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Mission Impossible: A Legislative Solution for Excessive Executive Compensation

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One of the great dilemmas of corporate law is how to address the problem of excessive executive compensation without replacing it with excessive government intervention. This Article proposes for the first time that Article 36(b) of the Investment Company Act ("ICA"), which enacted fiduciary obligations for investment advisers, be applied to general public corporations. The effect of this proposal—termed Corporate 36(b)—would be to impose upon CEOs and other highly placed corporate executives a fiduciary duty with regard to their compensation packages. This would enable federal courts to genuinely evaluate the procedural and substantive nature of executive compensation negotiations. As scholars, the media, and politicians have pointed out, excessive executive compensation reduces shareholder wealth, increases hostility in the workplace, and provokes societal anger. The Article demonstrates that the legislative history of the ICA supports the application of its principles to general corporations. It further shows that the courts' implementation of the ICA can be replicated in the context of general corporations. The Article argues that adoption of Corporate 36(b) will help to reduce executive demands, to empower and incentivize boards of directors, and to avoid undesirable federal regulation. The Article also addresses potential criticisms concerning the risk of nuisance suits and strike litigation, the vagaries of involving courts in business decisions, and the problems surrounding federalization of corporate law. The Article concludes with a brief description of how the proposed legislation could have been applied to deal with the controversial compensation package in the well-known case of Disney's hiring and firing of Michael Ovitz.

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Mission Impossible: A Legislative Solution for Excessive Executive Compensation

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I. INTRODUCTION

After the death of Apple icon Steve Jobs, Tim Cook took the reins of the company and likely became the highest-paid CEO in America in 2011.¹ The Associated Press reported that Cook's compensation package was valued at \$378 million.² At approximately the same time, the median salary for American workers had just fallen to a decade low of \$26,364 a year.³ Given this extreme disparity, there is little mystery as to why movements like "Occupy Wall Street" have received so much attention over the last year.⁴ Many people, including leading scholars and seemingly almost the entire nation, think that executive compensation in publicly owned American companies is excessive.⁵ In 2010, CEOs at a majority of the S&P 500 companies had an average salary equaling 343 times that of an average American worker.⁶ Securities and Exchange Commission ("SEC") Chairman William Donaldson has stated: "One of the great, as-yet-unresolved problems in the country today is executive compensation and how it is determined."⁷ The news is commonly filled with stories of

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¹ Ryan Nakashima, *Apple CEO Tim Cook Could Top Pay List in 2011*, YAHOO! FINANCE (Jan. 10, 2012, 11:04 AM), <http://finance.yahoo.com/news/apple-ceo-tim-cook-could-003124192.html>.

² *Id.* The Article notes that this was a large change for Apple, where in the past, former Apple CEO Steve Jobs accepted a salary of only one dollar for several years but owned approximately 5.5 million shares in the company, worth about \$2.3 billion as of January 2012. *Id.*

³ David Cay Johnston, *First Look at US Pay Data, It's Awful*, REUTERS (Oct. 19, 2011, 5:15 PM), <http://www.reuters.com/article/2011/10/19/idUS254294359320111019>.

⁴ *Id.* ("The data show why protests like Occupy Wall Street have so quickly gained momentum around the country, as people who cannot find work try to focus the federal government on creating jobs . . .").

⁵ Richard A. Posner, *Are American CEOs Overpaid, and, if So, What if Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1013–14 (2009).

⁶ Jennifer Liberto, *CEOs Earn 343 Times More than Typical Workers*, CNNMONEY (Apr. 20, 2011, 7:46 AM), http://money.cnn.com/2011/04/19/news/economy/ceo_pay/index.htm.

⁷ LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 189 (2004).

executive compensation.⁸ We are repeatedly encountering stories of executives prospering while the corporation they head and its employees are struggling, and we often hear instances of lavish perks given to CEOs even after they leave their jobs.⁹ Last year, in the *New York Times* alone, there were 268 articles dealing with executive compensation¹⁰ and over 10,000 articles appeared in publications across the nation.¹¹ While the financial crisis that began in September 2008 cannot be blamed solely on executive compensation, it is related at least indirectly;¹² indeed, executive compensation has been described as a “contributing factor” to the recent economic crisis by the Secretary of the Treasury, Timothy Geithner.¹³ This Article attempts to address the problem of excessive executive compensation by proposing the imposition of fiduciary duties on executives in matters dealing with executive compensation.

