managers may simply structure their pay in order to "camouflage" their compensation to make it less transparent.¹³⁷ In this way, the managerial power approach predicts not only high executive pay but also distortions and inefficiencies in how executives are paid. The stamp of approval by an outside compensation consultant can also dampen criticism by lending legitimacy to an executive's pay, notwithstanding that many observers doubt the independence of these consultants.¹³⁸

133. Kate Kelly, *Grasso Quits amid Pay Controversy*, WALL ST. J., Sept. 18, 2003, at A1.

134. Carol Hymowitz, *Investors Must Lead Charge to Keep Big Bosses in Line*, WALL ST. J., Sept. 17, 2002, at B1.

135. See generally Kate Kelly, *Familiar Firepower Is Reunited in Grasso Case*, WALL ST. J., June 18, 2004, at C1.

136. See, e.g., Tom Becker, *Delaware Justice Warns Boards of Liability for Executive Pay*, WALL ST. J., Jan. 6, 2003, at A14 ("Comments by the chief justice of the Supreme Court of Delaware that corporate directors could be held legally liable if they fail to act in good faith are being viewed as a warning shot for those who set executive pay packages."); E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 447 (2003) (suggesting there are "limits" to executive compensation). Historically, Delaware courts have scrutinized executive pay more intensely than is usually required under the business judgment rule.

137. Bebchuk et al., *supra* note 23, at 789-91; see also Ellen E. Schultz & Theo Francis, *Buried Treasure: Well-Hidden Perk Means Big Money for Top Executives*, WALL ST. J., Oct. 11, 2002, at A1. On this point, the Securities and Exchange Commission has recently indicated that it might reconsider executive compensation disclosure requirements under the federal securities laws. The use of stock options as opposed to cash compensation might be seen as a form of "camouflage," at least until options are required to be expensed. For more on the hidden cost of stock options, see Murphy, *supra* note 124.

138. See, e.g., Bebchuk et al., *supra* note 23, at 789-91 (discussing the role of compensation consultants); see also *infra* note 178 (discussing the ratcheting up of executive pay). In responding to the managerial power model of executive pay, Murphy and Hall have developed the "perceived cost" model of executive pay. In the perceived cost model, stock options have been generously dispensed to executives because companies routinely, but mistak-

To many people, efficiency, reducing agency costs, and aligning interests are beside the point as second-order concerns.¹³⁹ The principal problem with executive pay according to these observers is that it is simply out of control. Regardless of how much value the CEO creates or how well-meaning the CEO is, in this view, it is unfair, if not unconscionable, to pay top executives millions of dollars and several hundred times what the typical worker gets.¹⁴⁰ Proponents of this view often point out that managers in Europe and Asia are paid much less than their U.S. counterparts and, the argument seems to imply, are sufficiently industrious.¹⁴¹ More ardent proponents of greater fairness (that is, more compressed wage differentials) would forgo CEO effort and productivity at the margin in order to rein in executive pay and to ensure that employees have a larger slice of the smaller corporate pie.

CEO pay has come under scrutiny before and will come under scrutiny again. There seems to be a sort of ebb and flow to certain business-related controversies and concerns. Perhaps this reflects nothing more than the business cycle and the ebb and flow of bull and bear markets. When times are good, there is enough wealth to go around for everybody; when times are tough, people become more cautious financially and fight harder for the marginal dollar. To the extent that the executive pay controversy is more intense this time around, it might have something to do with the explosion in executive compensation resulting from stock options, as well as the attention that has been focused on CEO perks other than pay, including stories of six-thousand-dollar shower curtains and million-dollar toga parties, which seem to have nothing to do with motivating the CEO

only, treat options as relatively inexpensive to grant because they can be granted with no cash outlay and no accounting charge. Executives, however, understand that options are risky and therefore discount their value. This results in various grantee-friendly provisions and practices, such as below-market strike prices, option repricing, and reload provisions. The regulatory response Murphy and Hall suggest is to educate managers and boards about the true cost of options and to require that stock options be expensed to bring the perceived cost of options in line with their economic cost. For more on the perceived cost model of executive compensation, see Hall & Murphy, *supra* note 124; and Murphy, *supra* note 124.

139. For studies of executive pay from a fairness perspective as opposed to an optimal contracting or agency cost perspective, see, for example, DEREK BOK, *THE COST OF TALENT: HOW EXECUTIVES AND PROFESSIONALS ARE PAID AND HOW IT AFFECTS AMERICA* (1993); and GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES* (1991).

140. See Hall & Murphy, *supra* note 124, at 63-64 (summarizing data on the compensation gap between CEOs and rank-and-file workers). According to Hall and Murphy, the wide gap is largely attributable to CEO option and stock grants. *Id.*

141. See, e.g., BALSAM, *supra* note 116, at 277-81 (discussing CEO compensation across countries); Bebchuk et al., *supra* note 23, at 842-45 (also discussing CEO compensation across countries).

to run the business profitably.¹⁴² Plus, executive compensation currently is swept up in the larger wave of corporate scandal at Enron and elsewhere. Many see executive compensation as emblematic of the “infectious greed” some claim was at the root of the scandals that ultimately cost investors trillions of dollars and tens of thousands of employees their jobs.¹⁴³ A more nuanced take on the same point is that massive stock option grants gave executives a reason to “cook the books,” either by managing earnings or engaging in outright fraud, to prop up the value of their options. The incentive to inflate earnings intensified as the stock market bubble burst in 2000 and as the underlying economy began to slide and companies struggled to meet earnings targets. Worsening the perception of CEO pay, CEOs have continued to take home huge pay in the post-Enron era, even though stock prices remain significantly below their all-time highs.¹⁴⁴

To give some numbers,¹⁴⁵ Mercer Human Resource Consulting found that in 2003 the median “direct compensation” (defined as salary, bonuses, gains from the exercise of options, other long-term incentive payouts, and the value of restricted shares when granted) of CEOs at the 350 companies Mercer surveyed climbed over 16% to \$3.6 million.¹⁴⁶ Colgate-Palmolive’s Mark Rueben (\$141.1 million), Apple’s Steven Jobs (\$74.75 million), United Technologies’ George David (\$70.2 million), and Cendant’s Henry Silverman (\$54.3 million) took home some of the largest pay packages.¹⁴⁷ Notably, these figures do not take into account the value of unexercised options or the appreciation in restricted shares that chief executives hold. (The

142. For more on CEO perks and the debate over whether they enhance managerial productivity or evidence managerial excess, see RAGHURAM G. RAJAN & JULIE WULF, ARE PERKS PURELY MANAGERIAL EXCESS? (Nat’l Bureau of Econ. Research, Working Paper No. 10494, 2004), available at <http://nber.org/papers/w10494>; DAVID YERMACK, FLIGHTS OF FANCY: CORPORATE JETS, CEO PERQUISITES, AND INFERIOR SHAREHOLDER RETURNS (N.Y. Univ. Stern Sch. of Bus., Fin. Working Paper No. 04-008, 2004), available at <http://ssrn.com/abstract=529822>. The alleged abuses of Tyco CEO Dennis Kozlowski include a six thousand dollar shower curtain and a million dollar toga party for his wife’s birthday. See Complaint, Tyco Int’l Ltd. v. Kozlowski, No. 1:02-cv-07317-TPG (S.D.N.Y. filed Sept. 12, 2002) [hereinafter *Tyco Complaint*], available at 2002 WL 32152254.

143. Most notably, Federal Reserve Chairman Alan Greenspan referred to “infectious greed” as an underlying cause of the recent wave of corporate corruption at companies such as Enron. David Wessel, *Mission ‘Unlikely’: More Clouds May Beset Resilient U.S. Economy*, WALL ST. J., Oct. 10, 2002, at A2.

144. Even as a company struggles, its CEO could argue that the company would perform even worse with somebody else at the helm. Such arguments, regardless of their merit, are likely to fall on deaf ears.

145. For studies of 2003 CEO pay, see *Executive Pay: A Special Report*, N.Y. TIMES, Apr. 4, 2004, § 3, at 1 (compiling various articles about executive pay); and *Executive Pay (A Special Report)*, WALL ST. J., Apr. 12, 2004, at R1 (same).

146. *The Boss’s Pay: The WSJ/Mercer 2003 CEO Compensation Survey*, WALL ST. J., Apr. 12, 2004, at R6 (section of *Executive Pay*).

147. *Who Made the Biggest Bucks*, WALL ST. J., Apr. 12, 2004, at R1 (section of *Executive Pay*).

Mercer study found that the median value of shares owned by CEOs was \$9.08 million.¹⁴⁸⁾

Without a doubt, CEOs are paid very well. However, focusing on the level of CEO pay misses the real problem. There may be no justification for giving CEOs rents, and it makes sense to try to link CEO pay to firm performance. But at least when it comes to cash compensation and perks, except in very rare cases, the amount of firm value that large CEO compensation packages distribute to chief executives is unlikely to have a meaningful impact on a company's underlying economic well-being or financial performance, especially for larger public companies.¹⁴⁹⁾

CEO pay is a small portion of most companies' overall cost structure. A high level of CEO pay, in and of itself, is unlikely to cause a

148. *Id.*

149. Critics of executive pay assert that CEO pay is "excessive." But when is CEO pay "excessive"? Some say that CEOs simply should not be paid above a certain amount—say, two million dollars per year, at a maximum. Others argue that CEO pay is "excessive" when CEOs receive several hundred times what the average worker is paid. Some critics at least make an effort to tie the notion of "excessive" pay to a CEO's value to the corporation. For example, executive pay might be "excessive" if it is substantially out of line with how the firm has performed under the CEO's leadership. In this vein, New York Attorney General Eliot Spitzer is going after former New York Stock Exchange Chairman and CEO Richard Grasso's pay under a state law that prohibits (for executives of not-for-profit corporations) compensation that is not "reasonable" and "commensurate with services provided." See Kate Kelly, *Langone Says NYSE Wasn't Misled on Pay of Ex-Chief Grasso*, WALL ST. J., June 15, 2004, at C1.

Each of these standards for determining when CEO pay is "excessive" begs a host of questions beyond this Article's scope. But one basic point is important to make: Determining when CEO pay is "excessive"—in other words, determining how much a CEO "deserves"—cannot be reduced to conclusory statements about what is too much. More to the point, why should any sort of artificial cap be placed on the value of a CEO's services and what he is paid for providing them? The intimation seems to be that a CEO should accept his reservation price, or something approaching it, as opposed to having an opportunity to take home a larger share of the value he creates for shareholders—a view that seems to be colored by the fact that a CEO is bound by a fiduciary duty of loyalty. This perspective of CEO compensation is in sharp contrast to other settings, including other labor markets, in which the substantive regulation of the division of gains from trade between buyers and sellers is avoided.

Indeed, why not view the negotiation between the CEO and the board over the CEO's pay through the lens of market contracting and not through the lens of fiduciary duty? To be sure, CEOs should not be allowed to set their own pay by controlling the board. However, corporate governance changes have already been made—as a result of both regulation and market pressure—to better ensure arms-length bargaining. At public companies, for example, independent directors and shareholders now have a greater say over the compensation awarded to executives. In addition, the SEC is considering revising disclosure requirements to make executive pay more transparent, further empowering shareholder oversight. These tactics for reforming the process by which executive compensation is set are preferable to more substantive regulation that amounts to little more than efforts at price control. For a similar discussion of "excessive" CEO pay, see Hall, *Equity-Based Pay*, *supra* note 87, at 31-32, and for a discussion of whether CEO pay is even that high, see BALSAM, *supra* note 116, at 261-87.

company to fail or even directly impact its fundamentals.¹⁵⁰ Stock options are a somewhat different story. Options, if expensed, reduce reported earnings, and more outstanding shares dilute earnings per share, independent of expensing. Simply granting options reduces earnings per share on a fully diluted basis prior to exercise. Still, granting options, as such, does not deplete a company's assets or adversely impact a company's cash flow (other than perhaps from an opportunity cost perspective). Here, my emphasis is not on the effect of CEO pay, including options, on a company's reported earnings—an accounting concept—but on how the company is actually run.¹⁵¹

The real problem with executive compensation is not that it redistributes wealth or even that it might allow senior executives to get away with a form of looting. The real problem is that it can actually destroy firm value by creating distortions and perverse incentives in how managers run the business. Together, the size and design of executive compensation can give rise to several sources of corporate mismanagement. For example, executives may manage the business to optimize their compensation arrangement. Given the practical difficulties of compensation design, coupled with the reality that a corporation's circumstances change over time, there are no assurances of a tight link between CEO pay and corporate performance. Indeed, setting the appropriate measure of corporate performance—stock price, revenue, earnings, operating income—to create the right incentive structure for managers is in itself a difficult choice in compensation design. There may be a still greater misalignment between the interests of managers and shareholders if managers are able to influence their own compensation structures, as the managerial power approach claims.

Most notably, managers may alter the company's business plan and adjust the projects the company undertakes in order to meet Wall Street's expectations.¹⁵² Particularly with the explosion of stock option grants to senior executives, managers have a strong personal financial incentive to avoid the punishment investors routinely inflict on a company's stock price when earnings targets and growth estimates are not met. To meet the market's expectations, managers might focus on the short-run, perhaps even just the upcoming quarters, at the expense of long-run corporate performance and share-

150. A recent study of fifteen hundred companies found that in 2000, total CEO compensation, including options and stock, averaged 7.89% of corporate profits. Bebchuk & Fried, *supra* note 127, at 88 (citing BALSAM, *supra* note 116, at 262).

151. Somewhat surprisingly, the Boies, Schiller & Flexner LLP law firm acknowledged a similar point in the complaint it filed on behalf of Tyco against its former Chairman and CEO L. Dennis Kozlowski, admitting that the monies Kozlowski allegedly looted, although "substantial" to him, were "not material" to Tyco, a company with assets exceeding \$55 billion. See *Tyco Complaint*, *supra* note 142. Tyco is not an outlier in this sense.

152. See, e.g., Graham et al., *supra* note 57.

holder value. Alternatively, managers might undertake a risky project, recognizing the need for a big payoff to “make the numbers” or to otherwise signal that management and the company are headed in the right direction. Jensen and Fuller have recently explained that managers are sometimes even more blatant than this, using the consensus expectations of Wall Street as the starting point for the company’s budgeting process.¹⁵³

There is, of course, another way to meet expectations. If the company’s actual fundamentals are not on target, then it could choose to manage earnings or to engage in outright fraud.¹⁵⁴ In addition to the bona fide scandals that made headlines in recent years, companies have restated earnings at a record pace, with restatements steadily increasing: there were 116 in 1997, 158 in 1998, 234 in 1999, 258 in 2000, and 305 in 2001 (the year the scandals began to break).¹⁵⁵ The number of restatements in 2002 was 330, and the number was 323 in 2003.¹⁵⁶ The effects of this sort of “cooking the books,” whether or not illegal, extend beyond a particular company and its investors to impact capital flows and market integrity more generally. Where would investors have put their money had the finances, governance, and business plans of Enron and WorldCom been more transparent?

CEO overconfidence exacerbates the expectations game and the distortions and inefficiencies it can lead to. Overconfident CEOs have unrealistic expectations for the business, which in turn become the standard by which the market judges the company’s performance. Management, then, is under even greater pressure to meet the overly optimistic expectations it shapes.

The earlier discussion downplaying the consequences of the sheer level of executive pay was oversimplified. A high level of executive pay, in and of itself, can give rise to a number of important effects, other than the immediate effect of distributing wealth to CEOs. First, the sheer size of executive pay might lead managers to undertake bold, excessively risky projects to justify their pay. A manager may do this strategically to signal to the market that he is “worth every nickel.”¹⁵⁷ Further, a highly paid executive may take bold steps

153. See Fuller & Jensen, *supra* note 57.

154. For a discussion of earnings management, see Coffee, *supra* note 58; and Levitt, *supra* note 58.

155. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 624 (3d ed. 2003) (citing compilations of earnings in studies performed by Arthur Andersen and Huron Consulting Group).

156. See Cassell Bryan-Low, *Error-Driven Restatements Rose Again in 2003, but Pace Slowed*, WALL ST. J., Jan. 13, 2004, at C3; Cassell Bryan-Low, *Restatements Rise 22%*, WALL ST. J., Jan. 21, 2003, at C3.

157. For the view that managers are “worth every nickel” they are paid, see, for example, Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, HARV. BUS. REV.,

out of a sense of self-worth in order to convince himself that he deserves his rich pay.¹⁵⁸ It is not, however, the case that managers always undertake risky projects. Some managers may instead be overly conservative in order to avoid jeopardizing the company's well-being and, accordingly, their jobs and incomes if some project does not pan out. In other words, once a person becomes CEO, job preservation may lead to risk aversion, even if an individual has an incentive to take risks when trying to become CEO.¹⁵⁹ In either event, the bottom line is straightforward: the amount of executive pay itself can create perversities in managerial decisionmaking that undercut firm value.

Second, perceived inequities rooted in pay inequality can destroy firm value, blurring the lines between equity and efficiency. Building on social comparison theory, studies show that pay inequality can demoralize workforces and undercut collegiality and teamwork, leading to a loss of productivity and greater turnover.¹⁶⁰ Turnover is a particular concern for knowledge-based companies and for businesses that require a high degree of firm-specific investment in human capital to operate efficiently.¹⁶¹ The demoralizing effects of wide pay differences can impact not only rank-and-file employees and middle managers but also senior executives who believe they are underpaid compared to the CEO.¹⁶² The demoralizing effects may be amplified for senior managers who have been passed over for the chief executive job, as the tournament to become CEO can leave behind a group of frustrated "losers."¹⁶³ Third, high levels of executive compensation

Mar.-Apr. 1986, at 125. *See also* James B. Wade et al., *Worth, Words, and the Justification of Executive Pay*, 18 J. ORGANIZATIONAL BEHAV. 641 (1997) (discussing the symbolism and justification of executive pay); Edward J. Zajac & James D. Westphal, *Accounting for the Explanations of CEO Compensation: Substance and Symbolism*, 40 ADMIN. SCI. Q. 283 (1995) (discussing the symbolism and politics of CEO compensation).

158. For more on the justification of CEO pay, see generally Wade et al., *supra* note 157; and Zajac & Westphal, *supra* note 157.

159. *See* Hall, *Equity-Based Pay*, *supra* note 87, at 29-30 (describing managerial risk aversion as a job preservation strategy). Stock options, as well as overconfidence, are sometimes viewed as antidotes to managerial risk aversion.

160. For more on the relationship between executive pay and social comparison theory, see, for example, CHARLES A. O'REILLY III ET AL., OVERPAID CEOs AND UNDERPAID MANAGERS: EQUITY AND EXECUTIVE COMPENSATION (Stanford Univ. Sch. of Bus., Working Paper No. 1410, 1996) (on file with author) [hereinafter O'REILLY ET AL., OVERPAID CEOs]; Brian G.M. Main et al., *The CEO, the Board of Directors and Executive Compensation: Economic and Psychological Perspectives*, 4 INDUS. & CORP. CHANGE 293 (1995); O'Reilly et al., *supra* note 41; and Thomas, *supra* note 41. The classic article on social comparison theory is by Leon Festinger, *A Theory of Social Comparison Processes*, 7 HUM. REL. 117 (1954).

161. *See, e.g.*, Thomas, *supra* note 41, at 457 ("Tournament losers may leave the firm if the wage gap is too big, resulting in a decline in firm value if the losing managers have valuable, firm-specific human capital.").

162. On the other hand, a CEO may become demoralized and frustrated if he believes that he is underpaid compared to his counterparts at other companies.

163. *See* O'REILLY ET AL., OVERPAID CEOs, *supra* note 160, at 7 (stressing the adverse consequences of having an organization filled with past losers of tournaments); Donald C.

can erode the investor trust and confidence on which capital markets depend. Paying executives large sums calls into question the soundness of corporate governance. A huge CEO compensation package, for example, may be symptomatic of structural weaknesses in governance that can more seriously compromise a company's performance. Although the immediate dollars at issue may not be significant given a company's finances, the CEO's pay may indicate that the board, in general, is too lax and quiescent in overseeing management.¹⁶⁴ Investors and analysts focus on managerial oversight and effective corporate governance more today than ever.¹⁶⁵ Recent studies suggest a link between the quality of governance and better corporate performance, and companies thought to have poor corporate governance often perform less well and trade at a discount.¹⁶⁶

2. *The Behavioral Approach*

When considering the link between managerial behavior and executive pay, the emphasis typically is on incentives and agency costs. The question of managerial motives, for example, is central to both the optimal contracting and managerial power approaches. Both approaches view executive pay through the agency lens in trying to un-

Hambrick & Albert A. Cannella, Jr., *Relative Standing: A Framework for Understanding Departures of Acquired Executives*, 36 ACAD. MGMT. J. 733, 737-44 (1993) (explaining the "status degradation" that acquired executives often experience as a reason for their departure following the acquisition); Thomas, *supra* note 41, at 447 (explaining that "firms holding tournaments wind up full of 'losers' in the management ranks below the CEO").

