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CORPORATE GOVERNANCE, EXECUTIVE COMPENSATION, CORPORATE PERFORMANCE, AND WORKER RIGHTS IN BANKRUPTCY: SOME LESSONS FROM GAME THEORY

*Steven H. Kropp**

INTRODUCTION

In 2001 and 2002, as the American stock exchanges imploded, the public watched a series of companies admit to gross financial improprieties. Corporate scandals at Enron, Worldcom, Global Crossing, and Adelphia forced those companies into Chapter 11 bankruptcy and prompted criminal charges against company officers, auditors, and others.¹ Congress responded by passing the Sarbanes-Oxley Act.² The trajectory of executive compensation, however, has remained un-

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1. See Stephen Labaton, *Crime and Consequences Still Weigh on Corporate World; Four Years Later, Enron's Shadow Lingers as Change Comes Slowly*, N.Y. TIMES, Jan. 5, 2006, at C1 (providing a timeline for each company's bankruptcy proceedings and executive prosecutions). Other companies, such as Tyco and Disney, had their share prices cut substantially in value, but avoided bankruptcy. These companies' compensation packages came under fire, however, for criminal misconduct on the part of Dennis Kozlowski, Tyco's former CEO, and for potential civil liability in the case of former Disney president Michael Ovitz's \$140 million severance package received following barely one year of employment. *Id.*; compare *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 350 (Del. Ch. 1998) (holding that "courts [do not] overrule a board's decision to approve and later honor a severance package, merely because of its size"), with *Brehm v. Eisner (Disney II)*, 746 A.2d 244, 253–54 (Del. 2000) (overruling *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), and its progeny on the narrow but vital issue of the proper scope of review—the court changed the standard from the more deferential abuse of discretion standard to the much more searching de novo standard when a derivative suit had been dismissed by the trial court), and *In re Walt Disney Co. Derivative Litig. (Disney III)*, 825 A.2d 275, 291 (Del. Ch. 2003) (noting the recent increase in corporate scandals, the court commented that "corporation law's theoretical justification for disregarding honest errors simply does not apply to intentional misconduct or to egregious process failures that implicate the foundational directoral obligation to act honestly and in good faith to advance corporate interests").

2. Pub. L. No. 107-204, 116 Stat. 745 (2002).

affected, and pay for top executives seemingly climbs ever higher. The affected employees and investing public, on the other hand, have obtained little economic relief either from the passage of Sarbanes-Oxley or from subsequent corporate reorganizations, which have ordinarily benefited creditors.³

Many finance and pension law scholars have responded to this breakdown in corporate governance by proposing ERISA reforms. Several scholars have argued for restricting the percentage of employee pension dollars that can be invested in employers' stock to, for example, 10%.⁴

This approach has several flaws. First, although such a restriction would protect employees' pension funds by promoting stock diversification—a cardinal principle of finance—it would deny employees the opportunity to substantially profit if their employer's stock performs particularly well. Consequently, this limitation would provide employees with insurance but no upside return. Second, and perhaps more troubling, such a restriction may well encourage employers to drop their pension programs altogether.⁵ An employer providing company stock does not pay cash funds; thus, there is no impact on funds flow, profits, or the corporate balance sheet.⁶ Additionally, the employee motivation and loyalty that comes with stock ownership in the company would be lost. In other words, employers would lose an important economic incentive.

Instead, this Article recommends amending the Bankruptcy Code to protect worker pension plans. When a publicly held corporation files for bankruptcy, its senior management—its CEO, CFO, presi-

3. Labaton, *supra* note 1.

4. See, e.g., Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 *YALE L.J.* 451, 533 (2004) ("ERISA's ten percent cap should be extended to defined contribution arrangements also."); Sharon Reece, *Enron: The Final Straw & How to Build Pensions of Brick*, 41 *DUQ. L. REV.* 69, 135, 141 (2002) (suggesting "quick and decisive action" to curb the lack of stock diversification and evaluating various proposed plans for reform, such as Senator Wellstone's Retirement Security Protection Act of 2002, which would have capped employer stock holdings at 20% and provided for punitive damages for ERISA violations).

5. Reece, *supra* note 4, at 140 ("The [U.S. Chamber of Commerce] expressed concern about over-regulation and restrictions on investment options resulting in fewer employers offering Section 401(k) plans, employee stock ownership plans, and other retirement benefits.") (citing hearings with Secretary of Labor Elaine L. Chao, *Fiduciary Responsibility: Labor, Treasury Reviewing Pension Rules; Enron-Related Legislation Introduced*, *Pens. & Ben. Rep. (BNA)* No. 29, No. 5, at 297 (Jan. 29, 2002)).

6. See, e.g., Am. Bar Ass'n, Subcommittee on Executive Compensation, *Executive Compensation: A Road Map for the Corporate Advisor*, 40 *BUS. LAW.* 219, 237–38 (1984) ("No entries are made in the body of a company's balance sheet upon the issuance of stock options, but entries are required when the options are exercised and actual shares are issued. When this happens, the paid-in capital accounts are increased to reflect the option price plus the amount, if any, expensed for the exercised stock option.").

dent, and senior vice presidents—should be forced to disgorge all compensation beyond \$330,000 plus the value of annual health insurance for the previous three years.⁷ An annual salary of \$330,000 places an individual in the top 1% of income in the United States⁸ and recognizes that senior executives in our society expect compensation commensurate with their responsibilities in managing a public company. Disgorged moneys would include wages, bonuses, stock options, consulting fees, and all profits from sales of company stock received in connection with corporate service during a three-year, “look-back” period. Disgorged moneys recovered would then be applied to compensate employees for losses to their employee pension plans.⁹ In short, the advantages of this remedy are three-fold. First, this proposal provides a form of insurance for employee 401(k) pension plans in the event that the company goes bankrupt, similar to FDIC insurance of an individual’s bank account or ERISA for defined benefit pension plans.¹⁰ Second, this proposal acts as a proxy for re-

7. This proposed bright-line rule, like any such rule, has several advantages. It is easy to understand and apply and is difficult to circumvent. The basic criticism of any bright-line rule, however, is that it does not allow for particularized circumstances. Under this proposal, a CEO of a bankrupt company could not successfully assert that he did not contribute to the corporation’s demise if instead the company failed because of changes in technology, market forces, public tastes, or attitudes. Even if true, this is fair. A contemporary CEO is so well paid, precisely because she is expected to function in a rapidly changing, unpredictable business climate. Moreover, tying pay to performance invariably means that, just as unmerited success is sometimes rewarded, so too unmerited failure must sometimes be penalized. Part of the difficulty lies with the current system that protects CEOs as risk takers under the business judgment rule in cases of corporate failure but compensates them as though they are risk-averse individuals. The appropriate model is illustrated by the decision of a handful of CEOs to accept a token salary but substantial stock options for running a company. Lee Iacocca, as CEO of a troubled Chrysler Corporation, did so in 1980. This effectively tied his economic future to his ability to grow the company’s financial future. It worked, and his stock options made him wealthy.

8. An individual in the top 1% of the AGI income bracket earned an annual salary of \$330,000 [\$328,049] in 2004. I.R.S., Statistics of Income Division (Sept. 2006), available at <http://www.irs.gov/pub/irs-soi/04in05tr.xls>. The same individual in the top 1% earned \$300,000 [\$295,495] in 2003. *Id.* This represents a 10% rise in income over a one-year period. Board members would be required to disgorge all compensation received beyond \$5,000 annually.

9. This proposal arguably changes the structure of economic recovery under § 510(b) of the Bankruptcy Code. Currently, principles of equitable subordination dictate that a shareholder’s recovery for damages for the purchase or sale of the corporation’s stock be subordinated to all claims held by creditors. 11 U.S.C. § 510(b) (Supp. 2007).

10. In a defined benefit pension plan, the company guarantees the amount of an employee’s pension benefits based on her retirement age, salary, and length of service with the company. Accordingly, because the company guarantees the benefit schedule, it therefore bears the risk of downturns in the financial markets. For example, in 2003, General Motors was forced to sell bonds in order to shore up its ailing pension program. See Danny Hakim with Jonathan Fuerbringer, *G.M. to Raise \$10 Billion For Pension Gap*, N.Y. TIMES, June 21, 2003, at C1. Moreover, the Pension Benefit Guarantee Corporation, created as part of the 1974 enactment of ERISA, provides additional insurance in the event of a corporate default on pension benefits. By contrast, in defined contribution pension plans, such as 401(k) plans, companies contribute a fixed

couping excessive executive compensation when bankruptcy occurs. Third, this proposal respects employees' free choice and enables them to share in their company's rising economic future as reflected in its stock gains.

This proposal is rooted in the idea that senior executives and members of the board of directors should bear personal financial responsibility for corporate failures. The concept of personal accountability received recognition in the wake of the WorldCom collapse and subsequent bankruptcy. The telecom giant found itself in financial hot water when Wall Street discovered that WorldCom had been using fraudulent accounting methods to mask its deteriorating condition by painting a false picture of growth and profitability between 1999 and 2002.¹¹ After WorldCom filed for Chapter 11 bankruptcy, a group of former employees filed a class action suit in federal court, seeking full severance payments and benefits. On March 18, 2005, the parties reached a settlement agreement, whereby all class action claims were dropped against twelve former WorldCom directors in exchange for a combined payment of \$24.75 million out of the directors' own pockets.¹²

amount of money to employees' retirement accounts, and hence, these plans contain no guarantees of return upon any individual's retirement. The risk of market downturns is borne entirely by individual workers. Of course, executives are best able to assess the company's prospects for the future. The proposals advocated in this Article are directed primarily toward publicly held companies that fund their employees' 401(k) pension plans with company stock rather than with cash. See, e.g., Jim Webb, Editorial, *Class Struggle: American Workers Have a Chance to Be Heard*, WALL ST. J., Nov. 15, 2006, at A18.

11. J. Gregory Sidak, *The Failure of Good Intentions: The WorldCom Fraud and the Collapse of American Telecommunications After Deregulation*, 20 YALE J. ON REG. 207, 238-39 (2003); see also Adriaen M. Morse, Jr., *Breaking the Circle: The Problem of Independent Directors Policing Public Company Financial Disclosure Under the SEC's New Rules Governing Public Company Audit Committees*, 23 ANN. REV. BANKING & FIN. L. 673, 677 (2004) (describing the magnitude of the fraud).

12. See Stipulation of Settlement, *In re WorldCom, Inc. Sec. Litig.*, No. 02-Civ.-3288(DLC), (S.D.N.Y. Mar. 18, 2005), available at <http://www.worldcomlitigation.com/html/citisettlement.html>. Judge Denise Cote had previously rejected a settlement agreement, because it was too small and because it violated the Private Securities Litigation Reform Act (PSLRA). See *In re WorldCom, Inc. Sec. Litig.*, 354 F. Supp. 2d 455, 462 (S.D.N.Y. 2005) (addressing the PSLRA violation); *In re WorldCom, Inc. Sec. Litig.*, No. 02-Civ.-3288(DLC), 2005 WL 335201, at *1-6 (S.D.N.Y. Feb. 14, 2005) (setting forth the terms of the original settlement agreement and the events that led up to the litigation). Cf. Phred Dvorak & Serena Ng, *Check, Please: Companies Discover It's Hard to Reclaim Pay From Executives*, WALL ST. J., Nov. 20, 2006, at A1 (discussing the common corporate practice known as "clawbacks," whereby CEOs who receive bonuses based on performance are typically never required to return bonus money if and when the company restates its numbers such that the bonuses were never earned).

This type of settlement is the exception rather than the rule.¹³ Conservative political commentators commonly demand personal responsibility. Rarely, however, do those expectations reach the corporate hierarchy.¹⁴

The purpose of the American corporation is to maximize shareholder wealth.¹⁵ The theory of the corporation is that stockholders own the company, top-level management runs the company, and the board of directors oversees management for the benefit of the owners.¹⁶ Executive compensation is designed to reflect corporate performance.¹⁷ During the last two decades, however, executive compensation has increased dramatically, often without bearing any relationship to the company's performance.¹⁸

When a corporation files for bankruptcy, corporate performance does not warrant generous compensation for top executives. Thus, in light of bankruptcy, excessive compensation should be recovered. Recovered funds should be available to compensate employees for losses in their pension plans. Any excess money should then be applied to compensate other stockholders or creditors that have securities violations claims.

13. See Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055 (2006) (analyzing when outside directors personally pay legal expenses or damages for corporate misconduct and concluding that it rarely happens).

14. See Ellen Byers, *Corporations, Contracts, and the Misguiding Contradictions of Conservatism*, 34 SETON HALL L. REV. 921, 997 (2004) ("Frequently citing personal accountability as a core value for the responsible citizen, conservatives fight measures that would ensure it in business and politics.").

15. THE AMERICAN LAW INSTITUTE, *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 2.01(a) (1994) ("[A] corporation . . . should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain."). See Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065, 2072–74 (2001) ("The prevailing academic and business view in the United States is that shareholder wealth maximization fits with [our] utilitarian, greatest-good-for-the-greatest-number philosophy."); see also Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 439 (2001) ("There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.").

16. See, e.g., DEL. CODE ANN. tit. 8, § 141 (2006); WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 108–10 (9th ed. 2004).

17. 26 U.S.C. § 162 (2000); I.R.C. § 162(m)(1), (m)(4)(C) (2000) ("Certain excessive employee remuneration . . . no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000," unless certain performance based goals apply); see also I.R.C. § 280G (2000) (Golden Parachute Payments).

18. See *infra* note 21 and accompanying text.

This proposal is designed to compensate workers when their corporate employer files for bankruptcy. Employees risk both job loss and the destruction of their retirement funds.¹⁹ Bankruptcy is an appropriate triggering event, because corporations in bankruptcy typically lay off a substantial number of workers. With this safety net, workers are less likely to face the prospect of both loss of employment and loss of retirement savings.