Many people are concerned about the seeming unfairness of disproportionate executive compensation and promote the idea of governmental regulation to limit these perceived excesses.¹⁴ In times of economic difficulty or scandal, even conservative politicians embrace increased government control of corporations, and after the Enron and WorldCom scandals, President Bush praised the Sarbanes-Oxley Act for containing “the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt.”¹⁵ Politicians feel a strong need to appear to upset investors that they are “doing something” and being “aggressive” against possible corporate fraud.¹⁶ Furthermore, in the 2008 presidential election, candidates repeatedly used executive compensation as an issue that signified social inequities and required a

⁸ Jennifer S. Martin, *The House of Mouse and Beyond: Assessing the SEC's Efforts to Regulate Executive Compensation*, 32 DEL. J. CORP. L. 481, 484 (2007).

⁹ See *id.* at 485 (describing how ConAgra Foods employees are seeing their bonuses eliminated while the former Chairman received bonuses, stock options, and a \$20 million retirement package, and how General Electric CEO's retirement package included a New York City apartment, country club memberships, use of the corporate jet, and Red Sox tickets).

¹⁰ This resulted from a Westlaw search of the *New York Times* database using the search terms “ceo or executive w/5 pay or compensation” for the dates between 12/31/2010 and 1/1/2012.

¹¹ This resulted from a Westlaw search of the “ALLNEWS” database using the search terms “ceo or executive w/5 pay or compensation” for the dates between 12/31/2010 and 1/1/2012.

¹² Posner, *supra* note 5, at 1040–41.

¹³ Joe Nocera, *Geithner's Plan on Pay Falls Short*, N.Y. TIMES, June 13, 2009, at B1.

¹⁴ See James O'Toole, *Occupy Wall Street Reacts to Goldman Sachs Pay*, CNNMONEY (Oct. 20, 2011, 2:06 PM), http://money.cnn.com/2011/10/20/news/economy/goldman_sachs_occupy_wall_street/index.htm (relating statements by Amanda Saleen, Stephen Crawn, and Gabriel Brownstein—individuals who participated in Occupy Wall Street—when asked about Goldman Sachs setting aside \$10 billion for staff pay, including, “I think it's ridiculous” and “for the future of our nation there needs to be a change,” and calling for “more strict regulation” of the financial industry).

¹⁵ Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Spring 2003, at 26, 28.

¹⁶ *Id.* at 28.

regulatory solution.¹⁷ It was also an issue in the 1992 presidential campaign,¹⁸ and there is no reason to believe that the current election cycle will be any different. There is a history of major economic government interventions during times of crisis, including in matters of securities trading during the Great Depression, corporate takeovers in the 1980s, and corporate governance following the Enron and WorldCom scandals.¹⁹

In a poll performed by *Fortune* magazine in 1936, most Americans already thought that executives were paid too much.²⁰ Well before the current economic crisis, contemporary executive compensation had been criticized by scholars and the populace alike for decades.²¹ As pointed out recently by the Obama Administration's so-called "pay czar" (appointed to determine appropriate compensation levels for Troubled Asset Relief Program ("TARP") recipients),²² high levels of uncertainty and unemployment combined with low job security induce society at large to experience anger when finding out about the high salaries that executives receive.²³ This frustration will most likely eventually translate into government action.

Some politicians and others have claimed for several decades that the problem with executive compensation is that executives are accountable to directors whom they select themselves, rather than to the shareholders directly.²⁴ Yet, surprisingly very little has been done to give shareholders the ability to make executives accountable to them. Over time, much of the thought about executive compensation was based on economic assumptions that may be flawed. As Judge Posner from the Seventh Circuit Court of Appeals pointed out in a recent dissent, this "economic analysis . . . is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation."²⁵

¹⁷ Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. REV. 299, 305 (2009).

¹⁸ Susan Lorde Martin, *Executive Compensation: Reining in Runaway Abuses—Again*, 41 U.S.F. L. REV. 147, 148 (2006).

¹⁹ Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 591 (2003).

²⁰ Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 MINN. L. REV. 846, 858 (2011).