164. See, e.g., Mark Maremont, *Executives on Trial: Tyco Jury Hears About Huge Fee*, WALL ST. J., Jan. 14, 2004, at C1 (noting that Tyco's stock dropped twenty percent the day after the disclosure of a \$20 million payment to then director Frank Walsh and suggesting that the drop was attributable to a shock to investor confidence as opposed to the \$20 million transfer, as such).

165. See, e.g., Paul Sweeney, *Taking Off the Blinkers*, INVESTMENT DEALERS DIG., at <http://www.iddmagazine.com/idd/NYTSStories/nytsstories.cfm?id=9174&issueDate=current> (Feb. 21, 2005).

166. See, e.g., LUCIAN A. BEBCHUK & ALMA COHEN, THE COSTS OF ENTRENCHED BOARDS (Nat'l Bureau of Econ. Research, Working Paper No. 10587, 2004), available at <http://nber.org/papers/w10587> (reporting that the reduction in market value associated with charter-based staggered boards is significant, with a median reduction of 4%-6% and summarizing related literature); Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003) (reporting a relationship between greater shareholder protection and higher stock prices and a higher Tobin's *Q* and summarizing related literature); John E. Core et al., *Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations* (Sept. 2004) (unpublished manuscript) (reporting that firms with weak shareholder rights show underperformance in operating results), available at <http://ssrn.com/abstract=533582>.

Exorbitant executive pay raises concerns that the system is rigged in favor of insiders, particularly if one sees executive pay as a form of looting that implicates the board and not as the product of an arms-length bargain between managers and directors. Still, the primary concern with lax accountability is not that managerial disloyalty will go unchecked, but that the corporate discipline associated with good corporate governance guards against bad business decisions.

derstand managers' motives and how to channel managers toward improving corporate performance and maximizing firm value.

The behavioral approach to executive compensation advanced here views executive pay through the lens of cognitive psychology.¹⁶⁷ This approach emphasizes the potential impact of executive pay on the cognitive biases of CEOs. Instead of focusing on the details of why, when, how, and how much chief executives are paid, the behavioral approach is principally concerned with the consequences of executive compensation for CEO confidence and the impact of growing CEO confidence on corporate behavior. The behavioral approach to executive compensation theorizes that high levels of executive compensation can bolster CEO confidence and, accordingly, worsen the CEO overconfidence problem described earlier.¹⁶⁸

Notwithstanding significant advancements in the study of human behavior, there is always guesswork in understanding how people think and behave.¹⁶⁹ It is tough enough to measure CEO confidence, let alone its origins.¹⁷⁰ That said, an extensive literature indicates that past success, as well as other forms of positive feedback and reward, builds a person's confidence and self-esteem and can therefore exacerbate overconfidence.¹⁷¹ This link between success and "kudos," on the

167. The social comparison and investor confidence concerns described above are also in a sense psychological in nature. Further, the optimal contracting and managerial power approaches to executive pay are themselves behavioral in the broad sense that they study how motives affect executive behavior. The behavioral approach to executive pay that this Article emphasizes focuses distinctly on the cognitive impact of large executive compensation.

168. Hayward and Hambrick focus on three potential causes of CEO overconfidence—(1) recent organizational success; (2) media praise for the CEO; and (3) a CEO's sense of self-importance—in their study of the relationship between CEO overconfidence and bidder overpayment in acquisitions. Hayward & Hambrick, *supra* note 33, at 107-09.

169. The guesswork may be diminishing with advances in neuroscience. For interesting work on "law and neuroeconomics" (as compared to "behavioral law and economics"), see TERRENCE CHORVAT ET AL., LAW AND NEUROECONOMICS (George Mason Univ. Sch. of Law, Law & Econ. Working Paper No. 04-07, 2004), available at <http://ssrn.com/abstract=501063>; and Colin Camerer et al., *Neuroeconomics: How Neuroscience Can Inform Economics*, 43 J. ECON. LITERATURE 9 (2005).

170. As proxies for CEO confidence, Hayward and Hambrick used recent stockholder returns (measuring recent organizational success); content analyses of major newspapers and magazines about CEOs (measuring media praise for the CEO); and CEO compensation relative to the second-highest paid officer (measuring CEO self-importance). See Hayward & Hambrick, *supra* note 33, at 113-14 (explaining that each measured item is likely to bolster CEO confidence). For an alternative measure of overconfidence based on how long a CEO holds company options, see MALMENDIER & TATE, WHO MAKES ACQUISITIONS?, *supra* note 76, at 16-20; and Malmendier & Tate, *CEO Overconfidence*, *supra* note 76 (manuscript at 18-33).

171. See Brown, *supra* note 102, at 665-68 (explaining the link between rewards and various attributes of self-esteem); Daniel et al., *supra* note 61 (developing a model of investing in which investors become overconfident with success as a result of self-attribution); P. Christopher Earley et al., *Impact of Process and Outcome Feedback on the Relation of Goal Setting to Task Performance*, 33 ACAD. MGMT. J. 87, 87, 103 (1990) (explaining that "[f]eedback can provide information about the correctness, accuracy, and

adequacy of work behaviors” and reporting experimental results showing that positive feedback can boost self-confidence, even for individuals whose performances were “quite poor”); Gervais & Odean, *supra* note 15 (explaining that successful investors become overconfident as they take too much credit for their success); Hambrick & Cannella, *supra* note 163, at 739 (explaining that in the acquisitions context, acquiring executives may have “great confidence in their managerial abilities, a hubris that leads them to believe they can fully manage the acquired firm themselves or, at a minimum, impose their decisions on its executives”); Hayward & Hambrick, *supra* note 33, at 115-18 (reporting a relationship between greater media praise for a CEO and prior organizational success and greater overconfidence, as reflected in higher premiums in acquisitions); Edward B. Katz, *Self-Esteem: The Past of an Illusion*, 58 AM. J. PSYCHOANALYSIS 303, 311 (1998) (explaining the view that “high esteem is related to achievement, having power, significance in the eyes of others, virtue . . . and competence” and that “success, achievement, power, etc., lead to self-esteem to a very great degree”); Veronika Kisfalvi, *The Threat of Failure, the Perils of Success and CEO Character: Sources of Strategic Persistence*, 21 ORG. STUD. 611, 613-15 (summarizing literature showing a link between success and overconfidence); Kramer, *supra* note 100 (studying the relationship among the “heady effects of power’s rewards,” CEO overconfidence, and reckless leadership); Ellen J. Langer & Jane Roth, *Heads I Win, Tails It’s Chance: The Illusion of Control as a Function of the Sequence of Outcomes in a Purely Chance Task*, 32 J. PERSONALITY & SOC. PSYCHOL. 951 (1975) (explaining that “success” in predicting the outcomes of coin tosses led subjects to believe that they had greater skill at predicting the outcomes of coin tosses); Harry Levinson, *Why the Behemoths Fell: Psychological Roots of Corporate Failure*, 49 AM. PSYCHOLOGIST 428, 432 (1994) (“The higher one rises in an organization, the more self-confidence one is likely to develop about one’s proficiency in one’s role. Concomitantly, the higher one rises, the less supervision one is likely to have. The combination of these factors frequently gives rise to narcissistic inflation that becomes overconfidence and a sense of entitlement.”); Therese A. Louie, *Decision Makers’ Hindsight Bias After Receiving Favorable and Unfavorable Feedback*, 84 J. APPLIED PSYCHOL. 29 (1999) (explaining the link between past success and confidence in terms of self-attribution and the hindsight bias); Michael McCarrey, *Impact of Esteem-Related Feedback on Mood, Self-Efficacy, and Attribution of Success: Self-Enhancement/Self-Protection*, CURRENT PSYCHOL. RES. & REVIEWS, Winter 1984, at 25 (explaining that success boosts self-esteem and, in turn, self-confidence); Danny Miller, *The Perils of Success, or Failure, Where Is Thy Sting? A Comment on Whyte, Saks and Hook*, 18 J. ORGANIZATIONAL BEHAV. 433 (1997) (considering the link between success and greater confidence); Danny Miller, *What Happens After Success: The Perils of Excellence*, 31 J. MGMT. STUD. 325 (1994) [hereinafter Miller, *After Success*] (reporting empirical findings consistent with the view that past success leads to “greater extremes” of “strategy-making processes” by managers and can “engender” overconfidence “among leaders who come to believe that they truly understand and know how to control their environments”); William H. Starbuck & Frances J. Milliken, *Challenger: Fine-Tuning the Odds Until Something Breaks*, 25 J. MGMT. STUD. 319 (1988) (explaining in the context of the space shuttle Challenger disaster that individuals “grow more confident” as a result of success); Amber L. Story & David Dunning, *The More Rational Side of Self-Serving Prototypes: The Effects of Success and Failure Performance Feedback*, 34 J. EXPERIMENTAL SOC. PSYCHOL. 513 (1998) (finding that people who succeeded in tasks became more self-serving and came to see a stronger link between their skills and characteristics and their success); Vadim Subbotin, *Outcome Feedback Effects on Under- and Overconfident Judgments (General Knowledge Tasks)*, 66 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 268 (1996) (explaining experimental results showing that positive feedback increased confidence); Philip E. Tetlock, *Theory-Driven Reasoning About Plausible Pasts and Probable Futures in World Politics: Are We Prisoners of Our Preconceptions?*, 43 AM. J. POL. SCI. 335 (1999) (explaining study of experts’ predictions of geopolitical events and reporting that individuals whose predictions materialized took credit for being right and became more confident and that even individuals who were wrong “convince[d] themselves that they were basically right”); Glen Whyte et al., *When Success Breeds Failure: The Role of Self-Efficacy in Escalating Commitment to a Losing Course of Action*, 18 J. ORGANIZATIONAL BEHAV. 415 (1997) (reporting results from an investment experiment showing that a higher view of personal self-

one hand, and overconfidence, on the other, has intuitive appeal—whose confidence is not bolstered after they have been validated?—and stems in part from a person’s self-attributing tendency to take too much credit for positive results, while deflecting blame for poor outcomes. People who are successful or who receive kudos tend to become more confident in their skills and abilities and, consequently, are said to overestimate the likelihood of future success. In other words, “success makes a subsequent success appear more probable.”¹⁷² In layman’s terms, we might say a person has a “hot hand.”¹⁷³ This is not to say that a confidence boost is never justified on the heels of a good outcome; a person’s success may in fact indicate his high ability. It is to say, however, that overconfidence rooted in positive feedback and past success is a serious risk. As Tetlock put it, “The real threat to good judgment lies in the hubris that builds up from a succession of predictions that serendipitously turn out right.”¹⁷⁴

CEOs enjoy many successes, whether it is the profitable launch of a new product, a high-profile acquisition, or an effective expansion into a new market. Even a rising stock price in a rising market might be seen as validating the CEO’s talent, as opposed to the result of an overheated market that might have more to do with investor irrationality than fundamentals. Not only are CEOs likely to give themselves too much credit for such successes, but others are also likely to credit disproportionately a CEO’s skill and judgment. In general, CEOs receive much praise and recognition throughout their careers from the media, other executives, charitable organizations they support, politicians, and the like. Being a chief executive can be a heady

efficacy, rooted in past success, led to an irrational escalation of commitment); see also Gregory La Blanc & Jeffrey J. Rachlinski, *In Praise of Investor Irrationality*, in *THE LAW AND ECONOMICS OF IRRATIONAL BEHAVIOR*, *supra* note 20, at 542 (explaining the representativeness heuristic in investing as a variation on the “hot hand”); Krawiec, *supra* note 33, at 315 (attributing the link between recent success and greater overconfidence to the availability heuristic); Langevoort, *Taming the Animal*, *supra* note 33, at 168 (explaining that literature shows that “overconfidence grows with past success: analysts on a hot streak tend to become more aggressive in their subsequent forecasts, with a higher than average likelihood of inaccuracy, in comparison to their peers”); Prentice, *supra* note 33, at 1460-61 (explaining that “professional stock analysts who experience random success become overconfident in their stock-picking prowess”); Larry E. Ribstein, *Bubble Laws*, 40 HOUS. L. REV. 77, 81 (2003) (“Executives also are susceptible to overconfidence, particularly those who have the highest self-esteem and who may also be the most successful.”).

172. Starbuck & Milliken, *supra* note 171, at 323 (emphasis omitted).

173. For the classic article on the “hot hand,” see Thomas Gilovich et al., *The Hot Hand in Basketball: On the Misperception of Random Sequences*, 17 COGNITIVE PSYCHOL. 295 (1985). See also Thaler, *Anomalies*, *supra* note 10, at 198 n.7 (“[A]ccording to the hot-hand-hubris hypothesis, firms that have been doing well lately, perhaps because of a run of good luck, mistakenly think that they are ‘hot’ (i.e., good managers) and will be able to perform miracles with any firm they purchase.”).

174. Tetlock, *supra* note 171, at 361.

experience. Some CEOs have been criticized for being more celebrity than manager.¹⁷⁵

CEO pay is the most significant validation and form of recognition a chief executive receives, and high pay is more salient than other possible measures of a CEO's success and value to the firm. Not only is high CEO pay in and of itself success, but it also gives positive feedback on the chief executive's performance in running the company and more generally confers special status.¹⁷⁶ Numerous studies, for example, rank CEOs according to their pay every year, and compensation has repeatedly been characterized as an important "scorecard" by which CEOs gauge themselves. In 1997, Tyco CEO Kozlowski said, "If it's a system that's truly gauged toward incentivization or success for shareholders, compensation is your scorecard. It's a way of keeping score at what you're doing."¹⁷⁷ Since high executive pay signals a CEO's worth and that he is successful, it can be expected to bolster CEO confidence. The link between CEO compensation and confidence is probably stronger still if the CEO is among the most highly paid executives in his industry, let alone in the country.¹⁷⁸ Perhaps the link between CEO compensation and confidence

175. See generally KHURANA, *supra* note 8, at 51-80 (studying the rise of the "celebrity" CEO).

176. As Main, O'Reilly, and Wade have put it, "While few would dispute the importance of money, it is the status derived from it that may be most important . . ." Main et al., *supra* note 41, at 624.

177. Joann S. Lublin, *View from the Top: A CEO Discusses His Unusual Pay Package with a Shareholder Activist*, WALL ST. J., Apr. 10, 1997, at R14 (internal quotation marks omitted). Using a different sports metaphor, another CEO reportedly said, "My compensation is the most visible indication of my batting average." Donald B. Thompson, *Are CEOs Worth What They're Paid?*, INDUSTRY WEEK, May 4, 1981, at 64, 73 (internal quotation marks omitted). For more views on pay as the yardstick of success, see KHURANA, *supra* note 8, at 193 ("Search consultants and the business media fanned the flames by promulgating the idea that a CEO's compensation was a measure of his personal worthiness."); Sidney Finkelstein & Donald C. Hambrick, *Chief Executive Compensation: A Synthesis and Reconciliation*, 9 STRATEGIC MGMT. J. 543, 550-51 (1988) (explaining that "[p]ay is an important scorecard for individuals with high needs for achievement and recognition" and "provides a key representation of a CEO's achievement and worth"); Gomez-Mejia & Wiseman, *supra* note 116, at 337 (noting the view that "sizable compensation levels contribute to an image of higher status"); Martin M. Greller & Charles K. Parsons, *Contingent Pay Systems and Job Performance Feedback*, 20 GROUP & ORG. MGMT. 90, 91 (1995) ("[P]ay provides feedback on performance. How well has the individual done? How pleased is the organization with the individual's efforts?" (citations omitted)); Main et al., *supra* note 41, at 624 (explaining that "the real value of differences of money reward lies in the recognition or distinction assumed to be conferred thereby" (quoting CHESTER I. BARNARD, *THE FUNCTIONS OF THE EXECUTIVE* 145 (1938) (internal quotation marks omitted))); Arch Patton, *Those Million-Dollar-a-Year Executives*, HARV. BUS. REV., Jan.-Feb. 1985, at 56, 60 (explaining that many executives see "money as *the* measure of success").

178. Studies have shown that a board that relies on peer group compensation data in fixing its own CEO's pay will typically pay its CEO an amount that places him in the top half of the peer group. This not only signals the CEO's relative worth but also ratchets CEO pay higher and higher. Compensation consultants have been criticized for writing reports and analyzing data for their clients in a way that can be used to justify higher CEO

would be broken if CEOs did not believe they actually deserved their pay but viewed it as a windfall or even as excessive. This does not seem to be the case, however. To the contrary, there is reason to believe that chief executives, perhaps because of self-attribution tendencies or perhaps because of ego, believe that they are worth their pay.

The link between pay and confidence is not only about the absolute level of CEO pay but also about relative pay. In their study of sources of CEO hubris, Hayward and Hambrick assumed that CEOs exert influence over what they and other managers are paid, and thus they concluded that a large pay gap between a company's CEO and its other senior executives likely reflects the CEO's perception of himself as important and therefore deserving of considerably more compensation than other top executives. As they put it, "We expect that the greater the CEO's relative pay, the greater the self-importance of the CEO and the more likely he or she is to be infected with hubris."¹⁷⁹ Hayward and Hambrick's empirical study bears out their hypothesis. They found that a company was more likely to pay a higher acquisition premium—an indicator of hubris—the greater the gap was between CEO pay and the pay of other executives.¹⁸⁰

Pay differentials, however, may not only reflect CEO self-importance but may actually breed it. When a chief executive is paid several hundred times what a rank-and-file employee receives and substantially more than other senior executives, including the next most senior manager, the CEO may see the pay spread as another sign of success that validates his worth and value to the business. The self-confidence boost that arises out of this sort of positive self-reflection is the flip side of the demoralization effects that social comparison theory predicts for individuals who believe they are unfairly underpaid.

In addition to a CEO's cash pay and stock and option grants, perks are an important part of a CEO's compensation package and have drawn a great deal of scrutiny. CEO perks can include corporate jets, fancy apartments, artwork, huge expense accounts, and season tickets of all sorts, not to mention the \$15,000 umbrella stand and \$2200 wastebasket that Tyco's CEO, Kozlowski, got.¹⁸¹ At least for some CEOs, perks of the job also include being a guest in fashion-

pay. See generally Bebhuk et al., *supra* note 23, at 789-91 (discussing this ratcheting-up effect of CEO compensation and the role of compensation consultants).

179. Hayward & Hambrick, *supra* note 33, at 109.

180. *Id.* at 115-17, 121 (reporting the results of their study).

181. See RAJAN & WULF, *supra* note 142; YERMACK, *supra* note 142; Mark Maremont & Laurie P. Cohen, *The Tyco Way*, WALL ST. J., Sept. 18, 2002, at B1. For a summary of typical executive perks, see, for example, Lynnley Browning, *The Perks Still Flow (but with Less Fuzz)*, N.Y. TIMES, Apr. 6, 2003, § 3, at 6; Kramer, *supra* note 100, at 63.

able social circles, a regular on TV, a “cover” CEO on magazines, and an advisor to policymakers. Not every chief executive receives lavish perks and attention, and some perks actually can boost productivity. The risk, though, is that for CEOs who do enjoy such trappings of the job, the perks end up being less about the money and more about being treated better than others—like “royalty,” according to some observers.¹⁸² In other words, a CEO might view such lavish treatment as a conspicuous substantiation of his worth. Kramer has summed up the overconfidence concern of perks this way: “But as enjoyable as they can be, the trappings of power only serve to feed the dangerous illusions people already have about themselves. . . . [E]asy access to corporate jets and unlimited expense accounts turns those unrealistic beliefs into certain knowledge, resulting in a potentially fatal overconfidence.”¹⁸³

The behavioral view is notable in that it emphasizes the impact of executive compensation on managerial psychology, in contrast to more conventional models that study executive pay through the lens of managerial incentives and self-interest.