In contrast, senior managers are often privy to key information and, thus, know when to leave the corporation's employment, when to exercise severance pay rights, and when to collect upon stock options and bonuses. They can also ensure future employment with another organization. Moreover, when a company files to reorganize under Chapter 11 of the Bankruptcy Code, incumbent management often remains in place as the reorganization proceeds. Indeed, incumbent management, acting on behalf of the debtor-in-possession ("DIP"), often seeks retention bonuses for itself on the theory that key managers need added incentives to stay with a financially troubled company facing an uncertain future.²⁰

This dichotomy between the treatment of ordinary workers and that of senior managers strongly suggests the need for reform. In the past few decades, the gulf in compensation between senior managers and ordinary workers rose from a ratio of 42 to 1 in 1980 to a ratio of 531 to 1 in 2000.²¹ The goal of this plan is to align management's interests with that of the corporation so that all employees do well (or poorly) together.²²

19. E.g., Norman Stein, *Three and Possibly Four Lessons About ERISA That We Should, But Probably Will Not, Learn from Enron*, 76 ST. JOHN'S L. REV. 855, 856–59 (2002) (“[A]n employee's investment capital and human capital should not be tied together.”).

20. Compare 11 U.S.C. § 503(c)(1)–(2) (Supp. 2007) (Sections 503(c)(1)–(2) were added to the Bankruptcy Code in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 [BAPCPA], curbing abuses plaguing key employee retention bonuses (KERBs) and excessive managerial severance packages), with 11 U.S.C. § 365 (2000), which previously governed (business judgment rule applies to trustee's power to assume or reject executory contracts); see *In re Dana Corp.*, 351 B.R. 96 (S.D.N.Y. 2006) (holding that payment to executives still employed in Chapter 11 had to be viewed as retention payment).

21. RAKESH KHURANA, *SEARCHING FOR A CORPORATE SAVIOR* 201 (2002). See also *id.* at 266 n.20 (noting the declining share of earnings for the middle class); William S. Lerach, *Plundering America: How American Investors Got Taken For Trillions by Corporate Insiders—The Rise of The New Corporate Kleptocracy*, 8 STAN. J.L. BUS. & FIN. 69 (2002). Between 1990 and 2001, CEO pay increased by 535%, making it 531 times that of the average employee. During this same period, share prices rose by 300% while corporate profits rose by 116%. *Id.* at 96 n.77.

22. Compare ADOLPH A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 309–13 (rev. ed. 1968), and ADOLPH A. BERLE, JR., *POWER WITHOUT PROPERTY: A NEW DEVELOPMENT IN AMERICAN POLITICAL ECONOMY* (1959) (describing the consequences of separating the ownership and management functions), with Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983) (arguing

This Article proposes solutions to two distinct but related societal problems: (1) how to align the interests of corporate management with those of the shareholders; and (2) how to reduce the economic unfairness that befalls workers when their companies go bankrupt, often leaving their 401(k) pension plans worthless. The first goal has eluded our society despite persistent attention. The second goal, legal reform, often suffers from doubts that the proposed reform stands a realistic chance to influence the direction of the law.

Parts II and III sketch the basic outline of the public corporation. Specifically, Part II examines the principal-agency conflict in the public corporation,²³ and Part III briefly looks at the “nexus of contracts” theory of the corporation.²⁴ Part IV reviews the debate over senior executive compensation and concludes that there is no relationship between executive compensation and corporate performance.²⁵ Next, in Part V, this Article applies the Prisoner’s Dilemma from game theory to executive compensation and corporate performance, incorporating the proposals advocated in this Introduction.²⁶ The game theory paradigm demonstrates that a severe sanction imposed upon senior management can alter managerial behavior and reduce incentives to manipulate stock performance. Part VI draws a distinction between solvent and insolvent corporations that justifies differential treatment of executive compensation.²⁷ Part VII explains why two core bankruptcy concepts, fraudulent conveyance law and preference law, support the ideas advanced in this Article.²⁸ Part VIII examines recent reform proposals introduced in Congress but never enacted.²⁹ Finally, this Article concludes that the political environment is ripe for legislative reform to protect workers’ pensions when corporations file for bankruptcy.³⁰

that a successful corporation need not align the financial interests of the ownership [shareholder] and control [management] elements), and Lucian Ayre Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002) (arguing that executives have substantial power to influence their own pay, which can lead to inefficient pay arrangements that provide sub-optimal incentives and thereby hurt shareholder value).

23. See *infra* notes 31–39 and accompanying text.

24. See *infra* notes 40–44 and accompanying text.

25. See *infra* notes 45–67 and accompanying text.

26. See *infra* notes 68–91 and accompanying text.

27. See *infra* notes 92–104 and accompanying text.

28. See *infra* notes 105–193 and accompanying text.

29. See *infra* notes 194–202 and accompanying text.

30. See *infra* notes 203–207 and accompanying text.

II. THE MANAGEMENT-SHAREHOLDER CONFLICT: THE CONSEQUENCES OF THE SEPARATION OF OWNERSHIP FROM CONTROL IN THE PUBLIC CORPORATION

Shareholders depend on managers and directors to perform their roles with competence and integrity.³¹ Unfortunately, managers and directors often fail to fulfill these obligations. This basic issue arises because of the separation of ownership from control in the publicly held corporation. Corporate accountability requires that the shareholders (or some institution) monitor management's behavior.³² A typical publicly held corporation has thousands of shareholders, none of whom hold a stake large enough to justify investing their energy in overseeing the management's behavior.³³ In theory, shareholders can rely upon an independent board of directors to perform that task.³⁴ The board of directors, however, is not selected by the shareholders, but rather by management.³⁵

31. This principle is represented in corporate law as the business judgment rule: the "presumption that directors act in good faith, on an informed basis, honestly believing that their action is in the best interests of the company." *In re Tower Air, Inc.*, 416 F.3d 229, 238 (3d Cir. 2005).

32. See, e.g., Arnoud W.A. Boot & Jonathan R. Macey, *Monitoring Corporate Performance: The Role of Objectivity, Proximity, and Adaptability in Corporate Governance*, 89 CORNELL L. REV. 356, 361–66 (2004).

Sufficient shareholder control is necessary in order to overcome managerial inefficiencies, and important to address other objectives of corporate governance. Thus, a successful corporate governance system will seek to facilitate sufficient shareholder control, and a successful review of an already existing corporate governance system will focus on whether or not that system exhibits sufficient shareholder control.

Id. at 364.

33. See Bernhard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 527 (1990) (discussing shareholder passivity and collective action theory: "shareholders won't make economically motivated proposals or actively oppose manager proposals unless the potential gains are much larger than the cost of the effort."); Bernhard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 821 (1992) ("[A] shareholder proponent bears most of the cost of a proxy campaign, but receives only a pro rata share of the gains from success, while other shareholders can free ride on her efforts."); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1328 (1991) ("[T]wo factors—the inability to take large positions and an active trading style—explain why [institutional investors] will show only a limited interest in corporate governance issues, except possibly those related to takeovers.").

34. See Edward S. Adams, *Corporate Governance After Enron and Global Crossing: Comparative Lessons for Cross-National Improvement*, 78 IND. L.J. 723, 728–29 (2003) (showing a decline in director/management independence throughout the 1900s, though noting that the increased presence of institutional investors as major shareholders "is causing an evolution in corporate governance, where the board of directors is truly an independent oversight entity that can effectively monitor management").

35. *Id.* at 729–30 (discussing generally the history of management selection of directors, and the increasing problem of "inside" directors and non-independent boards).

Adolph Berle and Gardiner Means's enduring classic, *The Modern Corporation and Private Property*, observed that the large, publicly held corporation had separated ownership of the corporation—held by shareholders—from control of the corporation—held by senior management.³⁶ Shareholders do not possess the conventional bundle of owner's rights.³⁷ Rather, managers control how the property is used.³⁸ Modern corporation theorists have characterized this conflict as an agency problem: the need to persuade the agent (managers) to maximize the principals' (shareholders') welfare in the corporation.³⁹ In other words, top management has a strong incentive to cheat in order to maximize personal wealth at the expense of the shareholders. Thus, there are two related issues: the cost to the principal of monitoring the agent's behavior and the need for the principal to create a compensation system that provides appropriate incentives to the agent to maximize the corporation's success, aligning the interests of management with the interests of shareholders.

III. THE NEXUS OF CONTRACTS APPROACH IN CORPORATE LAW

So far, this Article has treated shareholders as the owners of the corporation. During the past two decades, however, the emerging trend in corporate legal theory is to view the corporation as a series of contractual relationships among shareholders, management, workers, and creditors.⁴⁰ Under this nexus of contracts approach, or contractarian model, shareholders are regarded not as owners but rather as suppliers of a particular form of capital: equity.⁴¹ Accordingly, shareholders are akin to creditors. Instead of a system of shareholder primacy, this model reflects a system of director primacy.⁴² The con-

36. BERLE & MEANS, *supra* note 22, at 112–16.

37. *See id.* at 47–65.

38. *See id.* at 66–84.

39. *See* William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 755–56 (2001) (arguing that separation of ownership and control creates agency costs that are sub-optimally high and cannot be solved by market forces); *see also* William W. Bratton, Jr., *The Nexus of Contracts Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 415–17 (1989) (tracing the origins of agency theory) [hereinafter *Nexus of Contracts*]. *See also* Eric W. Orts, *Shirking and Sharking, A Legal Theory of the Firm*, 16 YALE L. & POL. REV. 265, 327–29 (1998) (arguing that the traditional agency conception is too narrow—as a legal model centered around authority, power, and hierarchy, principal costs must be accounted for in addition to agency costs).

40. STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 47 (2002).

41. Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 9 (2002).

42. BAINBRIDGE, *supra* note 40, at 29; Bainbridge, *supra* note 41, at 8 (proposing a “director primacy” model: “[T]he board of directors is not a mere agent of the shareholders, . . . but rather is a *sui generis* body—a sort of Platonic guardian—serving as the nexus for the various

tractarian model focuses on the hypothetical *ex ante* bargains that parties would strike if they negotiated formal terms.⁴³ Default rules, such as statutes governing corporate law and judicial opinions interpreting those statutes, substitute for this private bargaining where it does not occur.⁴⁴

If shareholders sat down with managers in advance of investing—supplying capital—to negotiate the standards by which managers would be compensated, it is difficult to conceive of the shareholders agreeing that there would be no standards at all. Rather, both parties would certainly agree that the corporation's performance and the manager's contribution to that performance would be the basis for compensation beyond a base salary. The board of directors would probably be left with the difficult task of performance measurement. There would also be standards of performance expected from members of the board of directors to ensure proper monitoring of corporate executives. Thus, the nexus of contracts approach is quite different from the traditional shareholder-owner theory.

IV. IS EXECUTIVE COMPENSATION EXCESSIVE?

The need to align the interests of managers with shareholders remains the central conceptual problem in corporate law. Executive compensation crystallizes the dichotomy between managers and shareholders, because it clearly splits the interests of the two. But whether executive compensation is excessive depends in part on what measuring stick one uses.

There is an extensive body of literature addressing executive compensation. For example, a substantial number of scholars have criticized executive compensation as excessive.⁴⁵ On the other hand,

contracts making up the corporation.”). See generally Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395–1404 (1989). But see William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 Nw. U. L. REV. 180, 193–97 (1992) (rejecting the nexus of contracts theory and arguing that “[p]owerful theoretical foundations and ideological correctness are exciting and gratifying, but academic corporate law leans more to power talk than to theory talk”); Bratton, *Nexus of Contracts*, *supra* note 39, at 418–19 (challenging the basic assumptions—contract, rationality, desire to maximize profits, competition, and survival of the fittest—upon which nexus of contract theory rests).

43. Bainbridge, *supra* note 41, at 26 (“Although agents *ex post* have strong incentives to shirk, *ex ante* they have equally strong incentives to agree to a corporate contract containing terms designed to prevent shirking.”).

44. E.g., DEL. CODE ANN. tit. 8, § 228 (2006) (unless otherwise provided in the certificate of incorporation, actions based on the written consent of a majority of shareholders are permitted in lieu of a vote at the annual meeting).

45. See, e.g., Meredith M. Stead, *How Incentive Pay for Executives Isn't—And What We Can Do About It*, 80 N.Y.U. L. REV. 722, 724 (2005) (relating that both non-equity based compensation and equity based compensation in its current form are excessive and fail to effectively tie

there is no shortage of articles defending the existing levels of executive compensation.⁴⁶ Defenders of high CEO compensation often compare executive salaries with those commanded by major league athletes and Hollywood entertainers.⁴⁷ For example, in 1983 pop star Michael Jackson, then twenty-five, earned approximately \$50 million from his “Thriller” album, while Philip Caldwell, CEO of Ford, earned only \$7.3 million.⁴⁸ Critics of the high level of executive compensation, however, look at the distribution of wealth and income in the United States and note the vast disparity between the average CEO’s pay and that of the average worker.⁴⁹

An employee’s value is tested partly by the market and the scarcity of that employee’s skills, but ultimately by the contributions that the employee makes to the corporation.⁵⁰ This can be observed firsthand

performance to compensation); John E. Core et al., *Bebchuk & Fried: Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, 103 MICH. L. REV. 1142, 1183 (2005) (arguing that “it may be useful to impose additional restrictions on executive portfolios” and questioning whether additional incentives are necessary). See also Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2026–27 (2007); DEREK BOK, *THE COST OF TALENT: HOW EXECUTIVES AND PROFESSIONALS ARE PAID AND HOW IT AFFECTS AMERICA* 95–114 (1993) (arguing that CEOs are overpaid); Charles M. Yablon, *Bonus Questions—Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271 (1999) (noting the tendency for overgenerosity in executive pay).