²¹ See Mark A. Salky, *The Regulatory Regimes for Controlling Excessive Executive Compensation: Are Both, Either, or Neither Necessary?*, 49 U. MIAMI L. REV. 795, 795–96 (1995) (stating that the issue of excessive compensation is not new).

²² Deborah Solomon, *White House Set to Appoint a Pay Czar*, WALL ST. J. ONLINE, (June 5, 2009), <http://online.wsj.com/article/SB124416737421887739.html>.

²³ Kenneth R. Feinberg, *Symposium on Executive Compensation Keynote Address*, 64 VAND. L. REV. 349, 351 (2011).

²⁴ Salky, *supra* note 21, at 800.

²⁵ *Jones v. Harris Assocs.*, 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting).

The basic problem is one of agency costs, which arise in situations in which an agent is hired to do a job that the principal is either unable or unwilling to do; while the principal wants the agent to do the best job that he can, he also wants to pay him as little as possible.²⁶ The principal wants his own and the agent's interests to coincide, but because the agent is looking out for himself just as the principal is, the only way to ensure that the agent will be perfectly faithful to him is if he thoroughly monitors and gauges the agent's work and correspondingly adjusts the agent's payment.²⁷ Otherwise the agent is likely to "slack off, or divert revenues to himself, or both."²⁸ In this context, the task of a board of directors is to conduct that monitoring, but some individuals have begun to question whether boards of directors are controlled by long-term CEOs and are therefore not supplying the necessary oversight.²⁹ In support of this, they point out that CEOs are not fired that frequently; in fact, only between two-percent to two-and-one-quarter-percent of CEOs at large corporations are forced out each year,³⁰ a rate that some think is lower than warranted and that further indicates CEOs' control over boards.

Given the recurring nature of executive compensation questions, scholars have claimed that "any regulatory regime that can somehow grant shareholders more power over compensation decisions . . . is a positive step toward improving the inherent problems with existing compensation practices."³¹ Executive compensation has been soaring for decades despite various attempts to stop that trend, ranging from the imposition of increased tax burdens to mandatory disclosure requirements.³² In fact, the federal government is already exercising more control than ever over the relationship between boards and executives, and further regulations are likely, including possible ones requiring specific amounts of compensation.³³ There has already been some federal regulation of executive compensation, such as the Dodd-Frank Act,³⁴ which requires that if a corporation engages in erroneous reporting that results in it later having to correct its financial statements, then the corporation must have policies

²⁶ Posner, *supra* note 5, at 1015.

²⁷ *Id.*

²⁸ *Id.*

²⁹ See Charles K. Whitehead, *Why Not a CEO Term Limit?*, 91 B.U. L. REV. 1263, 1271–73 (2011) (arguing that one of the board's functions is to oversee the CEO, but the CEO actually exercises control over the board).

³⁰ *Id.* at 1267.

³¹ Salky, *supra* note 21, at 826.

³² See Simmons, *supra* note 17, at 304 (describing various responses that have failed to address increasing executive compensation including tax measures, board independence requirements, and mandated disclosures).

³³ See Whitehead, *supra* note 29, at 1276–77 (describing regulatory control over corporate governance and noting that "future proposals may include . . . implementing a range of CEO pay requirements that mandate certain types of compensation.").

³⁴ Dodd-Frank Wall Street Reform & Consumer Protection Act, 12 U.S.C.A. § 5301 (West 2010).

that enable it to claw back incentive-based pay from executives.³⁵ Indeed, there are already many different types of federal and quasi-federal organizations that affect the internal structure of corporations, such as Congress itself and agencies like the Internal Revenue Service (“IRS”) and the SEC, but also quasi-private institutions like the New York Stock Exchange and others.³⁶

Unfortunately, lawmakers have a tendency to go into “crisis-mode” and have “knee-jerk” regulatory reform responses in times of economic turmoil.³⁷ As a result, many of the previous remedies to executive compensation, such as increased disclosure, which seemed to be “uncontroversial,”³⁸ not only failed to reduce compensation but arguably increased it.³⁹ American CEOs are paid, on average, over twice as much as foreign CEOs, which is at least in part due to the fact that a much larger percentage of their pay is in the form of stock options;⁴⁰ this latter state of affairs arguably resulted from attempting to tie their pay to performance as the tax law encouraged.⁴¹ As Professor Richard A. Epstein has pointed out, there are always conflicts of interests between the firm’s welfare and an executive’s welfare, and there are downsides to every compensation package, which is why he argues that “regulation is such a foolhardy way to approach the problem.”⁴²

Not only have regulatory attempts to address executive compensation created problems, but the courts have not provided workable solutions, either. Traditionally, shareholders have had three options if they were dissatisfied with the corporation of which they owned a part: selling, voting, or suing.⁴³ Studies have shown that, while not impossible, it is very difficult for shareholders in public companies to have much success in

³⁵ Whitehead, *supra* note 29, at 1276.