The focus so far has been on a person’s compensation after becoming CEO. But the very process of becoming CEO can breed confidence too.¹⁸⁴ The process of climbing the corporate ranks to become the chief executive has been described in terms of a tournament where the winner takes all.¹⁸⁵ The winners of each round are promoted until finally senior managers emerge, including the individual who is chosen to fill the top post. By definition, any person who is even considered for the CEO position will have a history of important successes, with the crowning achievement going to a single individual who is awarded the CEO title, as well as, in many cases, the title of chairman of the board. A senior manager is likely to take personal credit for his promotions, attributing them to personal skill and ability while discounting other factors, such as luck and politics. More to the point, as mentioned earlier, the market to become CEO favors those

182. See, e.g., KHURANA, *supra* note 8, at 179 (“The selection of the new CEO then turns out to resemble nothing so much as Napoleon’s coronation as Emperor of France, when the new ruler—usurping what was supposed to be the Pope’s role—placed the crown on his own head.”); Gomez-Mejia, *supra* note 116, at 173 (“[S]pecial privileges and large compensation packages at the top may be intended to provide a sense of royalty and be used as a signaling device to reinforce a figurehead image for the chief executives.”); Ronald Alsop, *Scandal-Filled Year Takes Toll on Companies’ Good Names*, WALL ST. J., Feb. 12, 2003, at B1 (stating critics’ stance that companies “stop treating executives like royalty” (internal quotation marks omitted)).

183. Kramer, *supra* note 100, at 63.

184. For similar discussions of the impact on an individual of winning the tournament to become CEO, see Camerer & Lovallo, *supra* note 64; Kramer, *supra* note 100, at 60-61; and Langevoort, *Resetting the Thermostat*, *supra* note 33, at 297-304.

185. See *supra* note 41 and accompanying text.

who take risks,¹⁸⁶ and those who vie to reach the ranks of senior management are presumably a self-selected group of highly confident individuals to start with.¹⁸⁷ Thus, the ranks of senior management are likely to be populated with people who have taken too much credit for the successful outcomes of what very well might have been a number of excessive risks, at least from a net present value perspective, that happened to turn out well. This is not to say that CEOs and other top executives are not highly qualified and talented individuals; skill does affect who reaches the next round, as do other factors, such as politics. It is simply to suggest that senior executives, as a result of having successfully climbed the corporate ladder, will tend to overestimate their capabilities.

Instead of choosing its CEO from its own ranks, a company may look to outside candidates. These outside candidates also have strong track records of success and perhaps are already CEOs elsewhere. The wooing of the outsider can further feed the target individual's sense of self-worth. Additionally, the individual is now sought after by at least two companies. Once the person accepts the post, more recognition often follows, especially if it is a high-profile move that grabs both the media's and market's attention.¹⁸⁸

The upshot is that as an individual advances to the CEO post by repeatedly beating out others, the risk is that he will become more and more confident as he experiences success at each stage. As Camerer and Lovallo put it, "Perhaps as cream rises to the top, hubris does too."¹⁸⁹

186. See *supra* notes 39-41 and accompanying text.

187. For a similar point, see Langevoort, *Hyper-Competition*, *supra* note 33, at 969-71 (explaining that aggressive, confident, and highly competitive individuals are likely to succeed in the corporate tournament).

188. For an interesting study of the market for outside CEOs, see KHURANA, *supra* note 8.

189. Camerer & Lovallo, *supra* note 64, at 316 (discussing the "snowballing overconfidence" that comes with success and promotion). Langevoort has expanded on this point in discussing the tendency of people to take credit for their success and to discount, if not disregard, their shortcomings and adverse information:

Whatever may have been the reasons for success (luck, perhaps, or good social skills), managers are likely to self-interpret their success in terms of talent, skill, and just dessert. Self-esteem grows, with the predictable increase in resistance to information that is inconsistent with inflated self-image. At the very top of the organization, we see a rarefied group of survivors very adept at producing, but with diminished capacity to see things as they really are. Indeed, the noted organizational psychologist Michael Macoby [sic] has claimed that the ultimate tournament survivors in high-growth "intangible"-based firms is [sic] often the hard core narcissist—a personality trait (disorder in severe instances) that often produces highly charismatic leadership coupled with a strong disinclination to accept or admit the truth.

Langevoort, *Hyper-Competition*, *supra* note 33, at 971 (citing Maccoby, *supra* note 8, at 69-70); see also Kramer, *supra* note 100, at 66 ("The process of getting to the top almost always changes people in ways they don't anticipate or appreciate.").

B. *Too Much Deference*

Large executive compensation packages are paid to chief executives against the backdrop of a corporate governance system that is characterized by deference to the CEO and his business judgment. This leads to the second reason CEO overconfidence is a likely product of corporate governance: CEOs receive too little criticism and too much affirmation. A great deal of power inheres in the CEO position. The CEO is the most senior executive, unequivocally so when the CEO is also the chairman of the board. In addition to consolidating power, simply holding the titles of both CEO and chairman can be an ego boost. The CEO, however, has more than just legal authority over the enterprise. Although control is also dispersed to other senior officers, the board of directors, and shareholders, these individuals and groups generally defer to the CEO and allow the CEO a great deal of latitude in how the business is managed, as explained below.¹⁹⁰ The chief executive's authority is therefore extended as a result of his additional de facto power.¹⁹¹ Even the courts, in effect, defer to the CEO under the business judgment rule. Nor are the gatekeepers without a role in creating a heady environment for top managers. The bottom-line concern is that the concentration of control in the hands of the CEO and the CEO's relatively unbridled exercise of power can actually embolden the CEO and in turn contribute to CEO overconfidence.¹⁹² The theory is that CEO overconfidence is endemic to customary corporate governance practices and the power the CEO exercises.

Before exploring in more detail the atmosphere of deference that routinely surrounds CEOs, even in the post-Enron era, it is worth briefly highlighting some important feedback effects between CEO confidence and CEO power that amplify the overconfidence problem. First, as a chief executive becomes more confident, others will tend to follow him more readily, perhaps blindly. Second, as a CEO becomes more powerful in practice, he may be able to exert still more influence over his compensation. Third, as a chief executive has repeated successes, he may be given more discretion within the company and may be subject to even fewer constraints and less oversight.¹⁹³ A successful CEO who has delivered good results is likely to be less ac-

190. See *infra* Parts III.B.1, III.B.3, and III.B.4.

191. For a discussion of various sources of CEO power, see *infra* notes 225-28 and accompanying text.

192. This claim is consistent with the literature on overconfidence generally and the impact of success and positive feedback on overconfidence in particular.

193. Miller, *After Success*, *supra* note 171, at 330 (explaining that past success may lead to sloppy systems, controls, and processes); Starbuck & Milliken, *supra* note 171, at 230 (“[S]uccess . . . evades vigilance and fosters complacency and routinization.”).

countable and may, for the most part, be given a free pass in how he runs the company, at least for some time.

1. *Subordinate Officers*

Perhaps the most obvious deferential group is subordinate officers.¹⁹⁴ Although there are always exceptions, such as an influential chief operating officer, managers who report to the CEO can be expected to quiet their dissent, or at least not to push hard in second-guessing the chief executive.¹⁹⁵ This is particularly the case for officers who are two or three rungs down on the corporate organizational chart. Even if a senior officer presses the CEO in private, the officer may be especially reluctant to challenge the CEO openly in front of other members of the management team or the board. This is not to say that a senior executive should be working at cross-purposes with the CEO, and it is certainly not to say that a manager should undertake to foil a project simply because he disagrees with it. It is to say, though, that too much deference from the ranks of management can reinforce a CEO's self-confidence and belief that he is right.

The reluctance of subordinate executives to step up and challenge the CEO creates an interesting coordination problem. Safety exists in numbers. If the senior vice president in charge of marketing or the CFO, for example, were vigorously to press the CEO at a meeting about some proposal, it might open the door for other executives to express more freely their skepticism or even flatly to object to the proposed course of action. It might also foster a norm of frank discussion, constructive criticism, and dissent. Nobody, however, wants to find himself alone out on a limb. Instead, too commonplace is a sort of herd behavior among subordinate officers to go along with the CEO.¹⁹⁶ This in turn has collateral consequences, discussed below, for the information that is ultimately brought to the board's attention when exercising its business judgment.¹⁹⁷

194. IRVING L. JANIS & LEON MANN, *DECISION MAKING: A PSYCHOLOGICAL ANALYSIS OF CONFLICT, CHOICE, AND COMMITMENT* 874 (1977); Donald C. Langevoort, *Ego, Human Behavior, and Law*, 81 VA. L. REV. 853, 873-74 (1995) (explaining that subordinates are often "yes men" (citing Canice Prendergast, *A Theory of "Yes Men,"* 83 AM. ECON. REV. 757, 769 (1993))).

195. One example of the exception might be Steve Ballmer, who was Bill Gates' number two at Microsoft before Ballmer himself became the company's chief executive. Others have suggested that Frank Wells was a powerful counterweight as Eisner's number two at Disney, and that Eisner became more immoderate and more domineering at Disney after Wells' death a decade ago. See, e.g., Laura M. Holson & Sharon Waxman, *Criticism of Disney Chief Grows Bolder*, N.Y. TIMES, Dec. 8, 2003, at C1.

196. For more on the tendency of subordinate officers to go along, see *supra* notes 46-50 and accompanying text.

197. See *infra* notes 287-98 and accompanying text.

2. Gatekeepers

The gatekeepers—attorneys, accountants, investment bankers, credit rating agencies, and securities analysts—are another quiescent group, as the wave of corporate scandals at Enron and elsewhere showed.¹⁹⁸ I do not want to make too much of the gatekeeper role when it comes to CEO overconfidence, as opposed to the more central function of gatekeepers in identifying and rooting out fraud and corruption. Gatekeepers, for example, do not have authority to manage the firm, and they are not as knowledgeable about the company or as close to corporate decisionmaking as the board and the management team.¹⁹⁹ Some might argue that it falls outside the job description of many gatekeepers to second-guess management's business judgment. Still, gatekeepers can influence decisionmaking, and their views are often key in evaluating and carrying out business decisions. Indeed, in arguably the most significant transaction a company can undertake—an acquisition—a fairness opinion from an investment bank is a practical requirement to get the deal done. In almost every instance in which an investment bank is engaged to render a fairness opinion, the bank concludes that the deal is fair, in effect validating the CEO's favorable view of the transaction.²⁰⁰

To the extent that lawyers, bankers, and other gatekeepers treat the CEO with kid gloves and, in particular, do not press as hard as they could when it comes to the wisdom of a particular transaction or the company's business strategy, the CEO's confidence is likely reinforced or at least not shaken. One could imagine an alternative norm whereby gatekeepers are more willing to challenge management. At a minimum, gatekeeper quiescence contributes to the overall atmosphere of deference in which CEOs operate.²⁰¹

198. For an analysis of gatekeeper failures that contributed to the Enron wave of scandals, see John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 *BUS. LAW.* 1403 (2002).

199. Jack Grubman, a once high-flying telecommunications analyst who was barred from the brokerage industry for his involvement in the WorldCom scandal, was a notable exception. He took an active role in prominent companies he covered, including Global Crossing, Qwest, and WorldCom. See Laurie P. Cohen & Dennis K. Berman, *How Analyst Grubman Helped Call Shots at Global Crossing*, *WALL ST. J.*, May 31, 2002, at A1; Anita Raghavan, *Jack of All Trades: How One Top Analyst Vaults "Chinese Wall" to Do Deals for Firm*, *WALL ST. J.*, Mar. 25, 1997, at A1.

200. For more on fairness opinions and the concern that the desired opinion is too often "bought," see *infra* note 320.

201. In fairness to gatekeepers, it should be mentioned that as a result of a spate of post-Enron regulatory reforms, litigation, and settlements with the SEC and New York Attorney General Eliot Spitzer, it appears that gatekeepers have in fact stepped up their vigilance and oversight role in the corporate governance system, at least insofar as certain compromising conflicts of interests have been addressed.

3. *Boards of Directors*

The primary check on CEO power is the board of directors, in particular independent outside directors. Accordingly, when directors defer to the CEO, it might singularly boost a CEO's confidence. Additionally, deferential and passive boards have been routinely criticized as a reason executives are paid so much, which has prompted the NYSE and Nasdaq to require the independent directors of listed companies to set executive pay.

Statutory control over a corporation resides in the board under the corporation law of every jurisdiction. The Delaware corporation code, for example, provides that “[t]he business and affairs of every corporation . . . shall be managed by or under the direction of [the] board of directors.”²⁰² In other words, the CEO has control because the board, as a matter of course, delegates it to the chief executive.²⁰³ Having delegated control, the board of directors is supposed to be the primary monitor of the CEO, as well as of the rest of management; and even though the board does not exercise day-to-day control over the enterprise, it does retain an important managerial role: exercising authority over major decisions and the company's overall business strategy.²⁰⁴

Boards have been criticized, especially after the scandals at Enron, WorldCom, Tyco, and elsewhere, as too quiescent and deferential to the CEO.²⁰⁵ It is easy to see why inside directors might defer to the CEO. But why do outside directors defer? Outside directors often lack the time, information, and expertise needed to challenge the CEO on business matters, let alone to block a course of action the CEO supports, and may see little reason to doubt a CEO who can point to a track record of success.²⁰⁶ Being an outside director is a

202. DEL. CODE ANN. tit. 8, § 141(a) (2004). The Model Business Corporation Act contains a similar broad delegation of control to the board. *See* MODEL BUS. CORP. ACT § 8.01(b) (2002) (“All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors . . .”).

203. Here, I am referring to a CEO's legal authority over the corporation. A CEO may have many other sources of power over the firm. *See infra* notes 225-28 and accompanying text.

204. The following discussion draws from and builds on an extensive literature on the board of directors. *See, e.g.*, Lynne L. Dallas, *Developments in U.S. Boards of Directors and the Multiple Roles of Corporate Boards*, in CORPORATE GOVERNANCE IN GLOBAL CAPITAL MARKETS 191 (Janis Sarra ed., 2003); Margaret M. Blair, *Directors' Duties in a Post-Enron World: Why Language Matters*, 38 WAKE FOREST L. REV. 885 (2003); David A. Nadler, *Building Better Boards*, HARV. BUS. REV., May 2004, at 102; Paredes, *supra* note 24; *see also infra* note 214.

205. For a thorough review of the board of directors in the aftermath of the wave of scandals starting with Enron, see COLIN B. CARTER & JAY W. LORSCH, *BACK TO THE DRAWING BOARD: DESIGNING CORPORATE BOARDS FOR A COMPLEX WORLD* (2004).

206. *See, e.g.*, Langevoort, *Resetting the Thermostat*, *supra* note 33, at 310 (explaining that “a streak of good fortune for the firm—which may be managerial skill, but may be just

part-time job. A recent study of *Fortune 1000* companies by Korn/Ferry International reports that in 2003 forty-four percent of boards met quarterly, while only nine percent of boards met monthly, and that directors spent an average of nineteen hours per month on company matters, including review and preparation time, attending meetings, and travel.²⁰⁷ Further, CEOs have control over the board's agenda and, therefore, can set what the board considers at its meetings. Routinely, important matters are slated for little discussion. Many directors complain that they have relatively little say over what is brought before them and that scripted management presentations consume most of the time allotted to an agenda item, affording directors little opportunity to ask questions and to discuss the matter during the formal meeting.²⁰⁸

Directors often do not have (or have simply forgotten) valuable information or, in the alternative, are sent so much information that they become overloaded and unable to distinguish what is important. One constant, already alluded to, is that board members generally do not have enough time to consider fully the information they do have, and they lack the requisite knowledge and insight into the company to evaluate critically matters before them. Moreover, outside directors have limited access to various personnel, such as junior officers, office heads, plant managers, and managers of business units, who might help them vet issues; and outside directors have no appreciable contact with suppliers, customers, creditors, or rank-and-file employees. For all intents and purposes, outside directors depend on the information the CEO and the other top executives provide.

McKinsey & Company recently surveyed 150 directors who serve on the boards of more than 300 public companies.²⁰⁹ The study reported that approximately 56% of the directors polled said that they only "moderately" know what is going on at the companies where they serve, while 14% of the directors polled responded "partially" when asked to what degree they really know what is going on at their companies. Of the directors McKinsey & Company surveyed, 76% said that the CEO "largely" "control[s] and shape[s] what directors learn about the company."²¹⁰

as much the state of the economy—creates a psychological dynamic that works to the CEO's favor").

207. KORN/FERRY INT'L, 30TH ANNUAL BOARD OF DIRECTORS STUDY (2003).

208. Nonexecutive chairmen ameliorate these concerns and outside directors increasingly meet in executive sessions without management present.

209. See Robert F. Felton, *What Directors and Investors Want from Governance Reform*, MCKINSEY Q., 2004, No. 2.

210. *Id.* A study by the consulting firm Mercer Delta made similar findings regarding the lack of expertise and knowledge of directors. See Nadler, *supra* note 204.

For an interesting discussion of information flow to the board that builds on so-called "structural holes," see LAWRENCE E. MITCHELL, STRUCTURAL HOLES, CEOs, AND THE MISSING

Given the realities of board service, directors may understandably conclude that they are not equipped to exercise better judgment than the CEO.²¹¹ Accordingly, the rational choice for members of the board often is to go along with the insiders who have the best information and insight into the business. The CEO may be particularly convincing about his decision to pursue some course of action if he exudes confidence and a firm sense of being in control; and, if the CEO has a track record of achievement, the board may be more inclined to defer to the CEO and to give him additional leeway in running the company.²¹² A CEO's ability to persuade is an important source of CEO control, whatever legal right the board has to object. If the board doubts that the CEO is acting in what he, the CEO, believes is the best interests of the corporation or doubts that the CEO is competent to run the company, then the board must address a more fundamental concern—namely, a CEO succession plan—than how to vote on some project or investment opportunity. More to the point, many directors simply believe it is not their job to run the business. Asking outside directors to be more actively engaged in corporate decision-making might be counterproductive in terms of further straining the limited resources of directors and in deterring qualified individuals from serving, concerns already raised in a post-Sarbanes-Oxley era.²¹³

The accommodating stance boards historically have taken toward their CEOs is more often attributed to a lack of director independence than a lack of director competence.²¹⁴ An inside director may be beholden to the CEO because his job may be at risk if he dissents. An

LINK IN CORPORATE GOVERNANCE (George Washington Univ. Law Sch., Pub. Law & Legal Theory Working Paper No. 77, 2003), available at <http://ssrn.com/abstract=467980>.

211. Cf. Kuran & Sunstein, *supra* note 46, at 720-23 (discussing “informational cascades” whereby individuals defer to those whom they believe are better informed, creating a bandwagon effect for the supposed better-informed view). Of course, this is no excuse for failing to at least press the CEO.

212. For more on nonlegal sources of CEO power, such as those suggested here, see *infra* notes 225-28 and accompanying text.

213. For a thorough discussion of the constraints of time and information that boards face, see CARTER & LORSCH, *supra* note 205, at 15-40, 113-40. See also Langevoort, *Resetting the Thermostat*, *supra* note 33, at 292-95.

214. The literature on director independence, on which the following discussion is based, is extensive and can only briefly be summarized here. For more fulsome treatments of director independence, see Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999); Victor Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597 (1982); Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265 (1997); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001); Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283 (1998); Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233 (2003); and Paredes, *supra* note 24.

outside director may also be beholden, compromising his independence, because the director's renomination may be similarly jeopardized if he opposes the CEO, although the conflict may be less severe than for inside directors. Even if the prestige and director fees that accompany sitting on a board do not squelch dissent and lead to relative appeasement of the CEO, an outside director may be conflicted because of lucrative consulting arrangements or other business dealings he has with the company. Still other independence problems may arise when the company, if not the CEO personally, makes significant contributions to charities or other organizations important to the outside director.

Key regulatory reforms enacted in the aftermath of Enron were directed toward shoring up board independence by rooting out these types of conflicts.²¹⁵ But not only financial conflicts and economic ties compromise independence.²¹⁶ Social and personal relationships between a director and the CEO can also undercut a director's independence.²¹⁷ Whatever the relationship might be at the start of a directorship, the very process of working closely for a number of years can create affinities that over time cloud a director's independent judgment. Furthermore, an outside director, who himself is a CEO at another company, might be biased toward going along with the CEO on whose board he sits, identifying with and deferring to the chief executive, just as he hopes his board will defer to him; or the director might simply believe that CEOs generally know what is best for the business and should be afforded wide discretion.

In addition, an outsider may feel indebted to the CEO who put him on the board and might therefore give the chief executive the benefit of the doubt. Relatedly, the board may become highly committed to, and therefore highly supportive of, the CEO it has decided to retain or possibly selected as part of a management transition.²¹⁸ In-

215. See generally Chandler & Strine, *supra* note 30; Paredes, *supra* note 24; *Developments in the Law—Corporations and Society*, 117 HARV. L. REV. 2181 (2004).

216. For a good survey of the sorts of structural biases among directors referred to below, see 2 BLOCK ET AL., *supra* note 52, at 1765-73.