46. See, e.g., Jeffrey N. Gordon, *Executive Compensation: If There’s a Problem, What’s the Remedy? The Case for “Compensation Discussion and Analysis,”* 30 J. CORP. L. 675, 702 (2005) (recommending mechanisms to strengthen director independence and disfavoring expansion of shareholder powers, rather than limiting executive compensation packages); Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 221 (1996) (expressing a reasonable doubt that the free market has failed to properly set executive compensation levels and that “the case for additional and significant legislative, administrative, or judicial intervention is not compelling”); Kevin J. Murphy, *Top Executives are Worth Every Nickel They Get*, HARV. BUS. REV. 125, 131 (Mar.-Apr. 1986) (citing special interest groups as furthering their own agendas by confusing the public and creating controversy over pay levels that are actually designed to encourage executives to act on behalf of the shareholder); Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It’s Not How Much You Pay, But How*, HARV. BUS. REV. 138, 138, 141 (May-June 1990) (contending that most executives do not receive excessive salaries and that meaningful bonuses or penalties should be given for outstanding or poor performance).

47. John A. Byrne, *Worth His Weight*, FORBES, June 4, 1984, at 96 (comparing favorably the salaries of N.Y. Mets outfielder George Foster to Union Pacific CEO William Cook, among others).

48. *Id.* Caldwell was the highest paid CEO in 1983 despite the fact that Ford was recovering from a slump. *Id.* CEOs themselves often pointed to the high salaries earned by sports and entertainment figures to justify their own excessive salaries. See GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES* 31, 34–38, 47 (1991).

49. See Paul Krugman, *For Richer*, N.Y. TIMES, Oct. 20, 2002, sec. 6 at 62; Brian R. Cheffins & Randall S. Thomas, *The Globalization (Americanization?) of Executive Pay*, 1 BERKELEY BUS. L.J. 233, 237 (2004).

50. Carl T. Bogus, *Excessive Executive Compensation and the Failure of Corporate Democracy*, 41 BUFF. L. REV. 1, 81 (1993) (suggesting that executive “[c]ompensation is excessive

in professional sports and entertainment. Professional athletes are paid based on their potential and their realization of that potential. Similarly, in Hollywood, a music star is paid based on her ability to persuade the public to attend her concerts and buy her music. A screen actor is paid based on the popularity of her movies or television programs. In each of these highly paid endeavors, the employee sits on one side of the negotiating table, and the employer sits on the other.⁵¹ The employer has a strong incentive to pay no more than is appropriate, as the salary comes out of the bottom line.⁵² Conversely, the employee has a strong incentive to maximize her pay.

Comparisons to these industries are frequently used to justify high pay in the corporate world.⁵³ But there is a key difference: the board of directors, entrusted with protecting corporate interests, does not sit on the opposite side of the negotiating table from management. Rather, the CEO invariably selects the board members. The board typically delegates its responsibility to its compensation committee. In turn, that committee frequently employs an advisory executive compensation firm. These actors attempt to approximate the genuine negotiations that occur elsewhere.⁵⁴ The reality is, however, that no

whenever it is higher than necessary to (1) hire or retain the executive, (2) provide the optimum incentive to the executive, or (3) be fair”).

51. Compare Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. 971, 1027–31 (2004) (recommending the strengthening of board autonomy in the executive compensation decision-making process and the removal of statutory and regulatory requirements that “pervert” the executive compensation decision making process), with Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 996 (1993) (recommending stronger board oversight and monitoring, based on a self-motivational model: “each director must function as his or her own motivational force.”).

52. An analogous situation occurs when pay-scale is based on seniority. Employers systematically replace older workers with younger workers who cost the company less money to employ. See Richard A. Posner, *Employment Discrimination: Age Discrimination and Sexual Harassment*, 19 INT'L. REV. L. & ECON. 421, 421–25 (1999) (refuting the traditional economic justification for terminating older employees in favor of newer ones); Steven Kropp, *Collective Bargaining in Bankruptcy: Toward an Analytical Framework for Section 1113*, 66 TEMP. L. REV. 697, 716–18 (1993) (contending that, in the context of layoffs in bankruptcy, corporations should not be allowed to deviate from their seniority structure).

53. See CRYSTAL, *supra* note 48, at 32–38.

54. See, e.g., Iman Anabtawi, *Secret Compensation*, 82 N.C. L. REV. 835 (2004).

Nominally, the board of directors of a corporation has ultimate responsibility for determining the compensation of its key executives. A majority of the board may, however, broadly delegate its authority to one or more committees. . . . Public companies commonly establish a compensation committee and delegate to it the responsibility for overseeing the compensation of executive officers. Although the precise responsibilities of any given compensation committee depend on the board's specific delegation of authority, typical responsibilities of a compensation committee involve: (1) recommending compensation programs and pay levels for the CEO and other top executives; (2) approving employment agreements and other contracts with such executives; and

board is going to contend that its CEO is mediocre. The pool of CEOs will always be like Garrison Keillor's "Lake Wobegon," in which "everyone is above average,"⁵⁵ further pushing executive compensation ever higher.

As epitomized in Oliver Stone's *Wall Street*, the first wave of executive compensation scandals broke in the 1980s.⁵⁶ Subsequently, Congress sought to tie executive compensation to corporate performance.⁵⁷ Federal income tax laws were changed to require that executive compensation exceeding \$1 million annually be performance based in order for companies to receive a tax deduction.⁵⁸ The IRS planned to review executive compensation to determine compliance.⁵⁹ These changes in the tax laws, however, did not produce the intended effect.⁶⁰ Instead, during the 1990s, the pace of executive compensation continued to escalate. Proponents explained this phenomenon by referencing the substantial growth in the stock market indices. Executive compensation embraced not only an increasingly high base salary, but also included generous stock options, bonuses,

(3) administering equity-based and other long-term incentive compensation plans, including making individual equity grants.

Id. at 841–42.

55. *A Prairie Home Companion* (American Public Media).

56. *WALL STREET* (American Films 1987).

57. 26 U.S.C. § 162, I.R.C. § 162(m)(1), (m)(4)(C) (Supp. 2007) ("Certain excessive employee remuneration . . . no deduction shall be allowed under the chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000," unless certain performance based goals apply); *see also* I.R.C. § 280G (Golden Parachutes).

58. I.R.C. § 162(m)(1)(Supp. 2007).

59. *See* 2 BNA CORPORATE ACCOUNTABILITY REPORT 6, at 136 (Feb. 6, 2004).

60. Christopher Cox, head of the SEC, criticized the \$1 million tax deduction cap for top executive salaries that Congress passed in 1993 in his remarks before the Public Company Accounting Oversight Board of the Senate Banking, Housing, and Urban Affairs Committee. He told the committee that the cap forced companies that needed or wanted to pay their top executives more to often turn to stock options, which are always tax deductible if paid at-the-money. These option grants, in turn, led unethical companies and executives to the illegal practice of backdating in order to maximize their value. *See infra* note 64 (discussion of stock options and backdating).

[O]ne of the most significant reasons that non-salary forms of compensation have ballooned since the early 1990s is the \$1 million legislative cap on salaries for certain top public company executives that was added to the Internal Revenue Code. . . . [T]he stated purpose was to control the rate of growth in CEO pay. With complete hindsight, we can now all agree that this purpose was not achieved. Indeed, this tax law change deserves pride of place in the Museum of Unintended Consequences.

Testimony of Christopher Cox, 2006 WLNR 15498300 (Sept. 6, 2006) (also discussing new SEC rules that will require "the full disclosure of all aspects of executive and director pay and benefits").

and pension plans, as well as many esoteric benefits.⁶¹ As the sheer size of executive pay exploded in the 1980s and 1990s, scholars increasingly wondered what, if any, causal relationship existed between executive compensation, corporate performance, and the stock market.⁶²

Until recently, scholars have focused little attention on the critical issue of whether there is a relationship between corporate performance and executive compensation. Business leaders and economists reassured the investing public that the market for CEOs was, like other labor markets, governed by the forces of supply and demand and, thus, the product of arm's length negotiations between employees—here, CEOs—and employers—here, corporations represented by the board of directors.

As scholars investigated various aspects of executive compensation, they found holes in this neo-classical economic model. Studies determined that various factors made boards more or less responsive to CEO performance.⁶³ In a series of articles, Professors Lucian Arye Bebchuk and Jesse M. Fried analyzed the relationship between executive compensation and corporate performance.⁶⁴ They found that CEOs and compensation committees camouflaged the true costs of executive compensation to mask the rent-seeking behavior in which CEOs engaged. After examining previous empirical work on executive compensation, Bebchuk and Fried concluded that there was no relationship between corporate performance and the compensation awarded to high-level executives, because managers used their influence to decouple pay from performance.⁶⁵ Bebchuk and Fried contended, however, that one key restraint upon excessive compensation

61. See David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587, 640–55 (2005). Professor Walker discusses these various benefits (stock options, deal bonuses, corporate aircraft, executive loans, and insider trading) in detail through empirical evidence. He concludes that increased regulation and monitoring of these channels of compensation is necessary for institutional investors and shareholders to properly exercise their board oversight functions. *Id.* at 655–61. For an example of these esoteric benefits, see Rakesh Khurana, *Good Charisma, Bad Business*, N.Y. TIMES, Sept. 13, 2002, at A27.

62. See *infra* notes 68–91 and accompanying text.

63. See LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 31–34 (2004) (citing various studies).

64. See Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 846 (2002) (concluding that executive compensation is not generally the product of arm's length bargaining, but is the result of a process that executives can substantially influence); Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71, 89 (2003) (arguing that managerial power and rent extraction are likely to have an important influence on the design of executive compensation arrangements).

65. Bebchuk et al., *supra* note 64, at 846.

was shareholder and popular outrage, which they termed the “outrage constraint.”⁶⁶ They asserted that corporations hide the true extent of senior executives’ compensation in order to minimize such shareholder outrage.⁶⁷

This Article takes Bebchuk and Fried’s insights one step further in the corporate bankruptcy setting. In theory, if Company X pays its top management at an excessive rate unrelated to corporate performance, then mutual funds, public and private pension funds, and individual shareholders can vote against management and the board of directors at the annual meeting. Alternatively, shareholders can “dump” the stock outright. Thus, companies that link executive compensation to corporate performance will be valued accordingly. When a company files for bankruptcy, however, this does not hold true. In bankruptcy, shareholders, as a class, are typically wiped out; their stock is delisted and made worthless. Moreover, if the company is in bankruptcy, its executives must be held responsible for the corporation’s poor performance. Finally, an outrage constraint is of little monetary value to shareholders once a company files for Chapter 11.

V. LESSONS FROM GAME THEORY APPLIED TO EXECUTIVE COMPENSATION

For the reasons outlined above, analysis of executive compensation should focus on aligning the economic interests of management with the economic interests of the corporation’s shareholders. In the publicly held corporation, these interests simply are not aligned. Shareholders bear all of the risk, while management prospers irrespective of a corporation’s financial performance.⁶⁸ Generally, executive compensation does not bear a reasonable relationship to corporate performance over the long run.

Game theory suggests strategies for curbing opportunistic behavior by CEOs and other senior executives. The existing approach to executive compensation claims to align the two interests. It may even appear to do so in the short run. Currently, however, there are no

66. *Id.* at 786–88.

67. *Id.* at 789.

68. *See, e.g.,* CRYSTAL, *supra* note 48, at 31 (“CEO’s get paid hugely in good years and if not hugely, then merely wonderfully in bad years. So even the defense that high pay is required because of the high risks being taken is shot full of holes.”); Susanne Craig, *Wall Street Pain Stops at the Top: CEOs of Big Financial Firms Still Pull Down Fat Paychecks Despite a Dismal Environment*, WALL ST. J., Mar. 4, 2003, at C1. “In good times boards justify the big pay packages by saying the executives are doing a great job and in bad times they justify the pay by saying they are managing in a difficult environment. No matter what, they seem to find a way to rationalize it.” *Id.* at C3.

adverse financial consequences to senior executives who force a company into Chapter 11 bankruptcy. Such financial consequences are necessary to prevent harm to shareholders when a corporation enters bankruptcy.

The Prisoner's Dilemma, the classic game theory exercise,⁶⁹ provides useful lessons that may be applied in the corporate arena. In this exercise, two suspected robbers are arrested and separated. If both refuse to accept a plea bargain implicating the other suspect, both will receive light sentences for gun possession. If either one confesses and agrees to testify against the other, the one who accepts a plea receives a very light jail sentence of three months, while the other receives the maximum sentence of ten years in prison. If both confess, each will serve a moderately long sentence of eight years.⁷⁰ The purpose of the exercise is to evaluate the circumstances under which people choose to collaborate (cooperation) and, alternatively, at what point people choose to maximize their self interest at the expense of others.

The Prisoner's Dilemma is a non-zero-sum game⁷¹ in which it is possible for one party to win, both parties to win, or neither party to win.⁷² A "dominant strategy" is the best strategy for a player to choose, irrespective of the other player's actions. In the Prisoner's Dilemma, the dominant strategy for each player is to confess. If each

69. See R. DUNCAN LUCE & HOWARD RAIFFA, *GAMES AND DECISIONS* 94–95 (1957); ROY J. LEWICKI & JOSEPH A. LITTERER, *NEGOTIATION* 35–37 (1985). The Prisoner's Dilemma is also denominated in the plural as the Prisoners' Dilemma. See DOUGLAS G. BAIRD ET AL., *GAME THEORY AND THE LAW* 48 (1994). The singular focuses on the individual's perspective, the plural on their joint situation.