³⁶ Simmons, *supra* note 17, at 323.

³⁷ *Id.* at 362 (internal quotation marks omitted).

³⁸ Lawton W. Hawkins, *Compensation Representatives: A Prudent Solution to Excessive CEO Pay*, 72 BROOK. L. REV. 449, 461–62 (2007).

³⁹ This increase is apparent (1) in the “ratcheting effects” that are exacerbated by disclosure and (2) in the increased grants to CEOs of stock options, which is caused partly by the tax changes reducing deductions for pay not linked to “performance.” See BEBCHUK & FRIED, *supra* note 7, at 71–72 (stating that the vast majority of firms using peer-group information set CEO compensation at or above the fiftieth percentile of the peer group, leading to an increase in compensation); Simmons, *supra* note 17, at 346 (explaining that a tax law with the express purpose of containing executive compensation has resulted in an escalation of pay through stock options).

⁴⁰ Posner, *supra* note 5, at 1020–21.

⁴¹ Simmons, *supra* note 17, at 346.

⁴² Richard A. Epstein, *Steering Clear of the Executive Compensation Bog*, FORBES, June 16, 2009, <http://www.forbes.com/2009/06/15/salary-bonus-ceo-opinions-columnists-executive-compensation.html>.

⁴³ Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility*, 79 WASH. U. L.Q. 569, 569–70 (2001).

compensation lawsuits,⁴⁴ with the condition of demand futility⁴⁵ imposing a particularly high burden in these cases.⁴⁶ In the first pertinent case decided by the Supreme Court, a somewhat shareholder-friendly rule seemed to be emerging. The rule was that “[i]f 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.”⁴⁷ Yet, this seemingly shareholder-friendly approach by the judiciary was short-lived. Courts are usually reluctant to become involved in corporate executive compensation issues.⁴⁸ Many reasons exist for limited judicial intervention on internal corporate affairs, including the common belief that judges are unable to determine appropriate compensation packages, the minimal amount of legislative guidance in the area, and a fear of excessive shareholder litigation.⁴⁹

One of the problems with attempting to deal with high executive compensation is the fact that not everybody agrees that it is a problem at all. Just because executive compensation is high does not necessarily mean it is excessive. It could only be accurately described as excessive if it is above the “correct” price, and determining said price is very difficult.⁵⁰ There are at least two schools of thought regarding executive compensation. One could be classified as the adherents of the “optimal contract” theory, who basically assert that there is nothing wrong with the current situation and that modification is unnecessary; juxtaposed with the managerial power theorists, who advocate “sweeping changes to the current system.”⁵¹ The latter argue that a CEO’s only supervisor is the board of directors, which may be an unreliable agent of the principals (the shareholders) themselves.⁵² Some empirical studies have concluded that CEOs do in fact have significant bargaining power, and the differences between their contracts and those of other corporate workers “seem quite

⁴⁴ See *id.* at 571.

⁴⁵ See *infra* note 161 and supporting text.

⁴⁶ Thomas & Martin, *supra* note 43, at 571.

⁴⁷ *Rogers v. Hill*, 289 U.S. 582, 591–92 (1933) (citation omitted) (internal quotations marks omitted).

⁴⁸ But see Thomas & Wells, *supra* note 20, at 848 (explaining that “contrary to received wisdom, courts have from time to time engaged in serious review of executive compensation practices and pay packages”).

⁴⁹ Thomas & Martin, *supra* note 43, at 572.

⁵⁰ Hawkins, *supra* note 38, at 450; see also D.A. Jeremy Telman, *The Business Judgment Rule, Disclosure, and Executive Compensation*, 81 TUL. L. REV. 829, 874 (2007) (stating that extraordinarily generous compensation packages are not necessarily excessive).