217. See, e.g., *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 942-45 (Del. Ch. 2003) (finding that certain Stanford University colleagues serving on a special litigation committee of Oracle's board were not independent because of their social and professional connections to each other and to the defendants, including Oracle's CEO and Chairman Larry Ellison).

218. See, e.g., Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 343-44 (2003) ("Management failure inevitably is a bad reflection on the board that has endorsed the continued employment of the management team. This is especially true when a board has been in place during a management transition and is thus directly responsible for not only retaining management but also for identifying, selecting, and recruiting the managers."); see also Langevoort, *Resetting the Thermostat*, *supra* note 33, at 294 ("Once it has installed or chosen to retain a CEO, the board is motivated to trust the CEO more than it should.").

deed, the board may have actually transferred control to the CEO as part of the bargain to keep or hire him.²¹⁹ As a background point, directors may be biased toward preserving the status quo and may seek to avoid the dissension associated with CEO criticism and especially CEO turnover.²²⁰ Board commitment to the CEO could also explain the ratcheting up of CEO compensation, as a board routinely tries to pay its CEO in the top half of the relevant executive pay scale.²²¹

When presenting a project to the board, management may frame the issues to bias the board toward going forward with management's recommendation.²²² Indeed, the mere fact that management has a recommendation may bias the board toward signing off on it. It is very difficult as a practical matter for a board to stop a transaction that has considerable momentum, such as when senior management, the lawyers, the accountants, and the investment bankers have all signed off. Finally, directors might convince themselves that the CEO and other senior executives are right to avoid the stress and discomfort of the cognitive dissonance associated with disagreeing with the company's executives, as well as with other members of the board.

Aside from its implications for chief executive confidence, board deference to the CEO undercuts the purpose of group corporate decisionmaking. Corporations have boards of directors for a reason. A conventional explanation for why boards exist is that groups often make better decisions than an individual actor.²²³ The benefits of

219. In his study of the market for CEOs, Khurana argued that the deference the board shows to outside CEO candidates routinely results in an actual transfer of control to the CEO who is finally hired. KHURANA, *supra* note 8, at 179-85. According to Khurana, "When it comes to the candidate whom the board will ultimately select as its new CEO, it is during the deferential interview that control is actually transferred from the followers to the charismatic leader." *Id.* at 179.

220. For more on the status quo bias, see, for example, Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998); and William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7 (1988).

221. See *supra* note 178.

222. For more on framing effects, see James N. Druckman, *Using Credible Advice to Overcome Framing Effects*, 17 J.L. ECON. & ORG. 62 (2001); Cass R. Sunstein, *Moral Heuristics and Moral Framing*, 88 MINN. L. REV. 1556, 1590-97 (2004); and Tversky & Kahneman, *supra* note 79, at S251. See also Messick & Bazerman, *supra* note 100, at 13-14 (explaining the effect of risk framing on corporate decisionmaking); Russo & Schoemaker, *supra* note 67, at 11-12 (explaining that anchoring can cause overconfidence).

223. See, e.g., Bainbridge, *supra* note 33. See generally CASS R. SUNSTEIN, GROUP JUDGMENTS: DELIBERATION, STATISTICAL MEANS, AND INFORMATION MARKETS (Univ. of Chi. Law Sch., John M. Olin Law & Econ. Working Paper No. 219 (2d series), Pub. Law & Legal Theory Working Paper No. 72, 2004) (explaining the role of deliberation in group decisionmaking), available at http://ssrn.com/abstract_id=578301. An alternative explanation views boards as independent "mediating hierarchs" designed to control corporate assets and to allocate the firm's surplus among all the corporate constituencies in a way that encourages the optimal amount of firm-specific investment. For the leading proponents' dis-

group decisionmaking, though, depend on open and frank group deliberation. In terms of boards, this requires that directors, at the very least, consider a wide range of information and possibilities, develop competing ideas, and challenge each other as well as management. In other words, effective group decisionmaking requires constructive tension within the group and the willingness of individuals to share information and to express their independent views. When boards instead defer to the CEO, the deliberative process of boards is compromised as the CEO's view prevails unscathed. To put it in slightly different terms, groupthink negates the benefits of deliberation and group decisionmaking.²²⁴

There are two important background points that underpin board deference to the CEO. First, just beneath the surface of the discussion has been the question of CEO power. The extent of board deference depends in part on a CEO who has power that he is willing to cultivate and use. Not all CEOs have the same power bases, so the extent of CEO power and, accordingly, board deference is likely to vary from firm to firm. The management and leadership literatures have explored in depth several sources of CEO power.²²⁵ I will men-

discussion of this "mediating hierarchy" view, see Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

224. For a classic treatment of groupthink, see IRVING L. JANIS, *GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES* (2d ed. 1982). See also O'Connor, *supra* note 214.

225. For more on various sources of CEO power and influence, see KHURANA, *supra* note 8 (charisma); Maura A. Belliveau et al., *Social Capital at the Top: Effects of Social Similarity and Status on CEO Compensation*, 39 ACAD. MGMT. J. 1568 (1996) (social status); Jay A. Conger & Rabindra N. Kanungo, *Toward a Behavioral Theory of Charismatic Leadership in Organizational Settings*, 12 ACAD. MGMT. REV. 637 (1987) (charisma, including vision, self-sacrifice, risk-taking, self-confidence, and expertise); Sydney Finkelstein, *Power in Top Management Teams: Dimensions, Measurement, and Validation*, 35 ACAD. MGMT. J. 505 (1992) (expertise; compensation; education; outside directorships; education); Finkelstein & Hambrick, *supra* note 177, at 549, 551-52 (tenure); Gomez-Mejia, *supra* note 116 (compensation); Jerayr Haleblan & Sydney Finkelstein, *Top Management Team Size, CEO Dominance, and Firm Performance: The Moderating Roles of Environmental Turbulence and Discretion*, 36 ACAD. MGMT. J. 844 (1993) (creating an index of CEO power that includes, among other things, compensation, formal titles, education, outside directorships, and expertise); Main et al., *supra* note 160 (social influence, including reciprocity, authority, and similarity and liking); Janice S. Miller & Robert M. Wiseman, *Perceptions of Executive Pay: Does Pay Enhance a Leader's Aura?*, 22 J. ORGANIZATIONAL BEHAV. 703 (2001) (compensation; education; experience); Richard T. Mowday, *Leader Characteristics, Self-Confidence, and Methods of Upward Influence in Organizational Decision Situations*, 22 ACAD. MGMT. J. 709 (1979) (self-confidence); Salancik & Meindl, *supra* note 62 (impression management; image of control); Sosik et al., *supra* note 40 (charisma; impression management, including exemplification, ingratiation, self-promotion, intimidation, and supplication); Tedeschi & Melburg, *supra* note 40 (impression management, including ingratiation, intimidation, self-promotion, supplication, prestige, and status); Wade et al., *supra* note 40 (social influence, including norms of reciprocity, liking, and social consensus; reputation; tenure); James D. Westphal, *Board Games: How CEOs Adapt to Increases in Structural Board Independence from Management*, 43 ADMIN. SCI. Q. 511 (1998) [hereinafter Westphal, *Board Games*] (ingratiation, including flattery and doing favors; expertise; persuasion); James D. Westphal, *Collaboration in the Boardroom: Behav-*

tion just a few, some of which have already been alluded to. First, as a corporation's most senior executive, the CEO has far-reaching legal authority under corporate law and agency principles, and a CEO's authority extends further when he is also chairman of the board. CEO charisma is another important source of power that has received a great deal of attention in both the academic literature and the popular press.²²⁶ An aspect of charisma is self-confidence. Individuals are more likely to follow a CEO who shows self-confidence and appears to be in control.²²⁷ The mere fact that a CEO decisively makes a bold and risky move might persuade others to go along with him. Past success is another important power base. Understandably, people interpret prior achievement as a sign of ability. Even high CEO compensation may be a source of power and not just a product of it. The symbolism of CEO pay matters. As two commentators recently observed,

[t]he assumption that pay is relevant to perceptions of leader ability implies that pay level *in and of itself* communicates differences among executives. Since effective performance of the figurehead role depends on creating an aura of legitimacy, and if legitimacy is enhanced by the salary paid to an incumbent CEO, then it is reasonable that higher paid executives may command greater respect and are perceived as having superior credibility.²²⁸

Instead of being persuasive as such, some CEOs use either a strategy of ingratiation, like flattery, to induce followers or a strategy of supplication, suggesting that they need the support of the board. Finally, CEO power is related positively to factors such as CEO tenure, expertise, education, and reputation.

The second point underpinning board deference is that outside directors face only a slight risk of legal liability under state corporate law for failing to satisfy their responsibility to act with due care, even when they are relatively passive and essentially go along with management's recommendations for the business.²²⁹ Accordingly, there is little upside if directors oppose or even seriously challenge the CEO, and yet there are downside risks for doing so. Things might be changing, though. Several recent cases suggest courts today are

ioral and Performance Consequences of CEO-Board Social Ties, 42 ACAD. MGMT. J. 7 (1999) [hereinafter Westphal, *Collaboration*] (friendship; norms of reciprocity); James D. Westphal & Edward J. Zajac, *Who Shall Govern? CEO/Board Power, Demographic Similarity, and New Direction Selection*, 40 ADMIN. SCI. Q. 60 (1995) (demographic similarity; tenure); Zajac & Westphal, *supra* note 157 (tenure).

226. See sources cited *supra* note 8.

227. For more on whether CEO confidence is adaptive, see *supra* notes 102-14 and accompanying text.

228. Miller & Wiseman, *supra* note 225, at 705 (citation omitted) (reporting empirical results that cut against the figurehead view of CEO pay).

229. See *infra* notes 234-35 and accompanying text.

taking a harder look at director conduct and appear to be more willing to hold directors liable for breaching their fiduciary obligations. Going forward, directors may need to be more active when making decisions rather than simply engaging in pro forma process while approving management's proposals.²³⁰ Two notable cases that suggest a tougher judicial stance toward outside directors are *In re Walt Disney Co. Derivative Litigation*, in which Chancellor Chandler invigorated the fiduciary duty of good faith,²³¹ and *In re Oracle Corp. Derivative Litigation*, in which Vice Chancellor Strine tightened the definition of director independence.²³² In addition, the Sarbanes-Oxley Act, along with related SEC rules and regulations and the recently overhauled NYSE and Nasdaq listing standards, not only imposes a host of new requirements on the board, and independent directors in particular, but also might in effect stiffen fiduciary obligations. A board's failure to satisfy Sarbanes-Oxley, SEC, or stock market requirements in and of itself might be grounds for finding a fiduciary breach.²³³

This legal trend is noteworthy and should result, at least for the near term, in greater board oversight and involvement in the company. *Disney*, *Oracle*, and other recent cases notwithstanding, directors still are generally insulated from liability under state corporate law by the business judgment rule,²³⁴ exculpatory charter provisions exonerating directors from monetary damages, indemnification rights, directors and officers insurance, and procedural hurdles that make it difficult and costly for shareholders to bring derivative actions.²³⁵ Indeed, directors should continue to have relatively little ex-

230. See cases cited *infra* note 244 and accompanying text.

231. 825 A.2d 275, 278 (Del. Ch. 2003).

232. 824 A.2d 917 (Del. Ch. 2003). The Delaware Supreme Court, however, has recently cabined the effect of *Oracle*. See *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1054-55 (Del. 2004) (distinguishing *Oracle* by finding that certain personal relationships between Martha Stewart and various directors of Martha Stewart Living Omnimedia did not render such directors not independent).

233. See, e.g., Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 WM. MITCHELL L. REV. 1149 (2004) (explaining how the Sarbanes-Oxley Act is likely to influence state corporate law fiduciary duty analysis); see also Veasey, *supra* note 136, at 448 ("It is worth noting, as a matter of prudent counseling . . . that the issue of good faith may be measured . . . against the backdrop of Sarbanes-Oxley and [stock exchange listing standards] . . .").

234. In *Walt Disney*, for example, Chancellor Chandler, after holding that the plaintiff had alleged facts sufficient to defeat a motion to dismiss, found that the alleged facts indicated that the Disney board made no good-faith attempt to satisfy its fiduciary obligations in connection with the setting of Ovitz's compensation as Disney's president. 825 A.2d at 278.

235. See generally BERNARD BLACK ET AL., OUTSIDE DIRECTOR LIABILITY (Stanford Law Sch. John M. Olin Program in Law & Econ., Working Paper No. 250, 2003) (analyzing the minimal risk of legal liability that outside directors face), available at <http://papers.ssrn.com/abstract=382422>; BERNARD BLACK & BRIAN CHEFFINS, OUTSIDE DIRECTOR LIABILITY ACROSS COUNTRIES (Univ. of Tex. Law Sch., Law & Econ. Working Paper No. 31, Stanford Law Sch. John M. Olin Program in Law & Econ., Working Paper No. 266, 2004) (analyzing the risk of legal liability that outside directors face in

posure to legal liability so long as they manage to take minimum procedural steps in their deliberations and do not abdicate their authority or consciously ignore their fiduciary obligations.²³⁶

4. Shareholders

Shareholders' legal authority over the firm's operation is typically limited to voting on directors and on a small number of fundamental corporate changes, such as mergers or a sale of all or substantially all of the corporation's assets. Shareholders do not have control over ordinary business matters. Further, they have limited access to the company's proxy materials to make proposals that relate to the company's business.²³⁷ Accordingly, shareholders are constrained in their ability to express dissatisfaction with some course of action or to encourage the CEO to take certain steps in managing the business. To be sure, shareholders can solicit their own proxies. But the cost and challenge of coordinating dispersed shareholders frustrates shareholder action. Plus, the shareholder vote would not, in any event, be binding on the board or management.

Post-Enron, shareholders are more active and more outspoken in challenging both the CEO and the board. The number of shareholder proposals, for example, has jumped, particularly in respect to important corporate governance issues, executive compensation, and defensive tactics, such as staggered boards and poison pills.²³⁸ Further, together with shareholder watchdog groups like The Corporate Library and shareholder advisory firms like Institutional Shareholder Services, institutional investors, often led by public pension funds, are bringing more pressure to bear on CEOs and directors.²³⁹ Even a

Australia, Britain, Canada, France, Germany, and Japan), *available at* <http://papers.ssrn.com/abstract=438321>.

236. More concretely, even in the post-Enron era, when it comes to making business decisions that turn out poorly, directors are likely to escape liability if the board holds one or more meetings at which the directors consider the project before them with some modicum of care (the extent to which the board should consider the project depends on its magnitude and complexity); reviews important deal documents and reports; and hires outside advisors—low hurdles that most boards can clear but that might have managed to trip up the Disney board when it approved Michael Ovitz's compensation package. *See, e.g., Walt Disney*, 825 A.2d at 288-90.

237. *See infra* note 322.

238. *See, e.g.,* INVESTOR RESPONSIBILITY RESEARCH CTR. & INTERFAITH CTR. ON CORPORATE RESPONSIBILITY, 2003 SHAREHOLDER PROXY SEASON OVERVIEW: SOCIAL AND CORPORATE GOVERNANCE RESOLUTION TRENDS (2003), *available at* http://www.shareholderaction.org/files/proxy_season_overview_2003.pdf (last visited Feb. 15, 2005); Claudia H. Deutsch, *Revolt of the Shareholders*, N.Y. TIMES, Feb. 23, 2003, § 3, at 1.

239. For a thorough analysis of the "political model" of corporate governance, which depends in large part on informal pressures being brought to bear by institutional investors on directors and officers, see John Pound, *The Rise of the Political Model of Corporate Governance and Corporate Control*, 68 N.Y.U. L. REV. 1003 (1993).

private meeting with the CEO can be effective, particularly when backed by the credible threat of some sort of “shaming” campaign or a significant withhold vote for the CEO’s renomination to the board.²⁴⁰ The threatened removal of Michael Eisner at Disney in 2003 illustrates the impact shareholders can have, even without direct control of the company’s business.²⁴¹ Of further note was Microsoft’s decision to repurchase \$30 billion of its stock, issue a one-time \$3 per share dividend totaling \$32 billion, and double its annual dividend to \$3.5 billion per year in response to mounting pressure to distribute its huge cash reserves to its shareholders.²⁴²

Still, shareholders remain distant from actual corporate decision-making and remain limited in exercising the formal control and informal influence they do have because they are unaware of the day-to-day goings-on and business decisions being made, at least until that information is disclosed after the fact.

To be sure, a sell-off may follow when analysts lower their target price for a company. But even though a sell-off reflects concern about the company generally, it is not a direct or timely challenge to specific business decisions, let alone an up-close-and-personal challenge of the CEO himself. For the most part, shareholders still prefer the “Wall Street Rule,” in effect voting with their feet instead of with their voices by selling their shares if they are dissatisfied with the company’s performance. The decision to sell, however, is itself a form of investor capitulation to management. Instead of urging a management change or particularly criticizing the CEO, shareholders simply sell.²⁴³

While shareholder deference may not be as “intimate” as the deference directors show when they literally sit around a table together and expressly sign off on the CEO’s proposals, the lack of more pointed and direct shareholder pressure can still shore up a CEO’s confidence in how he is running the company, especially when the

240. See Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993) (discussing the impact of “just vote no” campaigns in which shareholders withhold votes for the renomination of directors); Skeel, *supra* note 132 (analyzing the role of shaming in corporate law); see also DAVID NOSAL, KORN/FERRY INT’L, THE IMPACT OF PUBLIC SCRUTINY ON CEOs AND BOARDS, <http://www.kornferry.com/library/ViewGallery.asp?CID=663&LanguageID=1&RegionID=23> (last visited Apr. 5, 2005).

241. Recent experience at Disney and elsewhere indicates that in the post-Enron era companies are more willing to listen to shareholder concerns and are more responsive, at least when it comes to matters of corporate governance. See, e.g., Bruce Orwall, *Disney Directors, Pension Officials Talk over Issues*, WALL ST. J., May 24, 2004, at B2.

242. See Robert A. Guth & Scott Thurm, *Opening Windows: Microsoft to Dole Out Its Cash Hoard*, WALL ST. J., July 21, 2004, at A1.

243. Of course, the decision of a target’s shareholders to sell to a hostile bidder, assuming defensive tactics do not block the bid, is not a form of capitulation to target management. To the contrary, the removal of the target board and management is part and parcel of the change of control.

CEO is likely to explain away any drop in the stock price as a result of shareholder selling.

5. Courts

Finally, there is judicial deference. Courts exercise control over corporations, particularly through the formulation of fiduciary obligations. A number of recent cases signal a tougher judicial stance when it comes to enforcing fiduciary obligations.²⁴⁴ Notwithstanding what appears to be greater judicial determination to oversee the management and governance of corporations, courts remain focused on the process of decisionmaking and not on the substance of the decisions. Although the caselaw might require more in the way of procedural due care going forward, courts still defer to and do not second-guess business decisions.

I do not want to overstate the role of judicial deference in promoting CEO overconfidence. Courts do not acquiesce to the CEO in the way boards have come under fire for doing in recent years or in the way subordinate officers might defer to their boss. Nonetheless, it is telling that as part of the overall climate in which a CEO heads his business, a chief executive faces little, if any, judicial scrutiny of his substantive decisions, as courts intentionally take a hands-off approach and do not pass judgment on the merits of business decisions.²⁴⁵ At the very least, judicial deference, operationalized by the business judgment rule, does nothing to undercut CEO confidence, and as described above, directors face only a minimal risk of legal sanction for failing to press management in exercising the board's responsibilities. Soft-look judicial review, indeed, does little to encourage CEOs to second-guess their own substantive business judgments before reaching a decision.

6. In Sum

The discussion here is not about power creating corrupt and self-interested managers. The behavioral approach to the firm and corpo-

244. See, e.g., *In re Abbott Labs. Derivative S'holders Litig.*, 325 F.3d 795 (7th Cir. 2003) (exculpatory provisions); *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001) (exculpatory provisions); *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001) (exculpatory provisions); *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003) (independent directors and special litigation committees); *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) (duty of good faith); *Biondi v. Scrushy*, 820 A.2d 1148 (Del. Ch. 2003) (independent directors and special litigation committees). For a good summary of the recent trend in Delaware corporate law, see A. Gilchrist Sparks, III et al., *Trends in the Delaware Corporate Law: Director Liability and Indemnification*, in A GUIDE TO MERGERS & ACQUISITIONS AND CONTESTS FOR CORPORATE CONTROL 2004, at 331 (PLI Corporate Law & Practice Course, Handbook Series No. B-1405, 2004).