70. LUCE & RAIFFA, *supra* note 69, at 95. Contemporary versions of the story can be found in AVINASH DIXIT & SUSAN SKEATH, *GAMES OF STRATEGY* 89–91 (2d ed. 2004) and in BAIRD ET AL., *supra* note 69. The hallmark of any Prisoner's Dilemma is that the suspect's best payoff comes through confessing. See *supra* text accompanying notes 69–74. This concept has proven easily confused by some otherwise very bright people. See, e.g., Robert Birmingham, *Telling Alternative Stories: Heterodox Versions of the Prisoner's Dilemma, the Coase Theorem, and Supply-Demand Equilibrium*, 29 CONN. L. REV. 827, 842–45 (1997) (criticizing Judge Easterbrook's explanation in *Page v. United States*, 884 F.2d 300, 301 (7th Cir. 1989)); Lee Anne Fennell, Book Note, 55 J. LEGAL ED. 295, 300–01 (2005) (reviewing ROBIN PAUL MALLOY, *LAW IN A MARKET CONTEXT: AN INTRODUCTION TO MARKET CONCEPTS IN LEGAL REASONING* (2004)) (criticizing Professor Malloy's textual mischaracterization). Both Judge Easterbrook and Professor Malloy stated that the payoff for mutual silence is the same as the payoff for defecting on one's fellow prisoner.

71. In a zero-sum game, one party's gain comes at the other party's expense and vice versa. In a non-zero-sum game, all parties can mutually gain by expanding the size of the pie. DIXIT & SKEATH, *supra* note 70, at 21.

72. LUCE & RAIFFA, *supra* note 69, at 96–97; LEWICKI & LITTERER, *supra* note 69, at 35. See also Zohar Goshen, *Voting (Insincerely) in Corporate Law*, 2 THEORETICAL INQUIRIES L. 815, 822–25 (2001) (discussing Prisoner's Dilemma in the context of voting strategies in collective decision making in the corporate arena).

player chooses her dominant strategy, knowing that the other player will choose his dominant strategy, that is known as a “Nash equilibrium.”⁷³ In the Prisoner’s Dilemma, however, a Nash equilibrium leaves both players worse off than if they had cooperated and not confessed.⁷⁴ This is one reason that the game’s name is so apt.

TABLE 1: THE PRISONER’S DILEMMA
Prisoner B

		Prisoner B	
		Confess	Not Confess
Prisoner A	Confess	8 years for A 8 years for B	3 months for A 10 years for B
	Not Confess	10 years for A 3 months for B	1 year for A 1 year for B

Political scientist Robert Axelrod ran a series of computer simulations of the Prisoner’s Dilemma.⁷⁵ Axelrod concluded that, if the game was played out over the long run, the most successful strategy is “tit for tat.” An accused criminal would have the following perspective: “I expect you not to confess, so I behave the same way. If you are bad and turn me in, then I am bad until you behave better.” If the game is only played out over the short run, however, this approach fails.⁷⁶ Instead, the likelihood of a severe sanction imposed upon an individual who behaves well (confesses) is needed to induce cooperation.⁷⁷ For example, knowledge that the person who testifies against

73. See DIXIT & SKEATH, *supra* note 70, at 87, 90.

74. *Id.* at 89–91.

75. More precisely, Axelrod invited game theorists in mathematics, political science, economics, and sociology to write computer programs to play a repeated Prisoner’s Dilemma simulation tournament. See ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* 27–32 (1984).

76. See *id.* at 32–55.

77. See *id.* at 124–32.

his partner in crime would be severely beaten by other gang members would induce his silence and persuade him to cooperate.

Initially, it may appear that negotiating the compensation package of CEOs and other top managers is one of an infinite series of events occurring over the long run. In fact, this is not so. The operative event is not the repeated negotiation of the CEO's compensation package, but rather the one-time event of the corporation facing bankruptcy. Thus, the correct analogy is to playing the Prisoner's Dilemma only once.

Table 2-A below applies the principles of non-zero-sum game theory to executive compensation and corporate performance. Fair compensation is denoted as a CEO earning \$500,000 annually, while excessive compensation occurs when the CEO receives a compensation package worth \$20 million annually. Although compensation varies considerably from year to year, these numbers make the point clearly. Here, the corporation is either profitable or insolvent. That is, the insolvent corporation enters Chapter 11,⁷⁸ while the profitable corporation earns substantial revenues.

In the typical situation, the public corporation's compensation committee has strong incentives to maximize the CEO's pay package.⁷⁹ The CEO generally chooses who serves on the corporation's board of directors.⁸⁰ Directors are well paid for their part-time service to public companies.⁸¹ Moreover, a CEO can directly reward directors through business connections and other indirect benefits.⁸² In addition to financial considerations, social and psychological factors come into play. Directors tend to respect the CEO who invited them to serve on the board. Members of the board may well view themselves as "part of the club."⁸³ This psychological income affects the board's decision-making process. For the foregoing reasons, the board's com-

78. The Bankruptcy Code does not require a corporation to meet any insolvency test in order for a corporation to file for Chapter 11 bankruptcy; however, fraudulent conveyance law concepts apply under both balance sheet insolvency and situations where the corporation is unable to pay debts as they come due. 11 U.S.C. §§ 109(a), (d), 101(9), (41) (Supp. 2007). *But see* § 303(h) (involuntary debtor unable to pay bills); U.F.T.A. § 2(a)-(b) (2006) (section 2(a)—balance sheet and section 2(b)—debts as come due).

79. *See* BEBCHUK & FRIED, *supra* note 63, at 23–38.

80. *See* KLEIN & COFFEE, *supra* note 16, at 135.

81. *See* Lucian Arye Bebchuk et al., *Lucky Directors* (Harv. L. & Econ. Disc. Paper No. 573 Dec. 2006) (discussing the frequency and similarity of the lucrative stock options received by both CEOs and directors).

82. *See* CRYSTAL, *supra* note 48, at 226–28 (describing the well-paid CEO-director as a valuable social reference for future job prospects).

83. Upon earning tenure at her law school, a friend of mine received an email from her associate dean, a senior colleague, welcoming her into "the club." Given how independent faculty are from each other, collegiality at a university is far less expected than in the boardroom.

pensation committee prefers to award the corporation's CEO excess compensation over fair compensation. On the other hand, the committee has a stronger preference for the corporation's solvency.

Ordinarily, a significant portion of a CEO's compensation comes from stock or stock options. That gives the CEO a strong economic incentive to manipulate the short-term stock price in order to maximize his compensation.⁸⁴ Instead of dedicating his efforts to improving the corporation's performance and profits, the CEO may focus on cheating.

TABLE 2-A: EXECUTIVE COMPENSATION AND CORPORATE PERFORMANCE

Executive Compensation Committee
(Annual Compensation)

		Fair Compensation	Excess Compensation
<u>CEO's Control of Stock Price and Corporate Performance</u>	Corporation Profitable	CEO received \$500,000 Committee's second preference	CEO received \$20 million Committee's first preference
	Corporation Bankrupt	CEO received \$1 million Committee's fourth preference	CEO received \$40 million Committee's third preference

As illustrated in the bottom right quadrant in Table 2-A, the corporation's compensation committee awarded the CEO excessive com-

84. Recent studies have found strong evidence of stock option manipulation known as "backdating" among CEOs and boards of directors. These options are usually granted at-the-money, meaning the exercise price of the options is set to equal the market price of the underlying stock on the date of the grant. Because the option value is higher if the exercise price is lower, directors and CEOs prefer to be granted options when the stock price is at its lowest. Backdating allows executives to choose a past date when the market price was particularly low, hence, inflating the value of the options. See Lucian Arye Bebchuk et al., *Lucky CEOs* (Harv. L. & Econ. Disc. Paper No. 566, Nov. 2006) (studying the relationship between corporate governance and opportunistic grant manipulation and finding over 1,100 instances of CEOs "fortuitously" receiving grants at the lowest price of the month among corporations studied between 1996 and 2005); Bebchuk et al., *supra* note 81 (making similar findings among boards of directors); Randall A. Herron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?*, 83 J. FIN. ECON. 271 (2007) (finding such grants were more prevalent among high-technology firms).

pensation, and the CEO has manipulated the stock price, a short-term goal to further increase his total compensation. The latter behavior came at the expense of improving corporate performance and ultimately bankrupted the company. Through this behavior, however, the CEO increased his compensation to \$40 million. Many of the dotcom companies that made public offerings in the 1990s and went bust in 2000 and 2001 fit this profile.

In contrast, the top left quadrant represents the model company. The compensation committee awarded reasonable compensation to the CEO, and the CEO focused on the corporation's performance. This approach is best exemplified by the Berkshire Hathaway Company, led by its legendary CEO, Warren Buffet. Buffet takes a reasonable, even modest, salary, yet he has earned an extraordinary fortune by improving the company's performance and, thereby, dramatically increasing the value of his stock in Berkshire Hathaway.⁸⁵

The top right quadrant probably reflects the majority of publicly held corporations. The CEO assured himself lavish compensation, but reinforced his entitlement to such pay and perks by growing the company's profits and raising the value of the corporation. This may be typical of the successful public company, exemplified by General Electric (GE). Jack Welch personified this behavior, dramatically improving GE's performance during his tenure, but also receiving an enormous compensation package.⁸⁶ Not every company in this category, however, is as successful as GE was under Welch. At some companies, the CEO takes excessive compensation and endeavors to grow the corporation's profits, but fails to do so. Recently, Home Depot's CEO, Bob Nardelli, earned over \$200 million after about five years of service (over \$40 million annually), despite a dismal record of nonperformance and failure to accomplish an increase in shareholder value in a rising market.⁸⁷ In sum, the top right quadrant embraces both companies that perform well and those that remain stagnant. A distinguishing feature of this category is that, in either case, the CEO has obtained generous compensation from her board.

85. See Lawrence A. Cunningham, *The Essays of Warren Buffet: Lessons for Corporate America*, 19 CARDOZO L. REV. 5 (1997) (collecting memoranda on various corporate governance topics from Mr. Buffet to his Board of Directors at Berkshire Hathaway).

86. The true extent of which became public during a messy divorce. See Rachel Emma Silverman, *Here's the Retirement Jack Welch Built: \$1.4 Million a Month*, WALL ST. J., Oct. 31, 2002, at A15.

87. See Allan Sloan, *Home Improvement Can Get Very Messy*, NEWSWEEK, Jan. 22, 2007, at 20. See also Eric Dash, *A Chairman's Fall; An Ousted Chief's Going-Away Is Seen by Many as Typically Excessive*, N.Y. TIMES, Jan. 4, 2007, at C4 (recounting ex-Pfizer CEO Henry A. McKinnell's multi-million dollar severance package).

The bottom left quadrant represents a conundrum. Although the CEO has been paid fair compensation, she apparently manipulated the stock price to obtain more income and drove the company into bankruptcy. Is this selfish behavior to increase personal income, or is this risky behavior that fails, but is nonetheless permitted, by the business judgment rule?

TABLE 2-B: EXECUTIVE COMPENSATION AND CORPORATE PERFORMANCE

Executive Compensation Committee
(Annual Compensation)

		Fair Compensation	Excess Compensation
		<u>CEO's Control of Stock Price and Corporate Performance</u>	Corporation Profitable CEO received \$500,000 Committee's second preference
	Corporation Bankrupt	CEO received \$330,000 Committee's fourth preference	CEO received \$330,000 Committee's third preference

Table 2-B represents the application of the bankruptcy proposals contained in this Article. Three observations emerge from an examination of Tables 2-A and 2-B. First, the hallmark of any Prisoner's Dilemma is that, while each player benefits by cooperating with the other player—maximizing their joint payoff—neither is able to communicate her strategy in advance, so that one player cannot directly influence the choices of the other player. When both players cooperate, each achieves her second best result, albeit an ideal joint outcome. On the other hand, an individual player fares best—receives the highest payoff—if she defects when the other player cooperates. This causes the latter player to suffer the worst possible payoff under any of the four alternatives.

Here, however, the CEO influences the decision of the board as to whether that CEO obtains a fair or excessive pay package. Moreover, in Table 2-A, the CEO fares well under every scenario, except when the board pays out fair compensation and the company nonetheless enters Chapter 11. Indeed, the CEO optimizes her situation by ex-

plotting both sides of the pay equation, taking excess compensation, and manipulating the stock price. The CEO's dominant strategy is to pursue a course of stock manipulation, reflected in the boxes labeled "Corporation Bankrupt," while the committee's dominant strategy is to grant excessive compensation. The CEO's strong dominant strategy leads to the top right quadrant, while her weak dominant strategy leads to the bottom right quadrant. The likely result is that companies end up on the "Excessive Compensation" side of Table 2-A. Here, both players reach a Nash equilibrium. Thus, Table 2-A reflects an imperfect example of the Prisoner's Dilemma. The theory underlying the Prisoner's Dilemma is, nonetheless, instructive.

Second, the bottom left and right quadrants significantly change from Table 2-A to Table 2-B. Table 2-B applies the Bankruptcy Code rules recommended by this Article. This effectively transforms the payoffs that the CEO obtains, making stock manipulation an undesirable choice. The CEO's preferences now align with those of the committee: both prefer excess compensation and corporate profitability. In the left quadrant of Table 2-B, the CEO realizes a relatively moderate decrease in compensation, from \$1 million annually to \$330,000 annually. It is unclear whether the result in this quadrant is due to the CEO's misconduct or simply bad fortune.

The bottom right quadrant of Table 2-B, however, stands on markedly different footing. Because the bottom right quadrant represents cheating by the CEO—with the CEO taking excessive compensation through the board and also manipulating the stock price to further line his pockets—a dramatic penalty is imposed.⁸⁸ The CEO's compensation declines from \$40 million to \$330,000 annually. This severe sanction punishes the CEO's misconduct and partly remedies the loss sustained by the employees' 401(k) pension funds.⁸⁹ Table 2-B demonstrates that a severe sanction will persuade all but the corporate grifters of the world not to take from both pockets.⁹⁰ Thus, insights from the Prisoner's Dilemma demonstrate that this sanctioning scheme can work.