⁵¹ Thomas & Wells, *supra* note 20, at 847–48.

⁵² Posner, *supra* note 5, at 1018.

stark.”⁵³

It is a fairly common belief that the discretionary power of both directors and executives in a corporation should be directed toward a single end, “the maximization of shareholder wealth,”⁵⁴ but how to achieve that goal is less clear. Many agree that placing a cap on CEO compensation would be a mistake.⁵⁵ Former SEC Chairman Christopher Cox noted in a speech in 2006 that it is not the government’s role to determine the appropriate level of executive compensation; rather, it is the shareholders’ and directors’ job “to determine how best to align executive compensation with corporation performance, to determine the appropriate levels of executive pay, and to decide on the metrics for determining it.”⁵⁶ As Judge Posner has indicated, “The more effective shareholder monitoring is, the less need there is for incentive-based compensation: the stick is substituted for the carrot.”⁵⁷ At the same time, the more complex the tasks are, the higher the cost of monitoring.⁵⁸ This Article will delineate a proposal that reduces these costs by not only increasing the amount of available outside monitoring but also decreasing the total amount of monitoring needed.

I suggest that the legislature should adopt Section 36(b) of the ICA, which imposes a fiduciary duty upon investment advisors and investment companies in relation to advisors’ compensation,⁵⁹ and should apply it to CEOs and publicly traded corporations when it comes to CEOs’ and other executives’ salaries. I call my idea “Corporate 36(b)” and will refer to it as such in this Article. Corporate 36(b) would subject the compensation packages of CEOs and other highly placed executives to federal litigation in the event of egregiously inflated salaries. Adopting a provision that contains numerous protections for all the parties, and that has received judicial approval from numerous appellate courts, including most recently the Supreme Court, will avoid the pitfalls of many other proposals.

I will begin by describing the argument that executive compensation has been set at artificially high levels for many years (if not for decades and beyond), and I will focus on the case that Lucian Bebchuk and Jesse Fried famously made in their book *Pay Without Performance: The*

⁵³ Stewart J. Schwab & Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 WASH. & LEE L. REV. 231, 266 (2006).

⁵⁴ Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1616 (2005) (reviewing LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004)).

⁵⁵ See, e.g., Posner, *supra* note 5, at 1045 (“Placing a ceiling on CEO salaries and other compensation would be a mistake.”).

⁵⁶ Christopher Cox, Chairman, SEC, Speech by SEC Chairman: Chairman’s Opening Statement; Proposed Revisions to the Executive Compensation and Related Party Disclosure Rules (Jan. 17, 2006), available at <http://www.sec.gov/news/speech/spch011706cc.htm>.

⁵⁷ Posner, *supra* note 5, at 1023.

⁵⁸ *Id.* at 1017.

⁵⁹ 15 U.S.C. § 80a-35(b) (2006).

Unfulfilled Promise of Executive Compensation,⁶⁰ which has been cited by over 300 law review articles and cases.⁶¹ I will then discuss the counter-arguments presented against their thesis and conclude that whether or not one fully agrees with Bebchuk and Fried, virtually all observers acknowledge that problems—albeit of varying degrees—exist in the status quo. I will then discuss the problems with the remedial measures attempted up to this point, including the failed efforts to correct the situation through tax reform, disclosure requirements, and shareholder litigation. I will then present the argument for adopting Corporate 36(b) as a partial solution to the problems previously identified, and lastly, I will respond to possible objections to the proposal, including the possibility of strike suits and the issue of federalizing a part of corporate law.

II. MANAGERIAL POWER THESIS VERSUS OPTIMAL CONTRACT THEORY: BEBCHUK AND FRIED'S "PAY WITHOUT PERFORMANCE" AND ITS CRITICS

A. *The Argument that Executive Compensation Is Broken*

In 2004, Lucian Bebchuk and Jesse Fried published a book that became the basis for many commentaries and criticisms of the corporate compensation structure; this book will serve as a foundation for my examination of the potential problems that currently exist with executive compensation. As Bebchuk and Fried indicated, a surge of corporate scandals in 2001 led many individuals to examine and question how executive compensation is determined in U.S. corporations.⁶² They concluded that due to the flaws of the compensation system, it was necessary to make boards not only more independent from executives, but also more dependent on shareholders.⁶³ They argued that the market constraints that are supposed to make boards and executives bargain over the executives' compensation package in an arm's-length manner are insufficient.⁶⁴ Empirical studies show that executives with more power receive better packages that are less sensitive to performance than do similar but weaker executives.⁶⁵

Bebchuk and Fried denied the claim that receiving these large pay packages is inherently unfair; rather, they explained that their opposition comes from a purely pragmatic and consequentialist perspective.⁶⁶ Indeed,

⁶⁰ BEBCHUK & FRIED, *supra* note 7.