245. See generally Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004).

rate finance assumes that managers act in good faith in pursuing what they honestly believe are the best interests of the corporation and its shareholders. Rather, my focus is on how concentrated control in the hands of the CEO and widespread deference to the CEO can lead to overconfident chief executives. The ability to influence and control others is as much a cause of CEO overconfidence as a consequence of it.

None of this is meant to suggest that CEOs are never challenged or never have to explain themselves. Every CEO is pressed from time to time and faces objections to his proposals. Some CEOs may even be taken to the proverbial woodshed occasionally or removed. Eisner is a notable example, suffering a 43% shareholder withhold vote on his renomination to Disney's board, after which he was replaced by George Mitchell as Disney's chairman before ultimately stepping down as chief executive.

Further, shifting greater control to shareholders, courts, or boards has its own risks. Few, if any, shareholders, including institutional investors, have the information or expertise to run the company.²⁴⁶ Moreover, greater institutional investor involvement creates its own agency and coordination problems, and shareholders may be subject to their own cognitive biases.²⁴⁷ Plus, if shareholders had a louder voice, as opposed to simply selling their shares when they believe the company is underperforming, then CEOs may become too cautious.

Similar concerns justify judicial deference under the business judgment rule. In short, judges are ill-equipped to second-guess business decisions and are likely to suffer from hindsight bias when reviewing corporate behavior. Through a gross negligence standard of judicial review of corporate conduct under the duty of care, courts have, in effect, tied their own hands in order to avoid chilling innovation and entrepreneurialism.²⁴⁸

246. Corporate control transactions are a notable exception. Given the significance of an acquisition, both bidder and target shareholders have an incentive to be informed about the transaction in a way that they may not be when it comes to whether a thousand new employees should be hired or whether a new factory should be opened.

247. See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277 (1991); Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987 (1994). For more on greater shareholder involvement, see *infra* notes 309-22 and accompanying text.

248. The concern that managers will be overdeterred from taking risks is exacerbated by the asymmetry of legal liability. In reality, managers face a risk of legal liability if they undertake a project and it turns out poorly. Managers do not face a risk of legal liability for imprudently forgoing some project. For general discussions of the business judgment rule, see ROBERT CHARLES CLARK, *CORPORATE LAW* §§ 3.4-.5 (1986); and CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, *CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS* 230-60 (4th ed. 2003). See also Paredes, *supra* note 53, at 1082-85 (discussing fiduciary duties).

Turning to the board, whatever the benefits are of greater board engagement, more friction in CEO-board relations comes at the risk of undercutting collegiality and teamwork. A CEO who is subject to strict board scrutiny may seek out the board's input less often, keeping the board in the dark even more, or may otherwise take a defensive posture in dealing with the board.²⁴⁹ Trust and openness are essential to good corporate governance. On the other hand, if corporate decisionmaking is too inclusive or too deliberative, the risk is that things will not get done. Decisive leadership is important; building real consensus can be paralyzing.²⁵⁰

Various post-Enron corporate reforms have emphasized containing executive compensation and ensuring greater corporate accountability. These changes, whether in response to Sarbanes-Oxley, SEC rules and regulations, stock market listing standards, or new best practices, have been driven by conventional agency concerns, in terms of both disloyalty and neglect of responsibility, and by efforts to root out fraud. More active independent directors, new CEO and CFO certifications, more demanding internal financial reporting controls, and more disclosure, to highlight just a few of the recent developments, might also address concerns about managerial overconfidence. Still, a beefed-up corporate governance system designed to police disloyalty, to motivate managers and directors to run the business profitably, and to prevent fraud does not substitute for a careful consideration of a corporate governance system that expressly accounts for the psychology of well-meaning managers.

A full-blown behavioral theory of the firm and corporate governance is beyond my present scope. The next Part, though, is a step in this direction, emphasizing a few early suggestions for how to manage CEO overconfidence and its effects on corporations.²⁵¹

IV. MANAGING CEO OVERCONFIDENCE

Starting from the premise that CEOs are overconfident, what can be done about it? Countering CEO overconfidence requires more than aligning incentives and motivating the CEO to work hard.²⁵² The fol-

249. For more on the potential adverse consequences of greater accountability, see *infra* notes 323-26 and accompanying text.

250. Put differently, although it is useful for dissenting views to be expressed, some individual or relatively small group needs final decisionmaking authority.

251. The scope and magnitude of any reforms designed in response to the psychology of CEO decisionmaking ultimately would need to account for a host of concerns relating to, among other things, transaction costs, coordination problems, imperfect information, agency costs, public choice, and the psychology of actors other than the CEO. Indeed, simply holding CEOs more accountable can be costly. See *infra* notes 323-26 and accompanying text. Such an extensive comparative institutional analysis is beyond my present scope.

252. See *supra* notes 98-99 and accompanying text; *infra* notes 323-26 and accompanying text; see also Mahzarin R. Banaji et al., *How (Un)ethical Are You?*, HARV. BUS. REV.,

lowing offers some preliminary suggestions.²⁵³ Although my focus is corporate governance, unconscious bias is important to consider in structuring any organization, not only firms.

Dec. 2003, at 56, 61 (explaining that “trying harder isn’t enough” to remedy unethical behavior rooted in unconscious bias); Koriat et al., *supra* note 59, at 117 (“Working harder will have little effect unless combined with a task restructuring that facilitates more optimal cognitive functioning.”); Tversky & Kahneman, *supra* note 79, at S274-75 (explaining that there is little experimental support for the view that “proper incentives” remedy cognitive bias). For a general discussion of debiasing in the legal literature, see CHRISTINE JOLLS & CASS R. SUNSTEIN, *DEBIASING THROUGH LAW* (Harvard Law Sch., John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 495, Univ. of Chi. Law Sch., John M. Olin Law & Econ. Working Paper No. 225, 2004), available at http://ssrn.com/abstract_id=590929.

253. The most conventional reform would be to limit executive compensation, and steps have already been taken in that direction because of concerns about looting and the misalignment of managerial incentives. In his final report on WorldCom, for example, Richard Breeden, the company’s court-appointed corporate monitor, urged various limits on both the cash and equity components of executive compensation. RICHARD C. BREEDEN, *RESTORING TRUST: REPORT TO THE HON. JED S. RAKOFF, THE U.S. DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK ON CORPORATE GOVERNANCE FOR THE FUTURE OF MCI, INC.* 31-33 (Aug. 2003), available at <http://www.sec.gov/spotlight/worldcom/wcomreport0803.pdf> (last visited Mar. 4, 2005). Most notably, Breeden recommended an overall cap of between \$10-\$15 million on an executive’s pay without a shareholder vote authorizing the board to pay more. The NYSE and Nasdaq companies went a different route. NYSE- and Nasdaq-listed companies now must allow independent directors to set executive pay, and their shareholders have a right to vote on certain equity compensation plans. Richard Parrino, *NYSE and NASDAQ Listing Standards Requiring Shareholder Approval of Equity Compensation Plans*, in *MANAGING THE FINANCIAL & OPERATIONAL COSTS OF SARBANES-OXLEY COMPLIANCE* 159 (PLI Corporate Law & Practice Course, Handbook Series No. B-1407, 2003); Peter J. Romeo et al., *Current Issues in Executive Compensation*, in *36TH ANNUAL INSTITUTE ON SECURITIES REGULATION* 679 (PLI Corporate Law & Practice Course, Handbook Series No. 1455, 2004). Following the corporate scandals and the outrage they incited, shareholders are more outspoken in their criticism of executive pay and have increasingly voiced their views through shareholder proposals recommending constraints on executive compensation. For more on the role of shareholder voice in reining in CEO pay, see, for example, RÜDIGER FAHLENBRACH, *SHAREHOLDER RIGHTS AND CEO COMPENSATION* (Univ. of Pa. Law Sch. Inst. for Law & Econ., Research Paper No. 03-05, 2003), available at http://ssrn.com/abstract_id=390144; Brian R. Cheffins & Randall S. Thomas, *Should Shareholders Have a Greater Say over Executive Pay?: Learning from the U.S. Experience*, 1 J. CORP. L. STUD. 277 (2001); Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201 (1996); and Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31 (2000).

Courts could also decide to assert greater say over the size and structure of executive pay by revitalizing the “waste doctrine.” See generally Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569 (2001). The waste doctrine gives Delaware courts the authority to enjoin a transaction if “no person of ordinary sound business judgment could view the benefits received in the transaction as a fair exchange for the consideration paid by the corporation.” *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 892 (Del. Ch. 1999) (quoting *Michelson v. Duncan*, 407 A.2d 211, 224 (Del. 1979) (quoting *Kaufman v. Shoenberg*, 91 A.2d 786, 791 (Del. Ch. 1952))) (internal quotation marks omitted). However, the waste doctrine seems to be in tension with itself. If a majority of independent and disinterested board members exercising due care approves a CEO’s pay package, that alone seems to undercut a finding of waste. Yet, if the board lacked the requisite independence and disinterestedness, did not exercise requisite care, or acted in bad faith, then there arguably is no need for the court to rely on waste because the directors might very well have breached their fiduciary duties in approving the CEO’s pay. Even if the waste doctrine were not revitalized, the Delaware ju-

Before proceeding, a few words of caution are in order. First, notwithstanding a vast and growing literature on the psychology of decisionmaking, important gaps remain in our understanding of how people make choices and why. Second, neither people nor decisions are monolithic. The different psychological makeup and motives of individuals, and the different decisions people face, make it even more difficult to predict behavior.²⁵⁴ Regulation can be a blunt tool for addressing the complexities of highly situational and individualistic decisionmaking. Rationality may turn out to be the most complete—or at least the most predictable—model of human behavior we have.²⁵⁵ Third, cognitive bias also affects lawmakers and judges.²⁵⁶ There is reason to believe, for example, that lawmakers and judges might overestimate their ability to “read” people and to craft the law to reflect human behavior. Replacing the assumption of rationality with an inaccurate reading of how people actually behave can do more harm than good.²⁵⁷ Fourth, a number of significant corporate

diciary, in the *Disney* line of cases, has suggested that it might be willing to take a tougher stance toward executive compensation as part of the unfolding fiduciary duty of good faith. Venturing further along this path, Seligman has proposed a federal waste standard, which Congress would adopt, prohibiting an executive from receiving “compensation that is so disproportionately large that it bears no reasonable relationship to the services rendered.” Joel Seligman, *Rethinking Private Securities Litigation*, 73 U. CIN. L. REV. 95, 135 (2004).

A controversial accounting change—the expensing of stock options—may also curb executive compensation. As options are expensed, companies are expected to limit the number of options granted to executives to mitigate the earnings hit of the expense. Interestingly, many observers have noted that the explosion in the number of options awarded to executives was at least in part the result of section 162(m) of the Internal Revenue Code, which was designed to keep executive pay in check by limiting the deductibility of nonperformance-based pay to one million dollars per year for a public company’s top five executives. See Joann S. Lublin, *Economists Call for Repeal of Curb on Executive Pay*, WALL ST. J., Nov. 24, 2003, at C14 (reporting Financial Economists Roundtable’s recommendation to repeal section 162(m) because it encourages stock option grants). Options have become the bulk of executive pay and are to a large extent the source of the outrage over CEO compensation by giving rise to CEO pay in the tens, and sometimes hundreds, of millions of dollars.

For an overview of various ways to limit executive pay, see BOK, *supra* note 139, at 114-18, 274-97.

254. See generally Korobkin, *supra* note 20 (discussing the challenges of basing policy recommendations on evidence of bounded rationality).

255. Gregory Mitchell has expounded on this point, arguing not only that people are more rational than behavioralism might suggest, Gregory Mitchell, *Taking Behavioralism Too Seriously? The Unwarranted Pessimism of the New Behavioral Analysis of Law*, 43 WM. & MARY L. REV. 1907 (2002) [hereinafter Mitchell, *Pessimism*], but also that people are not equally irrational, in which case a singular regulatory response to account for irrationality is imprudent, Gregory Mitchell, *Why Law and Economics’ Perfect Rationality Should Not Be Traded for Behavioral Law and Economics’ Equal Incompetence*, 91 GEO. L.J. 67 (2002) [hereinafter Mitchell, *Incompetence*].

256. See, e.g., Choi & Pritchard, *supra* note 59; Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165, 1196-1206 (2003); *infra* note 302.

257. In addition, there is the risk that the studies and experiments relied on may be incorrect, and there is a dangerous tendency to take a relatively narrow study or experiment that is highly qualified in its findings and to draw more general conclusions and im-

governance changes, the full costs and consequences of which are still unknown, have taken hold post-Enron. At some point, which may already be behind us, too much risk is regulated out of the market and too much of management's and the board's attention is diverted from running the business to complying with burdensome regulations and fending off judicial scrutiny. Fifth, highly confident CEOs may be inspiring leaders, and CEO overconfidence may counterbalance a CEO's incentive to avoid taking risks to protect his job. Finally, no single approach to corporate governance is optimal for countering CEO overconfidence in every case. To the contrary, corporate governance must be flexible enough to accommodate different personalities, management styles, corporate cultures, business needs, and budget constraints.

Still, we should not ignore the facts on the ground that instantiate CEO overconfidence. Serious thought should be given to designing a less CEO-centric corporate governance model. But reform should not be hasty. It is important to take psychology into account, but we should be cautious before implementing major reforms based on behavioral economics.²⁵⁸

A. Metacognition

The first of the three options I consider concerns "metacognition"—that is, thinking about and understanding how one thinks. The point is straightforward. Making managers aware of their cognitive tendencies and how they process and interpret information (that is, teaching executives how they deviate from perfect rationality) can mitigate cognitive bias.²⁵⁹ Put simply, recognizing the overconfidence

plications that the data may not sustain. The laboratory is not as complex or nuanced as the real world.

258. For different views from a variety of contexts on the question of how, if at all, bounded rationality and cognitive bias should shape regulation, see Korobkin, *supra* note 20; Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211 (2003); Choi & Pritchard, *supra* note 59; Mitchell, *Pessimism*, *supra* note 255; Mitchell, *Incompetence*, *supra* note 255; Paredes, *supra* note 15; Posner, *supra* note 19; Rachlinski, *supra* note 256; and Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159 (2003).

259. See, e.g., METACOGNITION, COGNITION, AND HUMAN PERFORMANCE (D.L. Forrest-Pressley et al. eds., 1985); Banaji et al., *supra* note 252, at 56-58 (explaining that to remedy bias, "managers must bring a new type of vigilance to bear. To begin, this requires letting go of the notion that our conscious attitudes always represent what we think they do. It also demands that we abandon our faith in our own objectivity and our ability to be fair."); Lovallo & Kahneman, *supra* note 16, at 61 ("Simply understanding the sources of overoptimism can help planners challenge assumptions, bring in alternative perspectives, and in general take a balanced view of the future."); Russo & Schoemaker, *supra* note 67, at 8-11, 13-15 (discussing the debiasing effects of metaknowledge (that is, knowing what you do not know) and explaining that "awareness alone may be all that is needed" to remedy overconfidence); Staw & Ross, *supra* note 66, at 71 (explaining that to counteract over-

problem can help solve it.²⁶⁰ A CEO, for example, who is aware of his biases can discipline himself by adopting decisionmaking techniques—such as seeking dissenting viewpoints, searching for disconfirming evidence, and interrogating his own assumptions and analysis more rigorously—to guard against his overconfidence, as well as any other cognitive bias or unconscious heuristic that might lead to suboptimal decisions.²⁶¹ Because of competitive pressures, the CEO has an incentive to discipline his decisionmaking once he is aware of his flawed judgment. Educating directors about how corporate managers make decisions and about directors' own biases is also helpful, because the board can then implement processes and controls designed to improve corporate decisionmaking.

A virtue of the kind of director and manager education envisioned here is that it skirts the need for more intrusive regulatory or judicial intervention into business and corporate governance. The only requirement is to teach the CEO, along with the board and other officers, about decisionmaking and judgment, including instructing them that corporate governance concerns should not be limited to addressing disloyalty and shirking but should include the psychology of decisionmaking as well.

B. "Chief Naysayer"

Studies show that explicitly considering the opposite—that is, considering arguments against a course of action, such as by asking probing questions and follow-ups, challenging key assumptions, focusing on counterfactuals, or developing other options—can reduce overconfidence.²⁶² The consider-the-opposite strategy is thought to

commitment, "[t]he most important thing for managers to realize is that they may be biased toward escalation").

260. Whereas simply working harder may only exacerbate it. *See infra* notes 323-26 and accompanying text.

261. Indeed, boards might voluntarily appoint a "chief naysayer." *See infra* Part IV.B.

262. *See, e.g.*, Hal R. Arkes, *Costs and Benefits of Judgment Errors: Implications for Debiasing*, 110 PSYCHOL. BULL. 486, 494 (1991) [hereinafter Arkes, *Implications for Debiasing*] (reviewing the "consider-the-opposite" strategy of debiasing); Hal R. Arkes et al., *Eliminating the Hindsight Bias*, 73 J. APPLIED PSYCHOL. 305, 306-07 (1988) (summarizing studies and finding that writing down "reasons for the opposite" reduced the hindsight bias); Hal R. Arkes et al., *Two Methods of Reducing Overconfidence*, 39 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 133, 141-42 (1987) (explaining that individuals who were less confident when they had to justify their answers might have been so because they considered other options and reasons they might be wrong); Stephen J. Hoch, *Counterfactual Reasoning and Accuracy in Predicting Personal Events*, 11 J. EXPERIMENTAL PSYCHOL.: LEARNING MEMORY & COGNITION 719 (1985) (reporting experimental results showing that counterfactual reasoning can improve predictive accuracy); Koriati et al., *supra* note 59 (reporting results showing that considering "contradicting reasons improved the appropriateness of confidence" by reducing overconfidence); Charles G. Lord et al., *Considering the Opposite: A Corrective Strategy for Social Judgment*, 47 J. PERSONALITY & SOC. PSYCHOL. 1231 (1984) (summarizing studies and reporting results showing that con-

work because explicitly emphasizing contrary arguments and what could go wrong makes risks more salient to the decisionmaker. It also impresses upon a decisionmaker that he exerts less control over outcomes than he might believe, and emphasizing con arguments can overcome blind spots in considering likely competitor responses. Moreover, forcing an individual to wrestle with uncertainty can arrest a person's tendency to reconcile conflicting information in order to avoid the unpleasantness of cognitive dissonance. Pressing a consider-the-opposite strategy denies a person the luxury of arguing away or simply assuming away the risks and costs of a project. At bottom, considering the opposite results in a more balanced and presumably more accurate assessment of a course of conduct.

Negative feedback is a complementary debiasing technique that has also been shown to reduce overconfidence.²⁶³ A strategy of nega-

sidering the opposite can improve judgment by countering the tendency of decisionmakers to search for and accept confirming evidence); Messick & Bazerman, *supra* note 100, at 20 ("To combat overconfidence, for instance, it is effective to say to yourself, 'Stop and think of the ways in which you could be wrong.' Similarly, to avoid minimizing risk, you can ask, 'What are the relevant things that I don't know?' Often, a devil's advocate, who is given the role of scrutinizing a decision for false assumptions and optimistic projections, can play this role."); S. Plous, *A Comparison of Strategies for Reducing Interval Overconfidence in Group Judgments*, 80 J. APPLIED PSYCHOL. 443 (1995) (summarizing studies but reporting results showing that appointing a devil's advocate and explicitly considering reasons why a group's answers might be wrong did not substantially reduce overconfidence as compared to individual or pooled decisionmaking); Rachlinski, *supra* note 256, at 1214 ("Problems such as overconfidence can be remedied by forcing people to submit their decisions to organizational review processes."); Russo & Schoemaker, *supra* note 67, at 12-13 (explaining that "[t]hink[ing] of reasons why your initial beliefs might be wrong, or ask[ing] others to offer counterarguments" can remedy overconfidence and that listing con arguments can counter overconfidence); Charles R. Schwenk & Richard A. Cosier, *Effects of the Expert, Devil's Advocate, and Dialectical Inquiry Methods on Prediction Performance*, 26 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 409 (1980) (reporting results showing that subjecting a decisionmaker to a devil's advocate led to more accurate predictions); David Trafimow & Janet A. Sniezek, *Perceived Expertise and Its Effect on Confidence*, 57 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 290 (1994) (summarizing studies and reporting weak findings that writing down why a person might be wrong decreased confidence); cf. Kramer, *supra* note 100, at 64-66 (explaining the importance of a splash of "cold water now and then on leaders' splendid illusions").

For perhaps the most thorough, if somewhat dated, review of debiasing techniques, see Baruch Fischhoff, *Debiasing*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES, *supra* note 20, at 422.