88. LUCE & RAIFFA, *supra* note 69, at 97 (suggesting that "one essential role of government is to declare that the rules of certain social [economic] 'games' must be changed whenever it is inherent in the game situation that the players, in pursuing their own ends, will be forced into a socially undesirable position").

89. See *supra* note 1. Where clear securities fraud or other criminal acts have taken place, litigation by disgruntled shareholders and by federal regulatory bodies may catch and punish some CEOs and their boards. This occurred at Enron, WorldCom, and some now defunct dotcom companies.

90. For example, these dishonest CEOs include Bernie Ebbers of WorldCom and Ken Lay of Enron. *Id.*

Because there is currently no relationship between corporate performance and executive compensation, there is no risk sharing on the part of executives, and only shareholders bear the risk of loss. There are no incentives for executives to work for the benefit of shareholders, because the CEO faces no consequences for poor performance. CEOs do well and take whatever compensation they choose: what might be described as the gluttony effect.⁹¹ The effect of the separation of ownership from control, then, is that management does well all the time, irrespective of the corporation's outcome.

Third, so far, Tables 2-A and 2-B above have focused on the corporation's CEO and compensation committee. What about the stockholders? Their preference is for a profitable corporation and fair compensation. Under Table 2-A, the CEO and the committee prefer either quadrant containing excess compensation. At least under Table 2-B, the CEO and the committee will prefer a profitable corporation, even if it is most likely the quadrant containing excess compensation. In conclusion, modeling corporate behavior in this manner enables policymakers to alter the CEO's behavior. Although this approach reduces the likelihood of stock manipulation and unprofitable corporations, its major limitation is that it does not produce the best result: a profitable corporation and fair compensation.

VI. THE BANKRUPTCY SYSTEM

While the reasons for reforming executive compensation exist independently of whether a publicly held company is solvent, this reform proposal is closely tied to a company's decision to file for bankruptcy. There is a compelling logic in distinguishing between a profitable company and an insolvent one. A stockholder in a publicly held company, one listed on the NYSE or NASDAQ stock exchanges, can always sell her shares if she is dissatisfied with either the stock or the company's performance.⁹² This point was recently emphasized when an embattled CEO graphically declared that, if shareholders did not trust the management, "then they should sell the goddamned stock and never ask another question!"⁹³ Shareholders can unload stock even from financially troubled companies outside of bankruptcy, albeit perhaps at a disappointing price. In contrast, once a company files for bank-

91. See, e.g., Jerry Useem, *CEO Pay*, FORTUNE, Apr. 14, 2003.

92. Similarly, shareholders have voting rights to elect or withhold a vote for the board of directors. See, e.g., DEL. CODE ANN. tit. 8, §§ 141, 212 (2006).

93. Sasha Talcott, *In the Gray World of Banking, Jay Sidhu Stands Out*, BOSTON GLOBE, Nov. 23, 2005, at D1 (quoting Jay Sidhu, CEO of Sovereign Bancorp, from John Engen, *Big Noise from Wyomissing*, INSTITUTIONAL INVESTOR, May 1, 2005, at 34).

ruptcy, the shareholders ordinarily find that their stock is delisted and worthless. In theory, shareholders continue to possess nearly all of the rights that they held outside of bankruptcy.⁹⁴ If the corporation were liquidated, however, shareholders, as the owners of the debtor-corporation, would receive payment for their stock only after all creditors were fully paid. Chapter 11 bankruptcy accounts for this principle under the absolute priority rule.⁹⁵ In a corporate reorganization, equity is wiped out unless the claims are fully paid. Reorganization proponents assume that the shareholders will vote against confirming the reorganization plan, because it wipes out their equity. In the process

94. See, e.g., *Kidsco, Inc. v. Dinsmore*, 674 A.2d 483 (Del. Ch. 1995) (discussing shareholder rights to initiate a special meeting to remove the board in response to a hostile takeover threat); *Smith v. Orange & Rockland Utils., Inc.*, 617 N.Y.S.2d 278 (N.Y. Sup. Ct. 1994) (voting procedure by shareholders for removal of a director according to accepted industry practice was not illegal or against corporate bylaws). Depending on the rules governing a corporation, the shareholders may have a difficult time exercising their voting rights when it comes to the board of directors. See Seth W. Ashby, *Strengthening the Public Company Board of Directors: Limited Shareholder Access to the Corporate Ballot vs. Required Majority Board Independence*, 2005 U. ILL. L. REV. 521, 522–23 (2005) (criticizing the corporate voting structure that allows CEO/directors, such as Michael Eisner, to retain power despite shareholder discontent by playing fast and loose with the rules); see also Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1430 (1989) (suggesting that a greater shareholder voice will lead to increased stock prices and an overall healthier corporation: “The mechanism by which stocks are valued ensures that the price reflects the terms of governance and operation.”); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985) (discussing the benefits of a corporate model, whereby the shareholders elect the members of the board: “If the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out.”); Randall S. Thomas, *Judicial Review of Defensive Tactics in Proxy Contests: When Is Using a Rights Plan Right?*, 46 VAND. L. REV. 503, 504–06, 560 (1993) (recommending stricter judicial scrutiny of management’s defensive tactics against shareholder proxies); Thomas W. Joo, *A Trip Through the Maze of “Corporate Democracy”: Shareholder Voice and Management Composition*, 77 ST. JOHN’S L. REV. 735, 765–66 (2003) (recommending increased shareholder access to corporate proxies, but concluding that dissident success in ousting incumbent management will remain difficult, because most shareholders will simply choose to sell their stock instead).

95. See *Bank of Am. Nat. Trust & Sav. Assoc. v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 436 (1999) (assuming that the absolute priority rule even contains a new value corollary or exception, debtor’s pre-bankruptcy equity holders could not, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interests in a reorganized entity without allowing others to compete for that equity or to propose competing reorganization plans). See also Josef S. Athanas, *Using Bankruptcy Law to Implement or Combat Hostile Takeovers of Targets in Chapter 11*, 55 BUS. LAW. 593 (2000).

The U.S. Supreme Court’s holding in the recent *LaSalle* case, however, that a plan of reorganization is unconfirmable if it permits the owners of the debtor to retain their ownership interest in exchange for new capital without extending the opportunity to other parties to either offer competing bids for the ownership equity of the debtor or propose competing plans, has significantly improved the leverage of hostile bidders. *Id.* at 623. Shareholders are the real losers in such situations, as corporate equity is depleted in the bankruptcy proceeding and their stock’s value drops to zero, while top executives and enterprising outside bidders are the only ones who benefit.

known as “cramdown,” a confirmation plan is forced upon dissenting impaired classes.⁹⁶ Granted, the unsecured creditors could agree to give something to the equity holders to speed up negotiations over a plan for reorganization. Given the time value of money, creditors might be so persuaded, because interest on their claims is rarely paid.⁹⁷ This is unlikely in large reorganizations, however, unless there is an equity participant who organizes and represents the class.⁹⁸ The Bankruptcy Code creates a series of creditors’ committees and permits equity holders to form a committee to advance their interests. Moreover, because their stock is worthless, small and diffuse shareholders are marginalized in typical reorganizations.⁹⁹ Ironically, the incumbent management remains at the helm, at least initially, when a corporation files for bankruptcy.

The impact on employee shareholders is far worse. Even successful corporate reorganizations substantially downsize workforces. Thus, many employee shareholders lose both their jobs and their pension funds, a double blow. Moreover, those workers who remain employed often find their pay and benefits cut.

96. See Bratton, *Berle and Means*, *supra* note 39, at 746.

Under absolute priority, no holder in a junior position can receive any value under a reorganization plan if any objecting holder in a senior position receives less than full value with respect to his claim. In other words, absolute priority wipes out insiders holding common stock if any senior bond or preferred holder receives less than one hundred cents on the dollar.

Id.

97. See Mark J. Roe, *Commentary on “On The Nature of Bankruptcy”: Bankruptcy, Priority, and Economics*, 75 VA. L. REV. 219, 235 n.36 (1989) (recounting a teaching story in a bankruptcy negotiation exercise that signifies the importance of the concepts of present value and time value of money).

98. See Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity’s Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 195 (1990) (In large, corporate bankruptcies, “the relative size of equity’s recovery appeared to be not so much a product of the financial conditions of the company as it was a product of the quality and aggressiveness of equity’s representation”); see also Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 529 (1983) (advocating a rule requiring an all-common-equity corporate structure as a legal “traffic regulator” in bankruptcy); David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 519–33 (1992) (suggesting a change in the current bankruptcy voting rules to allow creditors a better opportunity to collectively bargain, thus increasing their chances of recouping more money in settlement).

99. See Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993) (discussing empirical evidence of the common misalignment between shareholder interests, creditor interests, and management objectives in large-scale Chapter 11 cases); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 861 (2004) (suggesting that contractualism or a privately ordered recovery process in bankruptcy is at “a dead end” due to control disparities between small and large parties in the settlement negotiation).

Corporate executives are unjustly enriched if they are permitted to keep excess executive compensation given to them by the corporation they mismanaged into bankruptcy.¹⁰⁰ Restitution, resolving unjust enrichment, is an old, ideal concept.¹⁰¹ Financially distressed companies often project an image of economic health. Otherwise, rank and file workers, low- and mid-level management, investors, suppliers, and lenders will abandon the company. At least initially, only senior executives will know that the business is in financial trouble or at risk of failing. Those executives will continue to draw a salary, bonuses, and other perks, as well as profit from stock sales. Workers, unaware of an impending fiscal crisis, will not take the necessary steps to prevent economic catastrophe. Employee plaintiffs make a powerful case for disgorgement, because they can show that defendant executives have unjustly enriched themselves by the benefit workers have conferred on the executives by supporting the company.¹⁰²

Judge Posner, responding to the majority's holding in *Farrey v. Sanderfoot* that a judicial lien intended to secure a spouse's preexisting interest in marital property was avoidable under § 522(f),¹⁰³ wrote the following: "I had thought bankruptcy a branch rather than a rejection of equity. . . . [W]hen a debtor uses the Code to steal from his former wife we should not lightly conclude that the Code, properly read, commands such a result."¹⁰⁴ As the property division allocated during the dissolution of a marriage seeks to compensate both spouses for their contributions to the marriage, so too the Bankruptcy Code ought to recognize that the sweat equity of rank and file workers,

100. See RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 1 (Discussion Draft 2000) (noting that "[a] person who is unjustly enriched at the expense of another is required to make restitution to the other").

101. *Id.*

102. See Floyd Norris, *S.E.C. Accuses Former Sunbeam Official of Fraud*, N.Y. TIMES, May 16, 2001, at A1. See also Steven Kropp, *A Case of Misplaced Priorities: A Proposed Solution to Resolve the Apparent Conflict Between Sections 507 and 1113 of the Bankruptcy Code*, 18 CARDOZO L. REV. 1459 (1997) (proposing a harmonization of §§ 507 and 1113 by treating an un-rejected collective bargaining agreement the same as a § 507 administrative claim).

103. 899 F.2d 598 (7th Cir. 1990), *rev'd*, 500 U.S. 291 (1991). See also Richard E. Flint, *Bankruptcy Policy: Toward a Moral Justification for Financial Rehabilitation of the Consumer Debtor*, 48 WASH. & LEE L. REV. 515, 577 (1991) ("[S]ociety's humanitarian response to the debtor in the granting of exemptions is mutually dependent upon the fair dealing on the part of the debtor with his creditors.").

104. *Farrey*, 899 F.2d at 607 (Posner, J., dissenting). The 2005 Amendments codified this result by barring the discharge of all marital property settlements in § 523(a)(15). 11 U.S.C. § 523(a)(15) (Supp. 2007) (to a spouse, former spouse, or child of the debtor and "not of the kind described in paragraph (5) that is incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court of record, a determination made in accordance with State or territorial law by a governmental unit").

along with their purchases of company stock, bolstered the company's stock price; enabled the corporation's executives to obtain generous executive pay packages; and allowed them to sell their stock at a higher market price. When the corporation later reorganizes under Chapter 11, those executives should be required to account for the economic looting of the employees' pension funds.

VII. EXTENDING EXISTING DOCTRINES

Common law and statutory developments have shaped the relationship between corporate debtors and their creditors. One key feature of bankruptcy law and policy is the power of the trustee or DIP to upset certain previous commercial transactions. These "avoiding powers" are designed to promote equity among unsecured creditors.¹⁰⁵ The reform proposals advanced in this Article build upon these legal concepts. This Article's proposals differ from these concepts in that the remedy runs first to protect employees' pension funds and only secondarily to other creditors. This Part explores two areas of common law and their applicability to bankruptcy law: fraudulent conveyance law and the duty of loyalty. Section A describes the development of fraudulent conveyance law and argues for an extension of the concepts found in the Uniform Fraudulent Transfer Act to the excessive compensation paid to the CEOs of corporations in bankruptcy.¹⁰⁶ Subsection A1 details the extreme example of excessive CEO compensation described in the Walt Disney litigation regarding Michael Ovitiz's compensation package.¹⁰⁷ Subsection A2 discusses the related duty of loyalty that a CEO owes her corporation.¹⁰⁸ Finally, Section B explores the theory of preference law in bankruptcy and its clear application to excessive compensation paid to CEOs of insolvent publicly held corporations.¹⁰⁹

105. Although not commonly referred to as an "avoiding power," the DIP also has the authority under § 365 to abrogate unfavorable executory contracts and confine the non-breaching party to its unsecured claim for damages. Collective bargaining agreements that cover unionized workers receive limited, though preferential, treatment under § 1113 when a company reorganizes in bankruptcy. *See, e.g.*, Kropp, *supra* note 52.