⁶¹ This information results from a Westlaw search of the "ALLCASES, TP-ALL, JLR" data set using "pay without performance: the unfulfilled promise of executive compensation."

⁶² BEBCHUK & FRIED, *supra* note 7, at ix.

⁶³ *Id.* at x.

⁶⁴ *Id.* at 4.

⁶⁵ *Id.* at 5.

⁶⁶ *Id.* at 8.

there are several deleterious effects that can arise from excessive salaries, including smaller dividends for shareholders, a reduction of earnings per share, inefficiencies within the workplace that result in a negative impact on worker morale, higher turnover, and increased competitiveness among workers.⁶⁷ The authors disagreed with the traditional view that “boards, bargaining at arm’s length with CEOs, negotiate pay arrangements designed to serve shareholders’ interests.”⁶⁸ Rather, they pointed out that being a member of a board of directors has both financial and non-financial benefits that give strong incentives to board members to maintain their position.⁶⁹ These incentives to keep their position are clearly affected by the fact that the most significant element of staying on a board is being placed on the company’s nomination slate, which is often controlled (sometimes even directly) by the CEO.⁷⁰

Bebchuk points to many incentives on the part of the board to give the CEO what she wants, including: (1) “[d]irectors are often CEOs of other companies and naturally think that CEOs should be well paid . . . often they are picked by the CEO”;⁷¹ (2) CEOs can influence the compensation given to directors;⁷² (3) many directors have social connections or are even friends with the CEO;⁷³ (4) there is a desire to foster a collegial atmosphere because they will have an ongoing working relationship;⁷⁴ and (5) a working pattern of respect and possibly acquiescence exists due to the CEO’s position.⁷⁵ Even when supposedly external sources are used to determine compensation, problems persist. For example, firms that specialize in consulting on these matters, “which provide cover for generous compensation packages voted by boards of directors, have a conflict of interest because they are paid not only for their compensation advice but for other services to the firm . . . for which they are hired by the officers whose compensation they advised on.”⁷⁶ In 2005, one outside consultant, Hewitt Associates, worked for Verizon Communications and ultimately helped the compensation committee to arrive at a CEO compensation package worth \$19.4 million, a forty-eight percent increase from the previous year.⁷⁷ Unfortunately for Verizon, during the same time

⁶⁷ Simmons, *supra* note 17, at 335.

⁶⁸ BEBCHUK & FRIED, *supra* note 7, at 15.

⁶⁹ *Id.* at 25.

⁷⁰ *Id.* at 25–26.

⁷¹ Jones v. Harris Assocs., 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting).

⁷² BEBCHUK & FRIED, *supra* note 7, at 30–31.

⁷³ *Id.* at 31.

⁷⁴ Charles M. Yablon, *Is the Market for CEOs Rational?*, 4 N.Y.U. J.L. & BUS. 89, 108 (2007) (reviewing LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004)).

⁷⁵ BEBCHUK & FRIED, *supra* note 7, at 32.

⁷⁶ Jones, 537 F.3d at 730 (Posner, J., dissenting).

⁷⁷ Hawkins, *supra* note 38, at 488.

period, the value of company stock plummeted by twenty-six percent.⁷⁸ To make matters worse, since 1997, this “outside” consultant had earned over half a billion dollars from consulting services provided to Verizon and reported to the CEO.⁷⁹ This does not definitively show that the compensation package was inappropriate or that anything improper was done, but it does raise some questions. On the other side of the scale, there are relatively few incentives for consultants to propose lower compensation, including a reduction in the value of any stock that the board may personally have and possible harm to the board’s reputation.⁸⁰ Bebchuk and Fried are not alone in this observation, as other scholars have pointed out that executive pay determinations seem to be very one-sided, with little weighing in on the side of shareholders.⁸¹