263. See, e.g., Howard Garland et al., *De-Escalation of Commitment in Oil Exploration: When Sunk Costs and Negative Feedback Coincide*, 75 J. APPLIED PSYCHOL. 721 (1990) (summarizing studies showing that negative feedback that indicates that negative returns are endogenous to the decision itself can counter the commitment bias and reporting experimental results to the same effect); Louie, *supra* note 171, at 34-35 ("Similarly, those who receive unfavorable feedback might not have inflated recall for decision-supportive items. They would not be allowed the luxury of recalling only items that support their decisions because feedback information would attest to the importance of other factors. This, and the response of surprise, may prompt unfavorable outcome participants to produce a well-rounded recall of items supportive and not supportive of their decision. As a result, these participants may not show hindsight effects."); Rachlinski, *supra* note 256, at 1212 ("Several studies suggest that experts who consistently receive unbiased feedback learn to

tive feedback turns on its head the notion that past success boosts confidence. To overcome a person's tendency to deflect blame, negative feedback should be clear and specific. A respected director or a trusted lieutenant, for example, could point out to the CEO concrete examples of when he has been wrong, highlighting, if possible, particular mistakes the CEO made and how those mistakes contributed to the bad outcomes.

Although not urged with CEO psychology in mind, a number of features of post-Enron corporate governance—such as more independent directors, more involved institutional investors, and more independent securities analysts—can have the effect of forcing a CEO to consider why he might be wrong, or to at least explain himself more fully and to consider alternatives more carefully. Perhaps the most promising possibility is that corporate cultures will continue to evolve so that directors routinely press the CEO and other managers with tough questioning. It may simply take the board asking the CEO, What are the top five reasons why we should reject your proposal? Consider, for example, what might have happened if this question had been asked when AMR Corp., the parent of American Airlines, took steps to shore up the retirement packages of its top executives in the event of bankruptcy, while at the same time slashing costs at the carrier, including negotiating pay and benefits cuts with its unions.²⁶⁴ The move seems inexplicable in hindsight and quickly cost AMR CEO and Chairman Donald Carty his job.²⁶⁵

If considering the opposite does not debias the CEO as such, it at least arms the board with a more complete assessment when evaluating a project and inserts checks in the deliberative process that slow down what often seems like a rush to say “yes.”

Formally appointing a devil's advocate as part of corporate decisionmaking is the strong form of the consider-the-opposite strategy, and it could both reduce CEO overconfidence, meaning better deci-

avoid egocentric biases.”); Russo & Schoemaker, *supra* note 67, at 10-12 (explaining the effect on confidence of “precise, timely feedback”); Eric R. Stone & Ryan B. Opel, *Training to Improve Calibration and Discrimination: The Effects of Performance and Environmental Feedback*, 83 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 282 (2000) (summarizing studies and reporting results showing that performance feedback reduced overconfidence); Dan Zakay, *The Influence of Computerized Feedback on Overconfidence in Knowledge*, 11 BEHAV. & INFO. TECH. 329 (1992) (showing that certain kinds of computerized outcome feedback can reduce overconfidence). For good summaries of the literature on feedback, see William K. Balzer et al., *Effects of Cognitive Feedback on Performance*, 106 PSYCHOL. BULL. 410 (1989); and William Remus et al., *Does Feedback Improve the Accuracy of Recurrent Judgmental Forecasts?*, 66 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 22 (1996).

264. See Scott McCartney et al., *Carrier Created Protections for Executives in Event of Reorganization Filing*, WALL ST. J., Apr. 17, 2003, at A3.

265. Russell Gold, *AMR Won't Give Severance Package to Ex-CEO Carty*, WALL ST. J., June 16, 2003, at A6.

sionmaking in the first place before proposals reach the board, as well as embolden the board to veto or at least restructure ill-conceived projects that might otherwise be approved based on the CEO's endorsement. Companies have not yet added the devil's advocate function as a core feature of corporate governance, although the idea that firms should consider appointing a devil's advocate has received some recent attention.²⁶⁶ A devil's advocate function has been formalized in a wide range of other settings: Europe's chief antitrust regulator, Commissioner Mario Monti of the European Commission, appointed so-called "devil's advocate" panels to grill his staff on their conclusions in antitrust cases;²⁶⁷ the Pentagon has used "murder boards" to review important plans;²⁶⁸ in wrestling with the Cuban

266. See CARTER & LORSCH, *supra* note 205, at 174-75 (proposing that boards appoint a "designated critic" as a means of "legitimizing dissent" to better ensure that management is challenged but without creating "resentment and conflict"); RANDALL MORCK, BEHAVIORAL FINANCE IN CORPORATE GOVERNANCE—INDEPENDENT DIRECTORS AND NON-EXECUTIVE CHAIRS (Nat'l Bureau of Econ. Research, Working Paper No. 10644, 2004) (recommending nonexecutive chairmen of the board and independent directors to counter the psychological tendency of individuals to obey authority), available at <http://www.nber.org/papers/w10644>; BARRY NALEBUFF & IAN AYRES, WHY NOT? HOW TO USE EVERYDAY INGENUITY TO SOLVE PROBLEMS BIG AND SMALL 6-9 (2003) (arguing that boards should identify a devil's advocate to make counterarguments and in effect to ask "why not?" pursue some alternative course of action when presented with a proposal); O'Connor, *supra* note 214, at 1304-06 (advocating a devil's advocate on the board to counter groupthink); Harold J. Ruvoldt, Jr., *A Way to Get to "What if . . . ?,"* DIRECTORS & BOARDS, Fall 2003, at 31, 33 (stressing the importance of directors asking "what if?" and suggesting the development of "black papers" to articulate the worst-case scenario); cf. David Gray, *Wanted: Chief Ignorance Officer*, HARV. BUS. REV., Nov. 2003, at 22 (explaining that ignorance is a "precious resource," in part because it can spawn new ideas); Coutu, *supra* note 8, at 70 (quoting Manfred F.R. Kets de Vries as saying that leaders, including CEOs, need a "fool" or, more generally, "people with a healthy disrespect for the boss—people who feel free to express emotions and opinions openly, who can engage in active give-and-take"); Lynne L. Dallas, *The Multiple Roles of Corporate Boards of Directors*, 40 SAN DIEGO L. REV. 781, 784-86, 817-18 (2003) (recommending "business review boards" that would be charged with evaluating business decisions); Fanto, *Whistleblowing*, *supra* note 33, at 490-524 (advocating the election of so-called "public directors" who would bring an "oppositional" attitude to boards to counter groupthink).

Kahneman and Lovallo have suggested a complementary approach emphasizing that managers should take an "outside" view when evaluating a project. In particular, to introduce more objectivity into forecasting, the outside view would have managers: (1) select a reference class for the proposed project; (2) assess the distribution of outcomes; (3) make an intuitive prediction of the project's position in the distribution; (4) assess the reliability of one's prediction; and (5) correct the intuitive estimate. Lovallo & Kahneman, *supra* note 16, at 62; see also Kahneman & Lovallo, *supra* note 60.

267. See Mark Landler, *A Slayer of Monopolies, One Corporation at a Time*, N.Y. TIMES, Mar. 25, 2004, at C1; see also James Kanter, *Sony-Bertelsmann Music Deal Is Expected to Get EU Approval*, WALL ST. J., June 18, 2004, at B3.

268. See, e.g., Chip Heath et al., *Cognitive Repairs: How Organizational Practices Can Compensate for Individual Shortcomings*, in 20 RESEARCH IN ORGANIZATIONAL BEHAVIOR 1, 22 (Barry M. Staw & L.L. Cummings eds., 1998) (explaining that the "Pentagon for many years had what they called the 'murder board,' a group of experienced officers that reviewed the plans for important missions, with the goal of killing the mission"); Evan Thomas & John Barry, *Now, Flexible Force; Amid the Iraqi Buildup, Donald Rumsfeld Is Reshaping the Pentagon's Time-Honored Ways of Thinking About War*, NEWSWEEK, Mar. 3,

Missile Crisis, President Kennedy urged dissenting viewpoints and, in particular, appointed his brother and then-Attorney General Robert Kennedy as a devil's advocate;²⁶⁹ and as part of beatification, for centuries the Vatican used a devil's advocate whose job was to argue against a candidate for sainthood.²⁷⁰

The key benefit of actually appointing a devil's advocate, or "chief naysayer," to challenge the chief executive, as well as to put pressure on deferential members of the management team and the board, is that it institutionalizes dissent within the firm.²⁷¹ Dissent would not depend on directors or subordinate officers voluntarily stepping forward as the CEO's critic. Rather, it would be the specific job of an identified individual or group of individuals to develop the case against some course of action and to ensure a more open and frank discussion of issues. Even if a CEO says that he welcomes criticism and debate, individuals will understandably be skeptical and will remain reluctant to dissent or to ask too many tough questions, let alone develop a substantial case for "no." Formalizing the devil's advocate role would also remove from the CEO the obligation of asking for assistance and input from others if he wants opposing viewpoints. Whatever working relationship is expected to exist between a CEO, on the one hand, and subordinate officers and the board, on the other, a chief executive may be hesitant to seek advice and raise concerns because it might signal weakness and self-doubt.²⁷² Finally, once the case against some proposal has been made, it might be easier for others to rally around it. In sum, the very reason for having groups of managers and directors participate in making key business decisions could be advanced by institutionalizing dissent as a formal step in the deliberative process of corporate decisionmaking.

2003, at 28 (referencing Secretary of Defense Donald Rumsfeld's use of a "murder board" in developing the war plan in Iraq).

269. See, e.g., JANIS, *supra* note 224, at 141 (explaining that after the Bay of Pigs fiasco, President Kennedy's advisors were urged by him to be skeptical, with Robert Kennedy and Theodore Sorensen specifically assigned the role of "watchdogs"); see also Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549, 561-62 (2002); Messick & Bazerman, *supra* note 100, at 20.

270. See, e.g., George Weigel, *A Century of Saints*, WALL ST. J., Oct. 4, 2000, at A26.

271. Cf. Troy A. Paredes, *Foreword to Symposium, After the Sarbanes-Oxley Act: The Future of the Mandatory Disclosure System*, 81 WASH. U. L.Q. 229 (2003) (explaining that in the context of the spate of regulatory reforms in the aftermath of Enron, "[t]he true test of Sarbanes-Oxley might not come until the markets and regulators become lax during the next bull market . . . [and hoping] that by having routinized a host of new governance and disclosure practices, Sarbanes-Oxley will prevent any wave of scandal from spreading throughout the markets").

272. See, e.g., Westphal, *Collaboration*, *supra* note 225 (arguing that greater personal and social ties between directors and CEOs might foster greater trust and, as a consequence, more open discussions and greater board involvement in the business as CEOs more routinely seek board input).

The transaction costs and the cost of diverting the attention of the board and management from more important matters would be great if a devil's advocate had a role in every business decision, even those that are routine. More generally, sometimes the marginal cost of making a better decision is not worth it if the stakes are not high enough. Therefore, the approach discussed here could be limited to big-ticket items, such as significant mergers, acquisitions, new product launches, market entry, and regulatory strategies.²⁷³

There are many ways to operationalize the "chief naysayer" function, but three features of the approach are especially important. First, individuals filling the devil's advocate role should have stature and should be well-regarded so that their views are respected and heeded; and they should, of course, be independent of the CEO and otherwise unconcerned about the potential costs of expressing an opposing view. That having been said, it is equally important that other directors do not defer to devil's advocates. Devil's advocates exist not to block projects but to ensure that project risks are more evenly appraised.

Second, devil's advocates need access to good information in order to bring their independent judgment to bear effectively in pressing the CEO, as well as other senior managers and directors, with probing questions and in developing alternative strategies and courses of action.²⁷⁴ Among other things, this might mean giving devil's advocates more direct access to personnel throughout the firm, as well as to the firm's outside lawyers and bankers, so that the CEO and other senior officers are not the sole source of information. Another possibility is to support the person or group serving as the devil's advocate with an independent staff of professional advisors.

Third, the "naysayers" themselves may be a source of agency problems for the corporation. They may, for example, shirk their responsibilities by failing to spend enough time on the matters before them. At some point, individuals may simply adopt a "check-the-box" approach to the devil's advocate role, asking standard questions but without rigorously interrogating management's views. Simply going through the motions might do more harm than good by giving officers and directors "cover" if they make a bad decision. Further, the stamp of approval from the devil's advocate may actually embolden the

273. One additional concern is the risk that the questioning of a devil's advocate will become a roadmap for lawyers pursuing a breach of fiduciary duty case. The fact that con arguments were stressed but rejected and that the project went forward should not be fodder for plaintiffs, although the concern is legitimate. To the contrary, expressly considering the opposite should bolster the case of defendant-managers and defendant-directors.

274. Cf. Eric M. Pillmore, *How We're Fixing Up Tyco*, HARV. BUS. REV., Dec. 2003, at 96, 101 (recommending in his capacity as Tyco's senior vice president of corporate governance that directors have strong operational as well as financial backgrounds).

CEO, exacerbating the overconfidence problem the devil's advocate role is intended to redress. On the other hand, it is important that devil's advocates do not take themselves too seriously and actively try to block some CEO-favored course of action or act as co-CEO. The purpose of the devil's advocate role is to ensure that arguments against some project are heard, that risks are adequately considered, that assumptions are challenged, and that flawed logic is exposed—in short, to ensure that projects are fully aired—but without being too disruptive, grinding things to a halt, or usurping the CEO's role.

Regardless of who is tapped to be a devil's advocate, bounded rationality is a further concern. Individuals charged with the devil's advocate role will suffer from flawed judgment as a result of their own cognitive biases as well as whatever heuristics they use. For groups selected to serve as the devil's advocate, group dynamics and herd behavior must also be accounted for.

To mitigate these and other concerns, procedures should be adopted for monitoring and evaluating the performance of the devil's advocate. More generally, the firm should take steps to ensure that its appointed "naysayers" undertake the task with which they have been charged in good faith and with due care and attention.

As a starting point for implementing the devil's advocate role, companies could fill the devil's advocate role with term-limited independent directors or perhaps even shareholder nominees who are elected to the board. Of course, if shareholders are not afforded greater access to the corporate ballot, there will be few shareholder nominees to fill board seats.²⁷⁵ A form of devil's advocate "lite" might be to rely on a presiding or lead director or nonexecutive chairman of the board to be a counterweight to the CEO who can legitimately and credibly put competing views on the table and stand in opposition to the CEO, even without being designated a devil's advocate as such.²⁷⁶

275. Whatever its other merits or demerits, the SEC's shareholder access rule would have made it easier for shareholders to nominate directors, and it is reasonable to expect that shareholder-nominees, if elected, would be more responsive to shareholders. See Security Holder Director Nominations, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003).

276. Cf. Andrew Blackman, *Casting a Wider Net: Diversity in the Boardroom Is Gaining as a Way to Improve Governance and Business Decisions*, WALL ST. J., June 21, 2004, at R6 (reporting that companies are seeking more diverse boards to improve business decisions by reducing the likelihood that boards "will move in lock step"); Gaston F. Ceron, *Musical Board Chairs: Some Companies Hope that by Rotating Lead Directors, They'll Bring a Greater Array of Ideas to the Table; but This Approach Comes with a Price*, WALL ST. J., June 21, 2004, at R5 (reporting that some companies have adopted a "rotating system" for lead directors to better ensure a diversity of views is heard).

For more aggressive alternatives to a presiding or lead director or a nonexecutive chairman, see Fanto, *Whistleblowing*, *supra* note 33, at 490-524 (proposing a new government oversight board that would select a group of individuals from which shareholders would elect "public directors"); and Ronald J. Gilson & Reinier Kraakman, *Reinventing the Out-*

Given these general guideposts, in implementing the devil's advocate role, each company should consider its own particular needs and circumstances, including the rest of its corporate governance structure. No single approach is optimal for each firm.

C. Tougher Fiduciary Obligations

Perhaps the most controversial possibility centers on toughening fiduciary duty obligations. Courts take a relatively aggressive stance toward insider looting, self-dealing, and other forms of disloyalty under the fiduciary duty of loyalty. The fiduciary duty of care is a different story, however.²⁷⁷ Directors and officers are supposed to exercise reasonable care in running the company, but they are not actually held liable unless they are grossly negligent.²⁷⁸ Further, the duty of care is about procedural due care and not substantive due care; courts review the decisionmaking process of directors and officers but generally do not regulate the substance of their business decisions.²⁷⁹ Focusing as it does on process, the duty of care, as well as the rest of corporate law, is in large part predicated on the assumption that directors and officers are rational. In this view, good process, which is intended to ensure that the board and management have reviewed relevant information and have deliberated together before taking some action, generally will result in good outcomes, or at least better outcomes, than if courts imposed their business judgment.²⁸⁰

In short, courts take a more or less hands-off approach when it comes to monitoring how a corporation is run, so long as there is no indication of bad faith or disloyalty on the part of directors and officers. By design, the law of fiduciary duty has little, if anything, to say about poor business decisions that are made in the honest belief that they are in the best interests of the corporation and its shareholders.²⁸¹ As explained above, the hands-off approach courts take under the business judgment rule can contribute to CEO overconfi-

side Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863, 883-92 (1991) (proposing "professional directors" who would serve full-time, be independent of management, and actively oversee the business).

277. See *supra* notes 29, 52-53, 234-35, 245 and accompanying text (discussing the business judgment rule).

278. For more on the divergence between the standard of care and the standard of judicial review, see Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993). See also Paredes, *supra* note 53, at 1084 n.93 (discussing Eisenberg).

279. See *supra* note 245 and accompanying text.

280. For a general discussion of the relationship between process and outcomes in the context of the business judgment rule, see Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U. L. REV. 675 (2002).

281. See generally Roe, *supra* note 53 (explaining the limited role corporate law plays in policing mismanagement as compared to disloyalty).

dence, both because courts defer to management in how the business is operated and because directors, particularly outsiders, are given safe harbor from legal liability if they fail to press corporate managers meaningfully.²⁸² An accommodative board, in turn, means that a CEO can implement his business plan and favored projects without tough scrutiny, as internal corporate checks and balances become lax.

There is no illusion that the duty of care ensures against bad business decisions. Although it is the threshold for legal liability, gross negligence is not an exemplar of good corporate conduct. Yet, corporate law has to accommodate at least some mismanagement to ensure that corporate actors have adequate discretion in running the business and are not chilled from taking prudent risks. Giving directors and officers room to exercise their judgment is the price to be paid for a dynamic, innovative, and entrepreneurial economy that depends on relatively loose governmental and judicial controls over business operations.²⁸³

Once the psychology of CEO decisionmaking is taken into account, gaps in the coverage of the law of fiduciary duty seem even larger.²⁸⁴ As described above, corporate law focuses on policing and rooting out two sources of corporate mismanagement: (1) disloyalty and bad faith; and (2) inadequate care and shirking by directors and officers in exercising their responsibilities. Cognitive bias is an additional source of mismanagement that has been overlooked. The type of “good-faith mismanagement” that results from CEO overconfidence falls outside the scope of present fiduciary duty jurisprudence. The law of fiduciary duty does not address overconfident decisionmaking when there is no indication of bad faith or disloyalty on the part of corporate actors and when the consideration of the business decision at issue was not grossly negligent. In other words, irrationally overconfident corporate decisionmaking, as such, comports with fiduciary obligations, and there is no expectation that directors will account for the risk of CEO overconfidence

282. See *supra* notes 29, 52-53, 234-35, 245, 278-81 and accompanying text.

283. See Paredes, *supra* note 53, at 1141-44 (explaining the importance of managerial flexibility).

284. See Fanto, *Quasi-Rationality*, *supra* note 33, at 1386 (explaining that the judicial presumption of rationality “is overly simplistic and does not accurately reflect reality” and concluding that “[b]ecause courts are erecting the law [of fiduciary duty] upon this defective foundation, the capability of their jurisprudence to address adequately any problems” is questionable); Langevoort, *supra* note 194, at 872-78 (discussing the “apparent impotence” of corporate law since it does not cover self-serving but good-faith behavior rooted in ego); Langevoort, *Organized Illusions*, *supra* note 33, at 169-70 (explaining that penalties and rules mandating “reasonableness” or “good faith” do not remedy flawed decisionmaking rooted in cognitive bias because good-faith but biased decisionmakers are insensitive to such sanctions).

in evaluating proposals before the board or even take into account the board's own tendency to defer.