106. *See infra* notes 110–134 and accompanying text.

107. *See infra* notes 135–160 and accompanying text.

108. *See infra* notes 161–168 and accompanying text.

109. *See infra* notes 169–193 and accompanying text.

A. *Fraudulent Conveyance Law*

The concept of fraudulent conveyance is over four hundred years old.¹¹⁰ A fraudulent conveyance is a transfer by a debtor, including a sale or gift, of her assets into someone else's hands to prevent her creditors from reaching those assets. Contemporary fraudulent conveyance law includes a mix of common law, state statutory law, and the Bankruptcy Code. Fraudulent conveyance law should apply when the corporation, by paying senior executives excessive pay packages, moves assets that would have been available to creditors.

The Uniform Fraudulent Transfer Act (UFTA), adopted by most states, reaches two kinds of transactions.¹¹¹ First, Section 4 prohibits an insolvent or financially troubled debtor from disposing of or transferring her property to another party in order to prevent her creditors from reaching that property. Subsection 4(a) applies where a debtor has actual intent—similar to *mens rea* in tort or criminal law—to defraud her creditors. Subsection 4(b) applies where the debtor did not receive reasonably equivalent value (REV) for the exchange and the debtor was either undercapitalized or reasonably should have believed that it would incur unpayable debts.¹¹² This subsection applies both to present and future creditors. Thus, the transfer can be attacked not only by those who were creditors at the time the transaction took place, but also by those who will become creditors someday in the future.

Section 5 provides that, as to existing creditors, but not as to future creditors, a transfer is fraudulent if the debtor did not receive REV for the exchange. This requires, however, that the debtor was insolvent at the time of the transfer or has become insolvent as a result of the transfer. This situation can be found in cases where the corporation has “cooked the books.” The Enron and WorldCom scandals

110. 13 Eliz. 5 (1570). This early English statute made fraudulent conveyance a criminal offense, punishable by forfeiture, half to the complaining creditor and half to the crown. Robert Charles Clark, *The Duties of the Corporate Debtor to Its Creditors*, 90 HARV. L. REV. 505, 505 n.1 (1977).

111. See generally Unif. Fraudulent Transfer Act, §§ 1–13, 2 U.L.A. 13 (2006). UFTA, promulgated in 1984, modernized the Uniform Fraudulent Conveyances Act (UFCA). Compare Clark, *supra* note 110, at 560–61 (noting the lack of clarity in the law and of explicit analysis in reported cases concerning the concept of “fair consideration” and fraudulent conveyance law in general, before the passage of the UFTA), with Bruce A. Markell, *Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital*, 21 IND. L. REV. 469, 485–94 (1988) (discussing case law developments after the passage of the UFTA and noting increased judicial invalidation of a broad range of transactions).

112. In updating the statute, the concept of REV in UFTA replaced the concept of fair consideration in UFCA.

presented such a picture.¹¹³ In each case, the applicable transfer occurred when the corporation paid its senior executives excessive compensation at a time when the corporations were insolvent.

On a continuum, executive compensation ranges from fair to wasteful. REV should be understood as fair compensation. One clear obstacle, however, exists to the application of fraudulent conveyance law in this setting. Quite simply, how do courts measure REV from the CEO? The corporation, after all, obtained his employment services in exchange for his compensation package. Consideration concepts do not apply here: there is always valid consideration in the employment setting, because an employee swaps his labor for the compensation paid by his employer.¹¹⁴ REV suggests a useful starting point to ascertain whether a bankrupt corporation's CEO received excessive compensation, such that excess compensation must be disgorged. A comparison may be made with the alternative standards in corporate law generally.

In *Rogers v. Hill*, an early and influential executive compensation case, an incentive compensation system was established through a corporate bylaw widely approved by the shareholders in 1912.¹¹⁵ The system provided that the president and five vice presidents receive 10% of the company's annual profits above the company's 1910 earnings.¹¹⁶ By 1929, the American Tobacco Company, maker of Lucky

113. Enron laid off thousands of workers (4,500 employees in Houston alone). See Marianne Lavelle & Matthew Benjamin, *The Biggest Bust: Workers and Stockholders Are Enron's Worst Casualties*, U.S. NEWS & WORLD REP., Dec. 10, 2001, at 34 (discussing the consequences of Enron's collapse). Enron workers and retirees testified before Congress, pleading for bankruptcy reform to protect their retirement savings. Julie Mason, *The Fall of Enron*, HOUSTON CHRON., Jan. 24, 2002, at A13. Enron employees fared better than most. Aided by the AFL-CIO, Enron's former workers successfully sued and obtained settlements (\$40 million) from Arthur Anderson Worldwide and obtained a settlement through negotiations in New York Bankruptcy Court (\$30 million) to provide severance pay capped at \$13,500 each for about 4,200 employees. See Edward Iwata, *Payouts Anger Former Enron Workers*, USA TODAY, June 18, 2002, available at <http://www.usatoday.com/money/energy/enron/2002-06-18-pay.htm#more>. The New York Bankruptcy Court also authorized former Enron employees to challenge the retention bonuses paid to executives as preferences or fraudulent conveyances. See Nancy B. Rapoport, *Enron, Titanic, and The Perfect Storm*, 71 FORDHAM L. REV. 1373, 1382 n.54 (2003) (citing to former Enron employees' complaint).

114. See, e.g., *Langer v. Superior Steel Corp.*, 161 A. 571 (Pa. Super. Ct. 1932) (an early case finding consideration where a retiring executive receives a pension in exchange for a non-compete clause), *rev'd*, 178 A. 490 (Pa. 1935) (jury award later reversed on grounds of lack of corporate authority). Compare *Osborne v. Locke Steel Chain Co.*, 218 A.2d 526, 532-33 (Conn. 1966) (finding consideration where a retiring executive received pension in exchange for consulting services), with *Zupnick v. Goizueta*, 698 A.2d 384, 389 (Del. Ch. 1997) (stock options granted to retiring CEO were not waste even though CEO performed no additional duties and thus company received no consideration).

115. 289 U.S. 582, 584-85 (1933).

116. *Id.* at 584 n.1.

Strike cigarettes, was so successful that the incentive system provided extraordinarily generous bonuses to those six executives.¹¹⁷ A handful of dissenting shareholders challenged the bonus system as applied in 1929 and 1930.¹¹⁸ The Second Circuit majority dismissed the case,¹¹⁹ prompting a dissent by Judge Swan:

If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part and the majority stockholders have no power to give away corporate property against the protest of the minority. . . . [A] bonus of \$840,000 to an officer receiving a fixed salary of \$168,000 is presumptively so much beyond fair compensation for services as to make a prima facie showing that the corporation is giving away money, and a by-law which sanctions this is prima facie unreasonable, and hence unlawful.¹²⁰

Although the Supreme Court found the corporate bylaw valid as adopted by the shareholders, the Court nonetheless reversed the Second Circuit decision.¹²¹ The Court approvingly quoted the excerpt above from Judge Swan's dissent. However, it did not include the last sentence regarding fair compensation.¹²² The Court did not directly address the fairness standard espoused by Judge Swan to govern disputes over excessive executive compensation. Rather, the Court concluded that the dissenting shareholders should prevail if they could demonstrate that the bonuses paid to the executives constituted corporate waste. The case then settled out of court.¹²³

The final word came nearly a decade later in *Heller v. Boylan*.¹²⁴ There, different plaintiffs challenged the American Tobacco Company's incentive compensation system. The New York trial judge began his opinion by recounting previous federal litigation and the facts

117. *Id.* at 585 n.2.

118. *Id.* at 585. Prior to *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), a shareholder plaintiff who could establish diversity jurisdiction could choose between state and federal common law.

119. *Rogers v. Hill*, 60 F.2d 109 (2d Cir. 1932). Judge Manton authored the majority opinion, joined by Judge Chase. Manton, however, took bribes in a number of cases, apparently including this one, ultimately forcing him off the bench and into jail. See *U.S. v. Manton*, 107 F.2d 834 (2d Cir. 1939).

120. *Rogers*, 60 F.2d at 113-14 (Swan, J., dissenting). Judge Swan went on to point out that, in 1930, the president also received "special cash credits" of \$270,000 and participated with the other officers in a distribution "of almost 30,000 shares of stock at \$87 per share less than its then market value." *Id.* at 114.

121. The plaintiff shareholders had contended that "the by-law is invalid and that, even if valid, the amounts paid under it are unreasonably large and therefore subject to revision by the courts." *Rogers*, 289 U.S. at 585.

122. *Id.* at 591-92.

123. See *Rogers v. Hill*, 34 F. Supp. 358 (S.D.N.Y. 1940). The defendant was unsuccessful both in seeking to vacate the settlement Rogers struck in the American Tobacco Company litigation and in challenging the fee Rogers received as plaintiff.

124. 29 N.Y.S.2d 653 (N.Y. Sup. Ct. 1941), *aff'd*, 32 N.Y.S.2d 131 (N.Y. App. Div. 1941).

regarding the shareholder approved bylaw.¹²⁵ The judge noted that the shareholders had twice ratified the payments made to the executives under the bylaw in 1933 and in 1940.¹²⁶ The judge ruled that the appropriate standard was not fair compensation, but rather waste or spoilation.¹²⁷ After characterizing the compensation plan as “lush,”¹²⁸ “munificent,” “princely,” “fabulous,” “fantastic,”¹²⁹ and even as “immense, staggeringly so,”¹³⁰ the judge concluded that the performance basis made the bonuses legitimate. The judge distinguished between permissible excessive compensation and impermissible waste, finding that only the latter violated corporate law norms.¹³¹ The court was also influenced both by the high federal income tax rates applicable at that time and the fact that so few shareholders, both in total number and in the amount of shares owned, challenged the payments.¹³²

Heller reflects the modern approach to executive compensation. Delaware courts have also shown little inclination to police the levels of executive compensation.¹³³ Indeed, the Delaware Supreme Court

125. *Id.* at 660–61, 663–65.

126. *Id.* at 667.

127. The New York trial judge erroneously believed that the U.S. Supreme Court’s standards controlled. *Id.* at 665. *Accord* *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938).

128. *Heller*, 29 N.Y.S.2d at 660.

129. *Id.* at 669.

130. *Id.* at 671.

131. *Id.* at 673.

132. On an annual salary of \$1 million, an executive would have paid over \$700,000 in federal taxes; on an annual salary of \$500,000, an executive would have paid over \$330,000 in federal taxes. *Id.* at 674.

133. *See generally* DEL. CODE ANN. tit. 8, § 122(5) (2006) (“Appoint such officers and agents as the business of the corporation requires and to pay or otherwise provide for them suitable compensation.”); § 122(15) (“Pay pensions and establish and carry out pension, profit sharing, stock option, stock purchase, stock bonus, retirement, benefit, incentive and compensation plans, trusts and provisions for any or all of its directors, officers, and employees.”). Delaware’s role as the primary source of state corporate law, arguably because of the “race to the bottom,” remains controversial. *Compare* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 669–701 (1974) (asserting the race to the bottom theory and recommending federal legislation to provide uniform standards governing fiduciary duties for public corporations to protect shareholders), *with* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256 (1977) (asserting an opposite, “race to the top” theory: “With all due respect both to Professor Cary and to the almost universal academic support for his position, it is implausible on its face.”), *and* Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 859–60 (1993) (arguing in favor of state competition for corporate charters, singling out Delaware as a leader in, among others, takeover statutes), *and* Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Stock*, 54 U. CHI. L. REV. 119, 127–28 (1987) (rejecting the race to the bottom thesis as based on three misconceptions: “(1) that managers prefer exchange rules that allow them to exploit investors; (2) that it is in the interest of exchanges to adopt such rules; and (3) that the absence of regulation is necessarily evidence of a pro-management, anti-investor bias.”). More recently, a critical reappraisal of Delaware’s role has emerged. *See* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L.

recently commented that “the size of executive compensation for a large public company in the current environment often involves huge numbers.”¹³⁴

1. *The Absence of Meaningful Standards in the Corporate Context: The Case of Ovitz and The Walt Disney Company*

The extensive litigation over the \$130 million severance package paid to Michael Ovitz by The Walt Disney Company is an extreme illustration of excessive compensation.¹³⁵ On October 1, 1995, Disney and Ovitz executed a five-year employment agreement, and Ovitz began his tenure as president of Disney. Michael Eisner, Disney’s Board Chairman and CEO, personally hired Ovitz, a close social friend of twenty-five years.¹³⁶ A supine board, dominated by Eisner, readily acquiesced.¹³⁷ Ovitz, however, had no previous experience running a publicly held corporation.¹³⁸ Moreover, Eisner’s mercurial management style suggested an inability to work with well-known executives who wanted to succeed him as CEO.¹³⁹ The decision to hire Ovitz proved to be a poor one, but precisely the kind of decision the business judgment rule was designed to protect. Ovitz’s financial deal, however, stood on a different footing.

REV. 679, 748–49 (2002) (concluding that Delaware is not a leader in competition for corporate charters, because there is no competition; the barriers to entry into competition are simply too high for most states); Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588, 634–40 (2003) (noting the dynamic tension between Delaware’s judiciary and the threat of federal legislation to curb perceived abuses).

134. *Brehm v. Eisner (Disney II)*, 746 A.2d 244, 259 n.49 (Del. 2000); *accord In re Walt Disney Co. Derivative Litig. (Disney V)*, 906 A.2d 27, 54 n.72 (Del. 2006).

135. *Disney V*, 906 A.2d at 27; *In re Walt Disney Co. Derivative Litig. (Disney IV)*, 907 A.2d 693 (Del. Ch. 2005).