Furthermore, litigation is a difficult road to travel for disgruntled shareholders. Since any potential claims are concerned with harm to the corporation, shareholders have to file a derivative action.⁸² Generally, a demand upon the board must precede shareholder litigation, but this is problematic because boards can use the demand stage to take control and get lawsuits dismissed. Hence, to successfully file a derivative action, shareholders must circumvent this demand requirement by raising a reasonable doubt that the board was disinterested and independent.⁸³ If the shareholders are able to overcome this large hurdle, the board may still appoint a special litigation committee comprised of independent directors that could recommend terminating the suit, and most courts will defer to this determination.⁸⁴ If this hurdle is overcome, the shareholders will run into the business judgment rule, whose consequence is that a court will refuse to look at the substance of a board’s actions so long as procedural requirements are met.⁸⁵ For executive compensation claims, these procedural requirements are essentially that the board be nominally independent and informed.⁸⁶ If the rule applies, a court will not entertain arguments that the compensation package was unreasonable, and the only possible claim is that the alleged excessive compensation is corporate waste.⁸⁷ To prove waste, a shareholder would have to show that the package is irrational to such an extent that no reasonable person could

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ BEBCHUK & FRIED, *supra* note 7, at 34.

⁸¹ See Telman, *supra* note 50, at 870 (“The basic process [of setting executive compensation] seems to be fundamentally one-sided, with no elements of input weighing in on the side of reining in executive pay.”).

⁸² BEBCHUK & FRIED, *supra* note 7, at 46–47.

⁸³ *Id.* at 47.

⁸⁴ *Id.*

⁸⁵ *Id.* at 46.

⁸⁶ *Id.*

⁸⁷ *Id.*

approve it.⁸⁸ This task is so nearly impossible and unlikely that it has been compared to the likelihood of seeing the Loch Ness Monster.⁸⁹ Waste has even been described as a “vestige of discarded doctrines,” and commentators have urged that the doctrine be changed to “allow a majority shareholder vote to extinguish a waste claim.”⁹⁰

In addition to these hurdles, there seem to be many factors impacting CEO compensation that have very little, if anything, to do with maximizing shareholder wealth or any other measure of corporate benefit. For example, the compensation received by a CEO is significantly higher if the chair of the compensation committee was appointed after the CEO.⁹¹ But even if we accept the proposition that executive compensation is out of alignment with the economic interests of corporations, the path to possible solutions is rocky. Some have interpreted Bebchuk and Fried’s argument as stating that only “reducing takeover defenses, giving shareholders more power to change corporate rules, and opening up the nomination process to facilitate direct shareholder nomination of whole slates of directors” can begin to correct the flawed executive compensation system.⁹² Nevertheless, Bebchuk and Fried themselves recognize the fact that because shareholders are in possession of limited information regarding the company and are better equipped to help guide the “general contours of compensation plans,” they should be limited in how much detailed input they can exercise.⁹³ The scholars further claim that to address what they see as the problems with executive compensation, we need to “adopt[] reforms that would confront boards with a different set of incentives and constraints,”⁹⁴ and that one way to limit the board’s discretion while still allowing it to make beneficial decisions would be to require that shareholders approve certain board decisions.⁹⁵

Bebchuk and Fried state that the widely dispersed ownership of many modern corporations, which results in the increased power of the board and insulation from the shareholders, is not inevitable, but rather “this power is partly due to the legal rules that insulate management from shareholder intervention.”⁹⁶ Bebchuk and Fried further observe that “[c]hanging these rules would reduce the extent to which boards can stray from shareholder

⁸⁸ *Id.* For a general critique of the “reasonable person” standard in the law, see Irina D. Manta, *Reasonable Copyright*, 53 B.C. L. REV. 1303, 1310–15 (2012).

⁸⁹ BEBCHUK & FRIED, *supra* note 7, at 46.

⁹⁰ Thomas & Wells, *supra* note 20, at 874 (internal quotation marks omitted).

⁹¹ Whitehead, *supra* note 29, at 1281.

⁹² John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1159 (2005) (reviewing LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004)).

⁹³ BEBCHUK & FRIED, *supra* note 7, at 192.

⁹⁴ *Id.* at 189.