Corporate law receives more credit for promoting effective management that it deserves. Because it does not account for "good-faith mismanagement" rooted in the psychology of corporate decisionmaking, corporate law is less effective than recognized in rooting out mismanagement by imposing liability.²⁸⁵

One possibility, then, for addressing CEO overconfidence is for courts to take a tougher stance when enforcing fiduciary obligations under the duty of care and, in so doing, to account expressly for the one-two punch of CEO overconfidence and board deference. It is easier to say that courts should take a harder look at managerial and director conduct than to explain what this might mean in practice, especially since managers and directors need flexibility to run the business and the costs of chilling entrepreneurialism and risk-taking, as a result of greater accountability and judicial second-guessing, can be substantial. A governance system characterized by overconfident CEOs, quiescent directors, and a hands-off judiciary may result in better corporate performance than one characterized by self-doubting CEOs, an aggressive and hostile board, and intrusive judges who are willing to substitute their business judgment for the judgment of management and the board.

Presently, it takes a near abdication of responsibility before courts find a breach of the duty of care. Given their active involvement on a day-to-day basis in running the company, officers will not be found liable for breach of the duty of care in practice. When it comes to directors, who are much less involved in the day-to-day business, so long as there is a modicum of process in board decisionmaking, board conduct routinely passes muster under the business judgment rule. To enhance judicial review, courts might focus more carefully on the nature of the deliberations of the board and management by more skeptically assessing whether there in fact was a fulsome consideration of the matter at hand. In applying the duty of care, for example, courts could scrutinize the decisionmaking process to look for indications that the board and management considered arguments against a course of action and to verify that the CEO and other key managers

285. We might think of this underinclusiveness in terms of "Type II" errors of the law of fiduciary duty. See Fred S. McChesney, *Talking 'Bout My Antitrust Generation: Competition for and in the Field of Competition Law*, 52 EMORY L.J. 1401, 1411-18 (2003) (explaining "Type I" versus "Type II" errors); Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711 (1996) (also explaining "Type I" and "Type II" errors). Nor do market pressures or efforts to align managerial interests with shareholder interests through executive compensation adequately address psychological factors that lead to poor business decisions. See *supra* notes 86-99 and accompanying text.

supporting a project did not go unchallenged.²⁸⁶ After all, the formal-

286. The fiduciary duty reforms considered below contemplate a decidedly more active board that is more involved in corporate affairs, complementing the enhanced monitoring role that independent directors already must play in the aftermath of Sarbanes-Oxley and the revised NYSE and Nasdaq listing standards. An important concern, of course, is that the overconfidence problem may simply be relocated from the CEO to the board if directors were to step up their managerial function.

Caselaw under section 11 of the Securities Act of 1933 might inform what to require of directors under an enhanced fiduciary duty of care. See 15 U.S.C. § 77k (2000); see also LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1149-69, 1324-37 (4th ed. 2001) (discussing section 11); Langevoort, *Organized Illusions*, *supra* note 33, at 159 (explaining that the “independent evaluation of data involved in a due-diligence investigation [under section 11] provides a useful antidote to bias in initial public offerings and other settings where it is both required and practicable”).

Section 11 of the Securities Act creates a cause of action for purchasers in securities offerings if any part of the registration statement contained a material misstatement or omission when it became effective. See 15 U.S.C. § 77k(a). Directors of the issuer face liability for material misstatements or omissions under section 11, *id.* § 77k(a)(2), although they are afforded a due diligence defense, *id.* § 77k(b)(3). When it comes to nonexpertised portions of an effective registration statement, a director is not liable if “he had, after reasonable investigation, reasonable ground to believe and did believe” that the registration statement was true and complete when it became effective. *Id.* § 77k(b)(3). (The due diligence defense requires less of directors to escape section 11 liability for material misstatements or omissions in expertised portions of the registration statement. *Id.*) The statutory standard of “reasonableness” is “that required of a prudent man in the management of his own property.” *Id.* § 77k(c). Insofar as a director’s section 11 due diligence defense requires that he exercise more care than gross negligence in fulfilling his obligation to ensure the accuracy of the company’s registration statement, section 11 jurisprudence would be worth considering in fleshing out the substance of an enhanced duty of care under state corporate law.

The process behind CEO and CFO certifications required under sections 302 and 906(a) of the Sarbanes-Oxley Act, codified at 15 U.S.C. § 7241 (Supp. II 2002) and 18 U.S.C. § 1350 (Supp. II 2002) respectively, could also be informative. Indeed, the certification process might itself mitigate overconfidence as CEOs and CFOs, as well as those who report to them, presumably take a hard look at the company’s performance before signing off on the certifications.

For others who have recently evaluated the possibility of enhanced judicial review of corporate conduct in a variety of settings, see Fanto, *Braking the Momentum*, *supra* note 33, at 334-51 (arguing that directors should question a merger more critically and should justify the deal as the best option for the company to counter managerial overconfidence in acquisitions and urging enhanced judicial review of board behavior in the merger context to ensure such greater scrutiny by boards); Fanto, *Quasi-Rationality*, *supra* note 33 (arguing in the context of mega-mergers for greater disclosure to encourage boards to engage in greater scrutiny of proposed transactions and for tougher judicial scrutiny and suggesting that courts should start requiring a showing that boards considered psychological factors in approving the deal); Jill E. Fisch & Caroline M. Gentile, *The Qualified Legal Compliance Committee: Using the Attorney Conduct Rules to Restructure the Board of Directors*, 53 DUKE L.J. 517, 566-82 (2003) (considering increased director liability, changes to director compensation, and alternative director selection procedures as means for motivating directors to monitor management more carefully to reduce corporate misconduct); Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (2005) (arguing against applying the business judgment rule to officers); Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, WM. & MARY L. REV. (forthcoming 2005) (advocating a simple negligence duty of care standard for officers); and Thomas, *supra* note 41, at 466-68 (arguing that the duty of care should obligate boards to take into account the pay-performance link and, in particular, the demoralizing effects of wide pay differentials in setting executive pay).

ity of process is not an end in itself but is intended to ensure that there is a rich and frank debate before some course of action is agreed to. Although the law of fiduciary duty should not insulate investors from business risk, it can help protect investors from a flawed decisionmaking process by requiring corporate decisionmakers to engage in the dutiful deliberation of business matters.

The touchstone of the fiduciary duty of care is that prior to pursuing some course of action, the board should be reasonably informed, not only by having the relevant information in hand but also by deliberating with appropriate care and exchanging views regarding the corporation's alternatives.²⁸⁷ The same goes for senior managers. To exercise good business judgment, even sophisticated individuals need good information and need to spend considerable effort thinking about issues, and board members and senior officers must make the effort to formulate, and then to express, their independent views. E. Norman Veasey, former Chief Justice of the Delaware Supreme Court, recently discussed what should be expected of directors post-Enron:

Complete understanding is the key. Directors will approach their jobs in a more confident way, because they will have to completely understand everything that is presented to them and really do their homework to get it right. Instead of just looking at a powerpoint presentation, they need to understand every aspect of a company's business and legal issues.²⁸⁸

Although this might be the aspiration, such diligence is not presently required to comply with the duty of care.²⁸⁹

In effect, courts could adjust what it means to be "reasonably informed" under the business judgment rule to better ensure that corporate decisionmakers account for the cognizable risk of CEO over-

For analogous discussions of hard-look judicial review in the lawmaking and administrative agency setting, see William N. Eskridge, Jr. & John Ferejohn, *Structuring Lawmaking to Reduce Cognitive Bias: A Critical View*, 87 CORNELL L. REV. 616 (2002); Rachlinski & Farina, *supra* note 269; and Mark Seidenfeld, *Cognitive Loafing, Social Conformity, and Judicial Review of Agency Rulemaking*, 87 CORNELL L. REV. 486 (2002).

287. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) ("[T]o invoke the [business judgment] rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties.").

288. Alison Carpenter, *Records Inspections: Delaware's Veasey Highlights Merits of Books and Records Inspections*, 2 Corp. Accountability Rep. (BNA), May 21, 2004, at 535 (internal quotation marks omitted).

289. See *Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000) (Veasey, C.J.) (explaining that the "law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices" and that compliance with such aspirational goals is "not required by the corporation law and [the aspirational goals] do not define standards of liability").

confidence and the risk that directors and subordinate officers will too easily go along with the chief executive.²⁹⁰

Even under conventional views of the duty of care and the business judgment rule, once boards are on notice about the risk of CEO overconfidence, it might be gross negligence for directors not to search for counterarguments, challenge assumptions, and evaluate worst-case scenarios—in other words, to avoid liability, directors may need to be more suspicious and doubtful of what is presented to them and may need to evaluate and interrogate more carefully the potential payoffs of proposals put before the board.²⁹¹ Proactive inquiry and meaningful deliberation by boards would become a more central component of the duty of care under a business judgment rule that is more sensitive to CEO overconfidence, as well as the tendency of boards to defer.²⁹²

One particular possibility is for courts to stress that corporations must have improved internal information and reporting systems that ensure the proper flow of information to the board and that directors are in a proper position, with appropriate information, to weigh a project's pros and cons.²⁹³ If adequate reporting systems are in place, less

290. For general discussions of more comprehensive approaches to decisionmaking such as is contemplated here, see, for example, Daniel Kahneman & Shane Frederick, *Representativeness Revisited: Attribute Substitution in Intuitive Judgment*, in *HEURISTICS AND BIASES*, *supra* note 20, at 49 (discussing “System 1” and “System 2” decisionmaking); Kuran & Sunstein, *supra* note 46, at 746-61 (discussing “comprehensive rationality”); and Cass R. Sunstein, *Hazardous Heuristics*, 70 U. CHI. L. REV. 751, 763-67 (2003) (discussing the relevance of Kahneman and Frederick’s theories for policy and law).

291. A longstanding feature of the law of fiduciary duty is that in overseeing management, the board cannot ignore warning signs of managerial misconduct or otherwise be inattentive to indications of managerial misconduct, particularly illegal activity. See, e.g., *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963); *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996). Just as the board must respond to known indicia of misconduct in exercising its oversight role, the board should respond to the possibility of CEO overconfidence when the board is called upon to make a business decision in its managerial role.

In a related context (the discovery of financial fraud and company-wide financial reporting problems), Tyco’s senior vice president of corporate governance illustrates the kind of tough questioning boards could engage in:

One key to making the investigation truly exhaustive was that we asked questions explicitly—not in some vague way. To understand the difference, imagine it’s the cleanliness of your home that’s in question. I could ask you, “Are there any dust balls in this house?” And you would cast your eyes about somewhat aimlessly and most likely fail to spot one. But if I said, “Go look under the couch in the living room,” you’d focus in and find whatever was there.

Pillmore, *supra* note 274, at 96.

292. Cf. Bayless Manning, *The Business Judgment Rule and the Director’s Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984) (discussing the board’s duty of attention).

293. In a similar vein, Langevoort has suggested improved internal reporting controls to address misconduct and fraud that are rooted in self-serving managerial behavior and director deference. Langevoort, *Resetting the Thermostat*, *supra* note 33, at 5, 288-89, 314-16. Langevoort summarized his suggestion as follows:

of a burden is placed on individual directors to inquire proactively, as better information flows about both the company's ongoing operations and new projects become an institutionalized part of corporate decisionmaking. For guidance in developing such systems, companies might look to two reports prepared by the Committee of Sponsoring Organizations of the Treadway Commission (COSO): (1) the *Enterprise Risk Management Framework* report and (2) the *Internal Controls—Integrated Framework* report.²⁹⁴ Many companies have already turned to certain COSO recommendations for standards to follow in ensuring that their financial reporting and disclosure controls comply with new internal control requirements under the Sarbanes-Oxley Act.²⁹⁵

There is experience under Delaware corporate law with enhancing internal controls as part of evolving fiduciary duty standards.²⁹⁶ In

My simple (but still provocative) legal point is that an internal controls system may be deficient if it does not anticipate the risks generated by these tournament survival traits and the predictably pernicious way they can occasionally play out in the game of corporate governance. In other words, monitoring has to be thermostatic in nature, with appreciation of how situational variables prompt predictable (and not always rational) behavioral responses.

Id. at 289.

294. COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, ENTERPRISE RISK MANAGEMENT—INTEGRATED FRAMEWORK (2004), available at http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf (last visited Feb. 17, 2005); COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N, INTERNAL CONTROL—INTEGRATED FRAMEWORK (1992), available at http://www.coso.org/publications/executive_summary_integrated_framework.htm (last visited Aug. 26, 2004); see also Richard M. Steinberg, *Managing Risk—To Your Company and You*, DIRECTORS & BOARDS, Spring 2004, at 35 (explaining that enterprise risk management can drive share value and protect directors and resources).

295. See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 302, 404, 409, 906, 116 Stat. 745, 777, 789, 791, 806 (codified as amended in scattered sections of 15 and 28 U.S.C.); see also 17 C.F.R. §§ 240.13a-14 to -15, .15d-14 to -15 (2004). Even companies' enhanced financial reporting and disclosure controls might introduce greater rationality into corporate decisionmaking, separate from improving the accuracy of public disclosures. In short, improved financial reporting and disclosure controls should facilitate greater scrutiny of a company's underlying business and operations as part of more accurate disclosure. Cf. Langevoort, *Resetting the Thermostat*, *supra* note 33, at 315 ("Without careful control over information relating to trends, uncertainties and risks—information which goes deeply into the firm's strategic operations—how can anyone be sure that management's discussion and analysis of company performance, for example, is reliable?").

296. If the law of fiduciary duty were to change as contemplated here to account for CEO overconfidence and board deference, perhaps the most likely channel for doing so is the evolving fiduciary duty of good faith. See Veasey, *supra* note 136, at 444-48 (discussing the fiduciary duty of good faith and stating that "good faith requires an honesty of purpose and eschews a disingenuous mindset of appearing or claiming to act for the corporate good, but not caring for the well-being of the constituents of the fiduciary"). See generally Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004) (examining the duty of good faith). What good faith requires of directors and officers is unclear, although the demands of good faith are taking shape. Presently, the duty of good faith seems to require little more than that corporate fiduciaries do not abdicate or intentionally disregard their responsibilities to the corporation but make at least some attempt to fulfill their obligation to manage and oversee the company. As currently configured, then, one could think of a duty-of-good-faith violation as an extreme violation of the duty of due care. For the fiduciary

the well-known *Caremark* case, then-Chancellor Allen of the Delaware Chancery Court said that to ensure that the board can root out corporate misconduct, directors have “a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate,” is in place to bring evidence of misconduct to the board’s attention.²⁹⁷ Chancellor Allen explained that boards fall short in their

obligation to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.²⁹⁸

Although *Caremark* focused on the board’s duty to root out illegal behavior, the case’s rationale extends comfortably to the exercise of business judgment.

What is more, Delaware caselaw has taken recent steps toward recognizing psychological factors. In his *Oracle* opinion, Vice Chancellor Strine accounted for psychological factors and social influence in finding that members of a special litigation committee were not independent from the defendant-directors charged with breach of fiduciary duty.²⁹⁹ Although it subsequently cabined *Oracle*, the Delaware Supreme Court has nonetheless acknowledged the role of psychology, recently citing, for example, the possible influence on director judgment of “other-regarding preferences,” which, broadly speaking, refers to a person’s altruism, a trait at odds with the perfectly

duty of good faith to have real bite, it may ultimately need to take on a substantive due process quality, instead of simply being a way to relabel a duty-of-care violation as a duty-of-good-faith violation in order to end-run exculpatory provisions that exonerate directors from monetary damages. *Cf.* Veasey, *supra* note 136, at 447 (“If the board’s decision or conduct is irrational or so beyond reason that no reasonable director would credit the decision or conduct, lack of good faith may, in some circumstances, be inferred.”) (citing *Gagliardi v. Trifoods Int’l, Inc.*, 683 A.2d 1049, 1051-52 (Del. Ch. 1996)). Precisely because the content of the duty of good faith is uncertain and still unfolding, it can more easily be used as a means of hard-look judicial review, unlike the duty of care and the duty of loyalty. In other words, because the duty of good faith is malleable, Delaware judges have room to shape the duty of good faith, whereas judges have less flexibility extending the duties of care and loyalty, the contours of which are more fixed by an extensive body of caselaw and recognized corporate law principles.

297. *In re Caremark Int’l, Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996). More generally, then-Chief Justice Veasey of the Supreme Court of Delaware has recently stressed the evolving nature of the law of fiduciary duty that *Caremark* reflects. *See* Veasey, *supra* note 136, at 444-48 (stressing the “evolving expectations of the standards of conduct of directors and others” and of the character of the law of fiduciary duty, using the evolution from *Allis-Chalmers* to *Caremark* as an example).

298. *Caremark*, 698 A.2d at 970.

299. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917 (Del. Ch. 2003).

rational and self-interested *homo economicus* from rational choice theory.³⁰⁰

It is worth considering the option of more demanding fiduciary requirements to address the CEO overconfidence problem, but I remain skeptical of greater judicial review of corporate behavior. Part and parcel of the standard concerns about chilling managerial risk-taking and the lack of judicial competence in business matters is the risk that greater judicial attention to the process of corporate decision-making will inevitably mutate into a form of substantive due process, as the deferential gross negligence standard of judicial review gives way to a harder judicial look at corporate conduct.³⁰¹ At the very least, there is reason to worry if judges start playing the role of psychologist. Even if one favors greater substantive regulation of business decisions, it is possible that greater judicial scrutiny simply relocates the problem of overconfidence, along with other judgment errors, from executive suites and boardrooms to the judicial bench. Judges, like the rest of us, are subject to flawed decisionmaking.³⁰²

Instead of intervening more directly into how corporations are run, it might be preferable for courts to leverage the law's expressive function by simply exhorting directors and management to adjust their decisionmaking processes to address the risk of overconfi-

300. *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1052 n.32 (Del. 2004) (citing Lynn A. Stout, *On the Proper Motives of Corporate Directors (Or, Why You Don't Want to Invite Homo Economicus to Join Your Board)*, 28 DEL. J. CORP. L. 1, 8-9 (2003)). The *Beam* decision seems to cabin *Oracle* by finding that the plaintiffs, in the context of a claim of demand futility, did not plead facts sufficient to create a reasonable doubt as to the independence of directors who were personal friends of defendant Martha Stewart. *Id.* at 1051. An important procedural distinction between *Oracle* and *Beam*, however, should be noted. In *Oracle*, the special litigation committee bore the burden of showing director independence; in *Beam*, the plaintiff-shareholders bore the burden of creating a reasonable doubt of director independence to establish demand futility. The different burden can help explain the different results in the cases.

301. That having been said, other instances of what could fairly be characterized as enhanced judicial review of board process—including such well-known cases as *Van Gorkom* and *Caremark*—did not result in greater substantive due process under the business judgment rule. It is equally important to acknowledge that substantive review outside the duty-of-care context is not unheard of. Consider, for example, judicial review in the context of waste, defensive tactics, squeeze-out mergers, and self-dealing transactions. However, in each of these contexts, the challenged transaction is usually tainted by disloyalty, and it is not simply a matter of the court's substituting its business judgment for the judgment of the board or management team.

302. See Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83 (2002); Sale, *supra* note 33; Jeffrey J. Rachlinski, *Heuristics and Biases in the Courts: Ignorance or Adaptation?*, 79 OR. L. REV. 61 (2000); see also Mitu Gulati et al., *Fraud by Hindsight*, 98 NW. U. L. REV. 773 (2004).

The overarching challenge for judges is to calibrate their tougher scrutiny of corporate decisionmaking to account for their own inadequate information and shortcomings as decisionmakers and to strike the right balance between greater corporate accountability, on the one hand, and the need for managers and directors, on the other hand, to have discretion in running the business without judges second-guessing them.

dence.³⁰³ Rock, for example, has explained that judges can inculcate good corporate practices by stressing in their opinions, which he describes as “corporate law sermons,” how directors and officers *should* act, while at the same time refusing to hold parties liable for failing to live up to these aspirations.³⁰⁴ Many judges also shape corporate conduct through their speeches and writings. During his tenure as Chief Justice of the Delaware Supreme Court, E. Norman Veasey repeatedly encouraged directors to adopt various “aspirational norms for good corporate practice” that he outlined and to serve with character, which he defined as “expertise, diligence, good faith, independence, and professionalism”;³⁰⁵ and Vice Chancellor Strine uses his many speeches and articles to outline his vision of how directors should conduct themselves.³⁰⁶ Consider the result if members of the Delaware judiciary, through opinions, speeches, or articles, urged boards to appoint a devil’s advocate and stressed the importance of considering con arguments. The judicial articulation of a “best practice” such as this could stiffen the spine of directors, and possibly

303. For more on the expressive function of law—generally speaking, the idea that the law, separate from imposing sanctions, can make a statement about how people are supposed to behave—and the various modes through which the law’s expressive function might operate, see Matthew D. Adler, *Expressive Theories of Law: A Skeptical Overview*, 148 U. PA. L. REV. 1363 (2000); Elizabeth S. Anderson & Richard H. Pildes, *Expressive Theories of Law: A General Restatement*, 148 U. PA. L. REV. 1503 (2000); and Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649 (2000). See also SUNSTEIN, *supra* note 46, at 52-56 (discussing the expressive function of law and encouraging dissent). For a more complete discussion of the ideas that follow in the context of corporate governance, see Paredes, *supra* note 53, at 1089-91, 1137-39.