136. *Disney IV*, 907 A.2d. at 699–711 (recounting Ovitz’s arrival at Disney). Chancellor Chandler faulted Eisner’s role in hiring Ovitz, including his usurping the board’s role and pressuring the board to approve both Ovitz’s hiring and compensation package through a premature press release, but concluded that Eisner did not act in bad faith and was not grossly negligent. *Id.* at 762–63.

137. *Id.* at 700–01. “[Eisner was] the instigator and mastermind behind the machinations that resulted in Ovitz’s hiring and concomitant approval of the [hiring agreement]. In that aspect, Eisner is the most culpable of the defendants. He was pulling the strings; he knew what was going on.” *Id.* at 760. Between 1997 and 1999, *Business Week* ranked the Disney Board of Directors as the worst board in corporate America. See John A. Byrne, *The Best & the Worst Boards*, BUS. WK., Jan. 24, 2000, at 142 (1999 data); John A. Byrne et al., *The Best and Worst Boards*, BUS. WK., Dec. 8, 1997, at 90 (1997 data).

138. *Disney IV*, 907 A.2d at 702.

139. *In re Walt Disney Co. Derivative Litig. (Disney III)*, 825 A.2d 275, 279 (Del. Ch. 2003). See also *Disney II*, 746 A.2d at 250. The departure of Jeffrey Katzenberg, former head of Disney Studios, embroiled Disney in litigation that apparently cost Disney \$250 million to settle. *Disney IV*, 907 A.2d at 717.

The provision giving rise to the litigation was a no fault termination clause. Under that clause, if Disney fired Ovitz, other than for gross negligence or malfeasance, Ovitz received his entire unpaid compensation as severance pay: the balance of his salary, including his \$7.5 million annual bonuses, three million shares in stock options worth their current market price,¹⁴⁰ and \$10 million in lieu of stock earned if the contract was not mutually renewed.¹⁴¹ The no fault termination clause created a perverse incentive system. If Ovitz were to leave, he would maximize his profits by terminating employment as soon as possible.¹⁴²

Irwin Russell, chairman of the Disney Board's four-person compensation committee and Eisner's personal attorney, negotiated the terms of Ovitz's compensation.¹⁴³ Russell warned Eisner that Ovitz's compensation was "at the top level for any corporate officer . . . and that the number of stock options granted [him] . . . was far beyond the standards applied within Disney and corporate America."¹⁴⁴ Consequently, Russell recommended another study to justify the deal.¹⁴⁵

Disney then retained Graef Crystal, a noted executive compensation expert who had consulted on Disney's behalf for many years, to advise the compensation committee. Crystal informed Eisner and Russell that no non-CEO president of a public company had ever obtained an Ovitz-style compensation package.¹⁴⁶ Disney had a policy, consistent with Crystal's philosophy, against frontloading its executive compensation, such as through a signing bonus.¹⁴⁷ The rationale against awarding an executive with a signing bonus in a long-term contract was that, if the executive left the company prematurely, then the effective compensation for the time employed escalated dramatically.

140. Initially, Ovitz was guaranteed not less than \$50 million in appreciation. Because of adverse tax consequences to Disney, Ovitz's deal required renegotiating. *Disney IV*, 907 A.2d at 703-04.

141. *Id.*

142. The personnel practice at Disney, and in much of the entertainment industry, is to grant long-term contracts to most senior and even mid-level executives. In the aftermath of the Ovitz fiasco, Disney began scaling back this practice. See Bruce Orwall, *Careers: At Disney, A Push to Eliminate Job Contracts*, WALL ST. J., Feb. 9, 1999, at B1, B6.

143. *Disney IV*, 907 A.2d at 702. Besides Russell, the other three members of Disney's compensation committee consisted of the actor Sidney Poitier, who had recently joined the board and had been represented for many years as an actor by Ovitz; Raymond Watson, a long-time Disney board member; and Ignacio Lozano, publisher of a major Spanish language newspaper. *Id.* at 766-67.

144. *Id.* at 704.

145. *Id.*

146. *Id.* at 705 n.41, 708 n.80.

147. *Id.* at 703. See also *In re Walt Disney Co. Derivative Litig.* (Disney III), 825 A.2d 275, 280 n.6 (Del. Ch. 2003).

Ironically, the no fault termination clause produced the same undesirable risk, because it was qualified only if Ovitz quit or was fired for misconduct.

Subsequently, the compensation committee spent about twenty-five minutes reviewing the Ovitz agreement and discussed the appropriate bonus for Mr. Russell, eventually rewarding him \$250,000 for his efforts in securing Ovitz's employment.¹⁴⁸ In less than one year, Eisner decided to terminate Ovitz's employment.¹⁴⁹ Several months of negotiations over Ovitz's departure ensued, and, by December 1996, Ovitz walked away from Disney under the no fault termination provision with \$130 million.¹⁵⁰

In response, several stockholders filed a shareholder's derivative suit. They contended that Eisner and the Board breached their fiduciary duties by both approving the terms of Ovitz's employment contract and by failing to terminate Ovitz for cause, thereby triggering Ovitz's rights to substantial severance pay.¹⁵¹

The Delaware Chancery Court criticized Eisner and the Disney Board in unusually caustic language:¹⁵² "[Eisner] enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom . . ."¹⁵³ The court elaborated as follows:

[By virtue of his Machiavellian (and imperial) nature as CEO, and his control over Ovitz's hiring in particular, Eisner to a large extent is responsible for the failings in process that infected and handicapped the board's decision making abilities. Eisner stacked his (and I intentionally write "his" as opposed to "the Company's") board of directors with friends and other acquaintances . . .¹⁵⁴

Chancellor Chandler decided, however, that Eisner had acted in good faith, because he sincerely believed that Ovitz's hiring was in the company's best interest.¹⁵⁵ The Chancellor defended the magnitude of Ovitz's employment contract on the grounds that Ovitz was potentially giving up \$150 million in earned commissions.¹⁵⁶

148. *Disney IV*, 907 A.2d at 708-09, 709 n.88.

149. *Id.* at 724.

150. *Id.* at 724-37.

151. *Id.* at 697.

152. After initially dismissing the Complaint with prejudice, on appeal, the Delaware Supreme Court reversed and remanded to permit the plaintiffs to file an amended complaint. *Brehm v. Eisner (Disney II)*, 746 A.2d 244, 266 (Del. 2000).

153. *Disney IV*, 907 A.2d at 763.

154. *Id.* at 760.

155. *Id.* at 763.

156. *Id.*

On appeal, the Delaware Supreme Court affirmed the lower court.¹⁵⁷ The court outlined best practices in these circumstances as follows: the compensation expert prepares a spreadsheet describing the total amounts Ovitz would earn under the contract, under the foreseeable alternatives. These alternatives would include the cost to Disney under the no fault termination clause for each year of the proposed five-year contract. The expert presents her analysis to the compensation committee's members at the first meeting. The committee attaches the expert's spreadsheet to the committee's minutes. This spreadsheet then forms the basis for the committee's decision.¹⁵⁸

Despite deficiencies, the trial court found that the Committee knew the material facts of Ovitz's contract terms and the entire Board received a report from the chair of the compensation committee. Because, under Delaware law, the committee was permitted to rely upon the expert and the Board was permitted to rely upon its committee, the Court concluded that the failure to follow best practices constituted negligence, but agreed with the Chancellor that it did not rise to the level of gross negligence.¹⁵⁹ It is not surprising that the pro-management Delaware judiciary harshly rebuked the CEO and the Board for their mishandling of the process and substance of the transaction, yet found no violation of Delaware law. When a Delaware corporate board and a four-member compensation committee¹⁶⁰ get a free pass from legal responsibility, the sky is the limit when it comes to executive compensation.

2. *Fairness and the Duty of Loyalty*

Executive compensation implicates the duty of loyalty, because the CEO and other top executives generally serve as inside directors on the board. Moreover, the CEO seeks to maximize her compensation, while it is in the company's best interests to pay her no more than necessary.¹⁶¹ Accordingly, when shareholders challenge the compensation paid to a senior executive, one might conclude that the executive must demonstrate that, like any other self-dealing transaction, the compensation agreement is fair. That is not the case, however.

157. *In re Walt Disney Co. Derivative Litig. (Disney V)*, 906 A.2d 27, 75 (Del. 2006).

158. *Id.* at 56.

159. *Id.* at 59–60.

160. Russell, the Chair of the Compensation Committee and the CEO's personal attorney, also had a financial interest in the successful outcome of the Ovitz contract negotiations: the expectation that he would obtain a substantial bonus, which he did. *See supra* note 148 and accompanying text.

161. *See* Kropp, *supra* note 52.

Courts do not want to evaluate stockholder challenges to the fairness of CEO compensation.

The modern practice in handling executive compensation is reflected in the Model Business Corporation Act (MBCA). Under the MBCA, the board appoints a committee of outside (non-employee), disinterested, and independent directors to negotiate the compensation of top managers.¹⁶² An executive compensation firm or expert consultant then advises the compensation committee.¹⁶³ The resulting pay package is immunized from duty of loyalty and fairness reviews. Instead, this pay package is subject only to the duty of care as reflected in the business judgment rule.¹⁶⁴ That relaxed standard demands that the challenging shareholders prove either that the directors, through the compensation committee, failed to make an informed decision based on all material information reasonably available to them or that the decision constituted gross negligence.¹⁶⁵ Moreover, even if the directors committed gross negligence, the company's certificate of incorporation may absolve them of financial liability.¹⁶⁶ Finally, the Delaware indemnification statute, typically adopted by public corporations, further insulates directors from responsibility for even grossly negligent decisions.¹⁶⁷

The policies underlying fraudulent conveyance law offer another reason to treat excessive executive compensation in cases of corporate bankruptcy differently from cases involving solvent companies. Compensation that can justifiably be criticized as lush, munificent, princely, fabulous, fantastic, or staggeringly immense can be tolerated if it comes at the expense of shareholders, who have the power to remove the incumbent members of the board of directors.¹⁶⁸ It should not be permitted once a company files for bankruptcy, because then the interests of creditors are paramount.

162. MODEL BUS. CORP. ACT § 8.25 (1998) (Committees, Official Comment: "nominating and compensation committees, composed primarily or entirely of nonmanagement directors, have also become more widely used by publicly held corporations"); § 8.11 (Compensation of Directors provides that the board of directors sets its own pay). *See also* DEL. CODE ANN. tit. 8, § 141(c) (2006).

163. DEL. CODE ANN. tit. 8, § 141(e) (2006) (board and committee members are entitled to rely upon qualified experts who are selected with reasonable care).

164. MODEL BUS. CORP. ACT § 8.62 (1998) (Directors' Actions). *See generally supra* notes 135-159 and accompanying text.

165. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). *See also In re Walt Disney Co. Derivative Litig. (Disney III)*, 825 A.2d 275, 278 (Del. Ch. 2003) ("It is rare when a court imposes liability on directors of a corporation for breach of the duty of care.").

166. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2006).

167. § 145(a)-(b).

168. *See, e.g.*, §§ 141-46, 212.

B. Preference Law

No law prohibits a solvent corporation from choosing to pay one creditor at the expense of another. Even a distressed business can decide which bills to pay and which to ignore.¹⁶⁹ Bankruptcy laws, however, are quite different. A cardinal principle of bankruptcy law is equality among similarly situated creditors. Therefore, under § 547 (b)(4) of the Bankruptcy Code, the trustee may recover preferential payments from an insider¹⁷⁰ made by the company within one year of its bankruptcy filing.¹⁷¹

Excess executive compensation unrelated to corporate performance constitutes a preferential transfer by an insolvent corporation to its insider officers. That is, excess income was paid to one set of creditors—senior executives—at the expense of other creditors—including average workers. It is a preferential transfer, because the Internal Revenue Code prohibits a deduction for non-performance-based compensation that exceeds \$1 million to the CEO and other senior officers of a publicly held corporation.¹⁷² Moreover, independent of the federal tax code, CEOs and other senior employees whose remuneration is unrelated to their corporation's performance have arguably breached their duty of loyalty to the corporation.

There are, however, a number of defenses to a preference action, and several may well apply here. One exception to preference liability is the “contemporaneous exchange for new value” requirement.¹⁷³ The purpose behind the contemporaneous exchange exception is to encourage reluctant individuals and businesses to deal with financially

169. A comptroller in a small business facing financial difficulties many years ago related the following story to me: she was receiving many phone calls from irate, unpaid creditors. One particular creditor was verbally abusive toward her. She responded that she put all unpaid bills into a bowl every Friday and then pulled out one bill to pay that week. As a consequence of his abusive behavior, she said his bill would not even go into the bowl on Friday.

170. Section 101(31)(b) defines a corporate insider to include any officer, director, or their relatives. 11 U.S.C. § 101(31)(b) (Supp. 2007).

171. § 547(b). A payment is preferential under § 547(b) of the Bankruptcy Code if it involves a transfer of the debtor's property on account of an antecedent debt made while the debtor was insolvent during the applicable ninety day or one-year period. One element of a preference requires that the payment be for an antecedent debt. *Id.* Because a check is “paid” when the bank honors it, not when the debtor gives it to the creditor, salary checks given to executives will routinely constitute payment for an antecedent debt. See *Barnhill v. Johnson*, 503 U.S. 393 (1992).

172. I.R.C. § 162(m)(1) (2000) (“[N]o deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000.”). *But see* § 162(m)(4)(C) (unless certain performance-based goals apply). *See also* § 280G (Golden Parachutes).