304. See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016 (1997); see also Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1266-71 (1999) (discussing the aspirational quality of the duty of care); Paredes, *supra* note 53, at 1089-93 (discussing the “sermonizing” impact of Delaware judicial opinions); Stout, *supra* note 280, at 688 (“It is perhaps not too great a stretch to suggest that corporate directors view judges as persons of influence and authority similar to the experimenter in a social dilemma game, and that judicial pronouncements about how directors ought to behave can thus influence directors’ behavior even when not backed up by legal sanctions.”).

305. E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—Or Vice Versa?*, 149 U. PA. L. REV. 2179, 2180, 2190-91 (2001); see also Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (Veasey, C.J.); E. Norman Veasey, *Policy and Legal Overview of Best Corporate Governance Principles*, 56 SMU L. REV. 2135, 2145-46 (2003); E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681, 699-700 (1998). For an example of an opinion by Veasey in which he discusses aspirational goals, see *Brehm*, 746 A.2d at 244.

306. See, e.g., William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287 (2001); Chandler & Strine, *supra* note 30; Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919 (2001); Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 BUS. LAW. 1371 (2002); Leo E. Strine, Jr., *The Professorial Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic “Just Say No” Question*, 55 STAN. L. REV. 863 (2002); Leo E. Strine, Jr., *Warning—Potential Danger Ahead!*, DIRECTORS & BOARDS, Summer 2004, at 25.

subordinate officers, in challenging the CEO and could give directors and officers cover in doing so because they could legitimately claim simply to be following through on what the Delaware courts have instructed.³⁰⁷ In fact, CEOs themselves might take such judicial exhortations seriously and begin to encourage dissent. Additionally, organizations that now grade corporate governance structures, including Standard & Poor's and Institutional Shareholder Services Inc., could add the devil's advocate role or certain internal information and reporting controls to their grading scale. Articulated best practices can serve investors as a useful checklist in monitoring the quality of corporate governance, obviating the need for additional legal mandates or legal liability.³⁰⁸

D. Greater Shareholder Say

To the extent corporate law takes any account of managerial bias, perhaps greater authority should be handed down to shareholders, as opposed to courts (or lawmakers) shouldering any additional responsibility for disciplining business decisions. Delaware corporate law has blunted shareholder rights—particularly the rights of shareholders to sell and to sue—by broadly interpreting the board's authority to manage the business. Delaware caselaw, for example, has validated defensive steps that boards take to fend off an unsolicited bid for the company, effectively blocking shareholders of target companies from selling their shares to hostile bidders without the target board's blessing.³⁰⁹ Many observers believe that target boards can “just say no” to a hostile bid, with the limited exception of when *Revlon*³¹⁰ is triggered.³¹¹ In addition, the demand requirement usually results in the board, and not shareholders, deciding whether to bring a derivative suit against directors and officers who allegedly breached their fiduciary duties, in effect undercutting shareholders' right to sue.³¹² The legal course could be reversed in these two areas of corporate law, whether through caselaw or legislation.³¹³

307. By way of analogy, commentators have noted that no-smoking signs can embolden private citizens to enforce no-smoking ordinances, even though state and municipal authorities do not strictly enforce the prohibitions against smoking. See, e.g., Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643, 1674-75 (1996).

308. See, e.g., Paredes, *supra* note 53, at 1091-92, 1137-38 (describing market sanctions for failure to follow good corporate governance practices).

309. For a thorough treatment of the board's authority to block unsolicited bids, see Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002).

310. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

311. See, e.g., Paredes, *supra* note 12, at 132-63 (summarizing the takeover debate, surveying Delaware takeover law, and collecting citations to the takeover literature).

312. Before bringing a derivative action, shareholders generally are required to make a demand on the board of directors to initiate the suit on the corporation's behalf, unless

For example, shareholder choice could be advanced in a takeover setting by placing greater limits on the use of defensive tactics, as a number of commentators have urged over the years.³¹⁴ Reversing course in the derivative-litigation setting requires perhaps a more novel solution, such as the one recently offered by Thompson and Thomas.³¹⁵ Some threshold number of shareholders—such as a shareholder or group of related shareholders that holds between one and five percent of a company's outstanding shares—could be excused automatically from the demand requirement without showing demand futility or could override a board's refusal to bring a suit for fiduciary breach when demand is made.³¹⁶ Giving shareholders greater say in selling their shares to a hostile bidder or in enforcing fiduciary duties might better discipline how the business is run. This would encourage managers and directors to pay more attention to the risks of various projects.³¹⁷

If shareholders were handed more control, perhaps the strongest case can be made for giving shareholders more control over acquisitions.³¹⁸ Managerial overconfidence is usually studied in the context of

such a demand would be futile. See CLARK, *supra* note 248, §§ 15.1-.3; O'KELLEY & THOMPSON, *supra* note 248, at 325-69; see also Aronson v. Lewis, 473 A.2d 805, 811-13 (Del. 1984) (explaining the basis for the demand requirement and the board's authority to bring suits for breach of fiduciary duty).

313. After all, deciding whether to sell the company to a hostile bidder or whether to sue directors or officers is not an ordinary business decision in the same way that deciding whether to build a new factory, to hire two thousand additional employees, or to enter a new line of business is. Rather, accepting a hostile bid and suing for fiduciary breach are perhaps better characterized as "ownership" issues that shareholders should have final say over since these issues directly affect the right of shareholders to sell their shares and to enforce the fiduciary duties that the board and management owe them. For more on the distinction between "ownership" and "enterprise" issues, see Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 5-6 (1985); and E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 394 (1997). See generally Paredes, *supra* note 12, at 120-32 (distinguishing the "separate spheres" of board and shareholder control); Thompson & Smith, *supra* note 12, at 299-326 (defining a "sacred space" for shareholder control).

314. For proposals to expand shareholder choice, see Bebchuk, *supra* note 12; Easterbrook & Fischel, *supra* note 12; Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Paredes, *supra* note 12; Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. ECON. & ORG. 229 (1986); and Thompson & Smith, *supra* note 12.

315. See Robert B. Thompson & Randall S. Thomas, *The Public and Private Faces of Derivative Lawsuits*, 57 VAND. L. REV. 1747 (2004) [hereinafter Thompson & Thomas, *Public and Private Faces*]. For other interesting empirical work on shareholder litigation by Thompson and Thomas, see Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133 (2004).

316. Thompson & Thomas, *Public and Private Faces*, *supra* note 315, at 1790 (suggesting that the demand requirement for derivative litigation be excused for a one-percent shareholder).

317. An additional distinctive benefit is associated with expanding shareholder control over the decision to sell to an unsolicited bidder—that is, target shareholders can exit at a premium to the then-market price of their shares, and managerial irrationality at the target can be "arbitraged" more readily. See *supra* note 97 and accompanying text.

318. For a good discussion of the discipline it takes for managers to walk away from a deal, see Geoffrey Cullinan et al., *When to Walk Away from a Deal*, HARV. BUS. REV., Apr.

bidder overpayment in acquisitions, and major acquisitions can have a particularly significant and immediate impact that is difficult and costly to unwind if it goes bad.³¹⁹ Although shareholders generally have the right to vote on mergers, triangular merger structures can cut shareholders out of the approval process. Shareholders generally do not have the right to approve an asset acquisition or a tender offer launched by their company. An acquiring company's shareholders could be given greater say by granting them the right to vote on non-merger acquisitions, or at least those that cross some threshold as measured, for example, by the impact of the deal on the acquirer's balance sheet, the aggregate purchase price in relation to the acquirer's own market capitalization, or the relation between the acquirer's and the target's respective operating revenues.³²⁰ Such reforms presumably

2004, at 96 (explaining the importance of a formalized decisionmaking process with "formal checks and balances that rely on predetermined walk-away criteria" and with somebody identified to serve as devil's advocate).

319. Importantly, bidder overpayment is not simply a matter of transferring wealth from bidder shareholders to target shareholders. Rather, ill-advised acquisitions can destroy aggregate firm value and can lead to job loss, the closing of facilities, the loss of a good corporate citizen for communities, less innovation, and so on. Further, a company that leverages its balance sheet to finance a higher purchase price has a slimmer margin for error, has less free cash flow, and may be subject to more stringent debt covenants, all of which can affect how the business is run.

320. For additional discussions regarding the possibility of giving shareholders a greater say over acquisitions, see, for example, Black, *supra* note 42, at 652; Coffee, *Regulating*, *supra* note 42, at 1269-72; and Lawrence A. Hamermesh, *Premiums in Stock-for-Stock Mergers and Some Consequences in the Law of Director Fiduciary Duties*, 152 U. PA. L. REV. 881, 906-11 (2003).

The National Association of Securities Dealers (NASD) has hinted at a more modest step that might also discipline acquisitions, although without giving shareholders greater say. NASD has said that it plans to scrutinize conflicts of interest in investment bankers' fairness opinions. See Ann Davis, *NASD Scrutinizes Conflicts in Bankers' Fairness Opinions*, WALL ST. J., June 11, 2004, at A1. For more on fairness opinions, see, for example, Michael J. Kennedy, *Functional Fairness—The Mechanics, Functions, and Liabilities of Fairness Opinions*, in TECHNOLOGY & EMERGING GROWTH M&AS 2002, at 217 (PLI Corporate Law & Practice Course, Handbook Series No. B-1316, 2002); Lucian Arye Bebhuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27; William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523 (1992); and Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 OHIO ST. L.J. 951 (1992).

Two additional buy-side possibilities for constraining acquisitions are worth noting. First, just increasing the dividend a company pays can manage CEO overconfidence—not by debiasing the bias, but by depriving the CEO of the funds needed to finance projects without going back to capital markets. Many proponents of the decision by President George W. Bush and Congress to cut the federal tax on dividends pointed to the positive corporate governance implications of greater capital market discipline, in addition to the putative supply-side effects of the tax cut. High leverage also deprives management of free cash flow by increasing a company's debt service obligations, and debt covenants can constrain management as well. For two of the classic articles on the link between free cash flow and agency problems, see Jensen, *supra* note 42; and Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984). See also Heaton, *supra* note 12; Malmendier & Tate, *CEO Overconfidence*, *supra* note 76.

The second possibility would be for firms to add a cushion to the hurdle rate a project would have to clear before being approved in order to compensate for the tendency to overestimate a

could not be effected by the courts,³²¹ but would have to come from the legislature or perhaps the NYSE and Nasdaq for listed companies.³²²

project's benefits and to underestimate its costs. *Cf.* Heath et al., *supra* note 268, at 1, 4-5, 20-21 (discussing "safety factors," such as engineers use, as a cognitive repair).

321. Such reforms could not be effected by courts without some very creative and far-reaching attempt to refashion the law of fiduciary duty and shareholder franchise jurisprudence.

322. Even if shareholders were not given any additional legal control, shareholders could assert themselves more over the business along the lines that relational investing contemplates. For a sampling of the literature on relational investing, see Ian Ayres & Peter Cramton, *Relational Investing and Agency Theory*, 15 CARDOZO L. REV. 1033 (1994); Sanjai Bhagat et al., *Relational Investing and Firm Performance*, 27 J. FIN. RES. 1 (2004); Black, *supra* note 247; Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); Coffee, *supra* note 247; Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO ST. L.J. 1009 (1994); Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 (1994); and Rock, *supra* note 247. A relatively hands-off approach for stimulating greater shareholder activism would be for the Delaware judiciary, influential members of Congress, and regulators at the SEC to exhort shareholders, especially institutional investors, to be more assertive in monitoring management and the board and to be more engaged in influencing corporate strategy and policy. Second, a variety of regulatory restrictions under the federal securities laws (for example, mandatory SEC filing requirements for individual shareholders or shareholder groups that own more than five percent of a company's stock and the risk of short-swing trading liability under section 16(b) of the Securities Exchange Act of 1934 for ten-percent shareholders) have been said to discourage institutional investors from holding larger stakes and from taking a more active role in the companies they invest in. *See, e.g.*, Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 26-27 (1991). To the extent these regulatory burdens do, in fact, discourage shareholder activism, these requirements could be eased. The 1992 amendments to the federal proxy rules, which were passed to facilitate shareholder communication, provide some precedent for taking additional steps to encourage shareholder involvement. *See, e.g.*, Stephen Choi, *Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms*, 16 J.L. ECON. & ORG. 233 (2000). A third, and more intrusive, approach would be to afford shareholders greater access to the corporate proxy for purposes of making shareholder proposals. The federal proxy rules supplement shareholder voting rights under state corporate law by granting shareholders limited access to the company's proxy materials for the purpose of making proposals for a shareholder vote. The board, however, can omit many, if not most, shareholder proposals from the company's proxy materials. *See generally* LOSS & SELIGMAN, *supra* note 286, at 510-33. The SEC could consider limiting the ability of boards to exclude from the company's proxy materials shareholder proposals on the basis that they relate to the company's ordinary business. *See* 17 C.F.R. § 240.14a-8(i)(7) (2004) (allowing the company to omit shareholder proposals that relate to the corporation's "ordinary business operations"). Indeed, in the late 1990s, the SEC scaled back the ordinary-course exception by creating a carve-out for proposals that relate to important policy matters. Cracker Barrel Old Country Store, Inc., SEC No-Action Letter, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,418, at 77,284 (Oct. 13, 1992); *see also* LOSS & SELIGMAN, *supra* note 286, at 523-26. Presently, proposals relating to matters such as executive compensation, the expensing of stock options, and poison pills are routinely included in company proxy materials over the objections of the board and management. It might be worth exploring whether the expanded use of shareholder proposals, even if precatory and nonbinding, would constructively bring different ideas and opposing viewpoints to the attention of the board and management.

Calling for greater shareholder involvement is popular post-Enron, but greater shareholder involvement has its own costs. Before giving shareholders too much control, a host of coordination problems, social choice problems, agency costs, and cognitive biases at the shareholder level would need to be accounted for. For fuller discussions of some of the difficulties associated with a greater shareholder role in governance, *see, for example*, Bhagat et al., *supra*, at 5-6; Black, *supra* note 247; Coffee, *supra* note 247; Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347 (1991); Rock, *supra* note 247; and Roberta Romano, *Public Pension*

Even if shareholders were not afforded more direct say over the business or the enforcement of fiduciary duties, shareholders could be given a louder voice over who represents them on the board. It is reasonable to assume that a shareholder nominee who is elected to the board will be more responsive to shareholders and more willing to challenge the CEO, as well as other senior managers and directors. If shareholder-nominated directors are an effective means of ensuring more dissent and encouraging opposing views in firms, shareholders first need more access to the corporate ballot to make it cheaper and easier for them to nominate directors. This is easier said than done. The proposal the SEC floated to open the corporate ballot to shareholder nominees has met stiff resistance.

Because many of the suggestions for addressing CEO overconfidence rely on greater corporate accountability, one final point is important to stress. Greater accountability is a familiar response to corporate governance shortcomings. If the aim is to mitigate conflicts of interest and to motivate hard work, accountability may well be the answer. However, if the aim is to mitigate CEO overconfidence, greater accountability may make matters worse.³²³ Holding a CEO more accountable, whether to boards, to shareholders, or to judges, may actually worsen CEO decisionmaking. CEOs who have to explain themselves and justify their decisions may engage in “preemptive self-criticism” that can offset their overconfidence as they search for disconfirming evidence, consider con arguments, and the like.³²⁴ However, greater accountability may also lead to “defensive bolstering.” A CEO may become still more confident as he tries harder to reach the right decision, knowing that he has to justify himself to others.³²⁵ In short, a CEO may become more extreme in his views the

Fund Activism in Corporate Governance Reconsidered, 93 COLUM. L. REV. 795 (1993). Notably, a recent empirical study of the performance of over 1500 U.S. companies during the period 1983-1995 by Bhagat, Black, and Blair found that the effect of relational investing on corporate performance is inconclusive. Bhagat et al., *supra*.

323. For excellent surveys of the literature on accountability, see Philip E. Tetlock, *The Impact of Accountability on Judgment and Choice: Toward a Social Contingency Model*, in 25 ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY 331 (Mark P. Zanna ed., 1992); Christina L. Brown, “Do the Right Thing:” *Diverging Effects of Accountability in a Managerial Context*, 18 MARKETING SCI. 230 (1999); Jennifer S. Lerner & Philip E. Tetlock, *Accounting for the Effects of Accountability*, 125 PSYCHOL. BULL. 255 (1999); Philip E. Tetlock & Richard Boettger, *Accountability: A Social Magnifier of the Dilution Effect*, 57 J. PERSONALITY & SOCIAL PSYCHOL. 388 (1989); and Philip E. Tetlock & Jae Il Kim, *Accountability and Judgment Processes in a Personality Prediction Task*, 52 J. PERSONALITY & SOCIAL PSYCHOL. 700 (1987). See also Seidenfeld, *supra* note 286, at 508-26 (summarizing accountability literature).

324. See, e.g., Tetlock, *supra* note 323, at 343-44, 351-59; Brown, *supra* note 323, at 231; Lerner & Tetlock, *supra* note 323, at 263; Tetlock & Kim, *supra* note 323, at 700-01.

325. See, e.g., Tetlock, *supra* note 323, at 344-59 (explaining that “defensive bolstering” (that is, “efforts to generate as many justifications as possible”) can lead to greater confidence and commitment); Arkes, *Implications for Debiasing*, *supra* note 262, at 493 (“Incentives are not effective in debiasing association-based errors because motivated subjects will merely perform the sub-optimal behavior with more enthusiasm. An even more assiduous search for

more accountable he is. In addition, greater accountability may incentivize CEOs, in an attempt to shore up their control, to adopt more effective strategies of persuasion and ingratiation in order to sell their ideas, thereby undercutting the new accountability measures.³²⁶ Thus, even if general agreement can be found that CEO overconfidence is a problem, the indeterminacy of behavioralism makes it difficult to craft effective regulatory or market-based remedies.

V. CONCLUSION

Much remains to be learned about cognitive bias and how to manage it. It is still too early to revamp substantially corporate governance in response to managerial psychology generally, let alone in response to the particular risk of CEO overconfidence.

It does not follow, however, that we should stick with the status quo. The theory of the firm has evolved from viewing the firm as a production function; to the principal-agent model; to the nexus-of-contracts approach; to the transaction cost model; to recent property rights theories of the firm. It is important to continue thinking about the firm by prying open the “black box” of the managerial mind, just as other thinking about the firm has pried open the “black box” of the firm itself.³²⁷ The future challenge for the theory of the firm and for corporate governance—indeed, for all organizations—is to account for human psychology. In order to improve how corporations and other organizations are managed and how they ultimately perform, we need to better appreciate and account for how the people who run them think and behave.

confirmatory evidence will not lower one’s over-confidence to an appropriate confidence level.”); Brown, *supra* note 323, at 231 (“[S]ince accountability can encourage defensive thinking or ‘bolstering,’ it may create overconfidence in one’s predictions and encourage decision makers to stick with a losing course of action. This leads to the discouraging implication that accountability can distort decisionmaking exactly when it makes its adherents feel more certain they are ‘doing the right thing.’” (citations omitted)); *id.* at 244 (“This effect is exacerbated if accountability also creates overconfidence in one’s predictions, either because providing reasons for one’s predictions makes one more confident (whether or not the reasons are good ones), or because concern over being evaluated encourages one to express one’s ideas more confidently (whether or not one is genuinely confident).”); Lerner & Tetlock, *supra* note 323, at 257 (“Defensive bolstering should also lead people to generate as many reasons as they can why they are right and potential critics are wrong. This generation of thoughts consistent with one’s views then leads people to hold even more extreme opinions.” (citations omitted)); *id.* at 258 (“Research on attitude change reveals that people who sense that an audience wants to control their beliefs will often respond to the threat to their autonomy by asserting their own views all the more vigorously.”).

326. See Westphal, *Board Games*, *supra* note 225, at 511 (explaining that “changes in board structure that increase the board’s independence from management are associated with higher levels of CEO ingratiation and persuasion behavior toward board members” and that “such influence behaviors, in turn, serve to offset the effect of increased structural board independence”).

327. Cf. Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 873 (1993) (explaining that in order to develop a viable theory of organizations, it is important to “break open the black box called the firm, and this means understanding how organizations and the people in them work”).