173. 11 U.S.C. § 547(c)(1) (Supp. 2007).

troubled or insolvent businesses. Moreover, if the laws were otherwise, no one could safely engage in financial transactions with any insolvent business or person without running the risk that even payment immediately received for goods or services rendered to the debtor, other than in cash, would have to be returned months later. Further, the debtor's existing creditors are not thereby prejudiced, because the debtor presumably received something of value in exchange for the payment.

Next, affected executives may assert that their payouts constituted payments in the ordinary course of business.¹⁷⁴ The ordinary course of business defense has been widely criticized as an exception that swallows up much of the rule and undercuts the key policies preference law seeks to promote.¹⁷⁵ The ordinary course exception insulates financial transactions that are routine from both the creditor's and the debtor's perspectives. Although the case law tends to focus on payments to trade creditors,¹⁷⁶ an executive's wages paid on a regular basis, in exchange for that executive's services, might well qualify as payments received during the ordinary course of business.¹⁷⁷

There is, more importantly, one additional hurdle to overcome in order to apply preference law in the case of executive compensation: it is unclear whether these transfers are "on account of an antecedent debt."¹⁷⁸ Preference law focuses on existing creditors seeking to improve their economic position at the expense of other creditors. When a CEO signs an employment contract with the company, the parties' contract is wholly executory on both sides.¹⁷⁹ During each pay period, however, the CEO and the company have exchanged labor for services. The antecedent debt requirement necessary to constitute a preference is missing, except perhaps from the final pay period.¹⁸⁰

174. § 547(c)(2).

175. See Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 817 (1985); Charles Jordan Tabb, *Rethinking Preferences*, 43 S.C. L. REV. 981, 986 (1992).

176. See, e.g., *In re Tolona Pizza Prods. Corp.*, 3 F.3d 1029 (7th Cir. 1993) (recognizing that late payments to sausage suppliers by pizza restaurant debtors are common in the pizza restaurant industry).

177. Cf. *In re Kumar Bavashi & Assocs.*, 906 F.2d 942 (3d Cir. 1990) (finding a new value exception, albeit with a two-to-one decision); *Costello v. Fazio*, 256 F.2d 903 (9th Cir. 1958).

178. 11 U.S.C. § 547(b)(2) (Supp. 2007).

179. See generally Steven Kropp, *A Case of Misplaced Priorities: A Proposed Solution To Resolve The Apparent Conflict Between Sections 507 and 1113 of the Bankruptcy Code*, 18 CARDOZO L. REV. 1459 (1997); Kropp, *supra* note 52.

180. The Bankruptcy Code provides a fourth priority for workers' wages, in § 507, recently raised to \$10,000 and 180 days, from the prior version of the Code's third priority limits of \$4,925

Although the intricate requirements needed to constitute a voidable preference under bankruptcy law may not exist, underlying preference law policies suggest that an extension of the law is necessary. Applying the theory that one creditor should not be allowed to cut in line ahead of other creditors, it seems that executives should not be allowed to enjoy lavish compensation at the expense of displaced workers headed for unemployment and lacking the safety net of a secure pension fund. The Supreme Court emphasized the strong public policies that favor the protection of retirement funds in a trilogy of Chapter 7 personal bankruptcy cases discussed below.

In *Patterson v. Shumate*, the plaintiff was one of over 400 employees who participated in the employer's pension plan.¹⁸¹ When his employer went bankrupt in 1982, so did Shumate.¹⁸² Patterson, Shumate's bankruptcy trustee, sued to recover Shumate's pension money still held by the pension plan, while Shumate sought to have the money paid directly to him. Shumate argued that, under § 541(c)(2) of the Code, property of the bankruptcy estate did not include the debtor's beneficial interest in a trust restricted from involuntary transfer under non-bankruptcy law.¹⁸³ The Supreme Court agreed, finding that the statutory phrase "applicable nonbankruptcy law" included federal laws such as ERISA, as well as state laws.¹⁸⁴ Accordingly, the anti-alienation provision found in every ERISA-qualified plan constituted a restriction on transfer under non-bankruptcy law.¹⁸⁵ The Court observed that its decision "[gave] full and appropriate effect to ERISA's goal of protecting pension benefits . . . ensuring that 'if a worker has been promised a defined pension benefit upon retirement . . . he actually will receive it.'"¹⁸⁶

More recently, in *Yates v. Herdon*, the Court expanded the definition of "employee" under ERISA by including a physician who owned his practice.¹⁸⁷ The Court held that, so long as the physician and his

and three months. Under either version, the dollar and time limit impacts only senior management. 11 U.S.C. § 507(a)(4) (Supp. 2007).

181. 504 U.S. 753, 755 (1992).

182. *Id.* at 755.

183. *Id.* at 756.

184. *Id.* at 758.

185. *Id.* at 759.

186. *Id.* at 764–65 (citation omitted).

187. 541 U.S. 1 (2004). In 1989, Yates borrowed \$20,000 at 11% interest from his pension plan. *Id.* at 2. The loan required monthly payments over five years. Yates made no payments. *Id.* In 1996, Yates repaid the pension plan over \$50,000, representing principal and interest, a few weeks before his creditors filed an involuntary bankruptcy petition against him. *Id.* The Chapter 7 trustee then sought to avoid the payment as a preferential transfer under § 547(b). *Id.* at 9–10.

spouse were not the only employee participants in the pension plan, the physician, although a working owner, qualified as an employee.¹⁸⁸ The decision in *Yates* directly benefits working owners of small businesses and professional practices. This result also creates a strong incentive for owners to include their employees in pension plans. In that sense, the *Yates* decision promotes the development of pensions for ordinary workers.

Finally, in *Rousey v. Jackoway*,¹⁸⁹ after Richard and Betty Jo Rousey each lost their jobs, their employer-sponsored pension plan required them to take a lump sum distribution, which the Rouseys then deposited into Individual Retirement Accounts (IRAs) in each of their names.¹⁹⁰ Several years later, they filed jointly for bankruptcy.¹⁹¹ Although they acknowledged that their IRAs constituted property of the estate under § 541, they claimed that the IRAs were exempt property under § 522(d).¹⁹² The Court went beyond the formal limitations of an ERISA-qualified retirement plan and protected their individual IRA accounts. The Court's willingness to liberally interpret the Code to protect IRAs during personal bankruptcy supports the argument that worker pensions deserve similar protection during corporate bankruptcy. There is little value in according pensions such a preferred place if the plans are easily wiped out during corporate bankruptcy.¹⁹³

VIII. LEGISLATIVE REFORM EFFORTS

In the wake of the stock market collapse of 2001-2002, proposals to curb abuse by senior executives, particularly CEOs and CFOs of publicly traded companies, picked up steam. Congress adopted modest reforms to correct abusive executive compensation practices as part of the Sarbanes-Oxley Act of 2002 ("SOX").¹⁹⁴ First, SOX requires both

188. *Id.* at 2.

189. 544 U.S. 320 (2005).

190. Mr. Rousey was forced into early retirement at Northrop Gruman while Mrs. Rousey was laid off from that same corporation. Brief for the Petitioners, No. 03-1407, 2004 WL 1900505, at *2 (Aug. 20, 2004).

191. *Rousey*, 544 U.S. at 322.

192. *Id.*

193. Congress indirectly signaled its approval of *Rousey* when it added §§ 512(n) and 522(d)(12) in 2005, permitting a debtor to exempt up to one million dollars in an IRA account. 11 U.S.C. §§ 512(n), 522(d)(12) (Supp. 2007).

194. Sarbanes-Oxley Act of 2002; 15 U.S.C. § 1743 (Supp. 2007). Compare Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFF. L. REV. 721, 722 (2005) (arguing that Sarbanes-Oxley "effectively captures the political economy at work" and fairly referees "the familiar institutional competition between regulation and the market"), with Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud*:

CEOs and CFOs to disgorge all bonuses, incentive-related compensation, and profits from the sale of stock received during the previous twelve months if, as a result of misconduct, the company restates its earnings because of material noncompliance with any financial reporting requirement.¹⁹⁵ Second, SOX bars publicly traded companies from making unreasonably favorable loans to senior executives if the terms were not available to other employees.¹⁹⁶ These restrictions apply outside of bankruptcy and, presumably, apply inside of bankruptcy as well.

Efforts to further strengthen SOX's limitations on excessive executive compensation were less successful. Two senior members of the Senate Banking Committee have each unsuccessfully authored a proposal for broader reforms. Senator Dorgan attempted to amend SOX to require that CEOs, CFOs, and directors pay all profits from the sale of the company's securities in the twelve months preceding the company's bankruptcy filing back to the company.¹⁹⁷ Senator Boxer proposed amending SOX to require executives to forfeit all bonuses and incentive-based compensation as well as all profits from the sale of the company's securities earned in the twelve months requiring a restatement of earnings. Forfeited funds would then be paid to former company employees whose job losses were caused by the need to restate earnings.¹⁹⁸ These amendments were unsuccessful.

Senator Grassley, then Chair of the Senate Finance Committee, introduced the Corporate Accountability in Bankruptcy Act in 2002. The Bill would have permitted trustees to recover excessive compensation from officers, directors, and other insiders paid by the bankrupt corporation within one year of its bankruptcy filing.¹⁹⁹ The Bill would have also extended the recovery period to the previous four years if a corporate employee had engaged in securities or accounting violations.

A Critique of the Sarbanes-Oxley Act of 2002, 28 J. CORP. L. 1, 61 (2002) (concluding that Sarbanes-Oxley is unneeded and costly: "Although markets will remain imperfect, the potential for a market response, combined with the likely costs of regulation, make the case for additional regulation dubious."). See also Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521 (2005) (attacking Sarbanes-Oxley as a knee-jerk political reaction prompted by a shift in public mood regarding big business and high profile corporate scandals).

195. Sarbanes-Oxley § 304(a); 15 U.S.C. § 7243(a) (Supp. 2007).

196. Sarbanes-Oxley § 402(a), 15 U.S.C. § 78m(k) (Supp. 2007).

197. See S.A. 4214, 107th Cong. (2002). 148 CONG. REC. S6657-01 (daily ed. July 11, 2002) (statement of Sen. Dorgan).

198. 148 CONG. REC. S6657-01 (daily ed. July 11, 2002) (statement of Sen. Boxer).

199. See S. 2901, 107th Cong. (2002).

Most recently, Congressman Barney Frank introduced a bill in the House of Representatives requiring that shareholders vote to approve CEOs' compensation.²⁰⁰ His bill initially garnered little support in the Republican-led House.²⁰¹ Frank, who now serves as Chair of the House Financial Services Committee, plans to reintroduce his Bill in the 110th Congress where, at least in the House, it will stand a strong chance of passage.²⁰²

IX. CONCLUSION

Workers bear the risk of corporate failure. These workers lose their jobs and often their pensions. They are left to survive on unemployment insurance or welfare and are urged to undergo retraining to fit into the new economy.²⁰³ On the other hand, corporate executives play by rules that guarantee no accountability for poor performance. Rather, they ensure their economic situation through legally enforceable employment contracts with several favorable components: lucrative stock options or outright grants of company stock for meeting minimal performance targets; pension plans that are protected from the risk of corporate bankruptcy; golden parachutes upon severance; or bonuses for staying through a corporate reorganization.²⁰⁴ Legislative reform is needed to level the playing field and, at the very least, treat workers and executives under the same rules.

After a series of pension fund scandals, Congress enacted ERISA in 1974 to guarantee that a worker's vested interest in her company's defined benefit pension plan would actually provide her a pension when she eventually retired.²⁰⁵ Because corporations have increasingly eschewed defined-benefit pension plans for 401(k) plans filled with corporate stock, today's workers are again vulnerable to the risk

200. See H.R. 4291, 109th Cong. (2005).

201. See Robert Schroeder, *Executive Pay Returns to the Crosshairs*, MARKETWATCH, Jan. 16, 2007, available at <http://www.marketwatch.com> (enter the title into the search box, then follow the link to the article) (last visited Feb. 10, 2007).

202. Practically speaking, only members of Congress and CEOs set their own pay. At least members of Congress face periodic elections. One virtue of Congressman Frank's proposed legislation is that CEOs would meet the same test of approval or disapproval. Yet stockholders may believe that a vote against CEO pay could harm the corporation or that it would be an exercise in futility.

203. See John E. Silvia, *Domestic Implications of a Global Labor Market*, 41 BUS. ECON. 23 (2006); Ross Koppel & Alice Hoffman, *Dislocation Policies in the U.S.A.: What Should We Be Doing?*, 544 ANNALS AM. ACAD. POL. & SOC. SCI. 111 (1996).

204. See Jessi D. Herman, *Pay to Stay, Pay to Perform, or Pay to Go?: Construing the Threshold Terms of § 503(c)(1) and (2)*, 23 EMORY BANKR. DEV. J. 319 (2006).

205. See *supra* notes 1-6 and accompanying text.

that promised pensions will not materialize upon retirement.²⁰⁶ The prospect of senior executives forfeiting substantial sums of money in the forms of salaries, bonuses, stock options, and pension funds will give those executives strong incentive to cabin their greed and manage the corporation with both eyes on the company's long-term prospects instead of short-term gains.

In 2006, a dramatic, mid-term change in Congress produced a set of elected officials who recognize that, over the last twenty-five years, the United States has witnessed the growth of an unacceptable economic chasm between the average American worker and the economic elites.²⁰⁷ This Article contributes to the public and political conversation surrounding the economic disparity between executives and workers both inside and outside of bankruptcy. The next step is to translate this conversation into concrete action.

206. Enron's 401(k) plan was a prime example. It provided employees with nearly twenty different investment choices, but Enron's matching contribution of up to 6% was given only in Enron stock, which employees were required to hold until age fifty. Prior to its collapse in 2001, combining employee and employer contributions, nearly 60% of the employees' 401(k) funds were held in Enron stock. See Stein, *supra* note 19, at 856-57.

207. See Webb, *supra* note 10.