⁹⁵ *Id.* at 195.

⁹⁶ *Id.* at 216.

interests and would much improve corporate governance.”⁹⁷ Before addressing whether my proposal addresses these concerns, we should first consider the arguments of individuals who do not believe that the current system of executive compensation poses problems.

B. The Argument that Executive Compensation Is Efficient

There are numerous scholars and professionals who disagree with Bebchuk and Fried’s managerial power thesis.⁹⁸ Some have also pointed out that managerial power is more complicated than Bebchuk and Fried’s model may indicate in that it involves intricate social interactions in which the CEO utilizes informational advantages, “personal dynamism, exploitation of cognitive biases, social norms and fear of disruption of the status quo” to convince the board of his position.⁹⁹ While acknowledging that Bebchuk and Fried have some valid points, other scholars have indicated that their theory leaves some questions unanswered. For example, they question why boards are willing to fire poorly performing CEOs but are still under CEOs’ influence when it comes to pay, why increased disclosure has not resulted in decreased packages, why new CEOs get paid more than incumbent CEOs in similar companies,¹⁰⁰ and how it is that salaries go up and down if the theory that managers dominate their boards is correct.¹⁰¹

On the other side of Bebchuk and Fried’s model of failed corporate governance in the area of compensation is the position that executives are in fact paid high salaries appropriately for the great value of the services that they provide.¹⁰² Many practitioners and experts have claimed that while executives make large salaries, they are not unique in that other professionals like musicians, actors, athletes, venture capitalists, and investment bankers also receive very large salaries.¹⁰³ Other commentators have stated that there is no problem with excessive compensation and that the high salaries are in fact warranted due to the size and complexity of some modern corporations.¹⁰⁴ Furthermore, executives help to create jobs

⁹⁷ *Id.*

⁹⁸ See IRA T. KAY & STEVEN VAN PUTTEN, MYTHS AND REALITIES OF EXECUTIVE PAY 30–33 (2007) (discussing academic responses to Bebchuk and Fried’s model); see also Bainbridge, *supra* note 54, at 1629–31 (listing several scholars with competing and complementary views).

⁹⁹ Yablon, *supra* note 74, at 118.

¹⁰⁰ *Id.* at 94.

¹⁰¹ See KAY & VAN PUTTEN, *supra* note 98, at 15 (questioning how the rise and fall in executive pay can be explained by the theory that managers dominate their boards).

¹⁰² *Id.* at 1.

¹⁰³ *Id.* at 12; see also Simmons, *supra* note 17, at 354 (comparing the market for executives to the level of competition with free agency in professional sports).

¹⁰⁴ Hawkins, *supra* note 38, at 463.

and investment opportunities for the average investor.¹⁰⁵ The contrary position to Bebchuk and Fried's argument is that pay packages are very sensitive to corporate performance and that executives typically make more money when the corporation they run does well.¹⁰⁶ Experts have also pointed out that managerial power theorists claim to be correct not only when citing to examples where executives prospered while their companies faltered, but also where executives were making large salaries *and* the companies were prospering.¹⁰⁷ In the latter cases, these theorists either choose to ignore the success of the companies or acknowledge it but still argue that the large salaries result from managerial power. Those who adhere to optimal contract theory, however, believe that if the corporation is prospering, then the executive is doing his job and his high salary is justified. In the last ten to fifteen years, while it is true that CEO compensation has risen faster than inflation and average employee pay, "[i]t has not risen faster than the broad stock market and individual company share prices,"¹⁰⁸ and "[s]ome economists believe that the way the United States pays its executives is a major source of competitive advantage and that we reject it at our peril."¹⁰⁹

Further, commentators have argued that the salaries are appropriate notwithstanding their magnitude because the markets where CEOs are paid less have not performed as well as the U.S. markets.¹¹⁰ Such salaries also enable optimal management practices, which lead to better survival of the company in bad economic times and allow it to pull out of problems more quickly than other companies, which saves jobs.¹¹¹ Even more commentators argue that the dramatic increase in CEO compensation is understandable when one looks at the corresponding dramatic increase in the asset value of the corporations in question.¹¹² As pointed out previously, just because a salary is high, that does not necessarily make it excessive.¹¹³ One reason for high salaries is that boards think that having their respective CEOs in the top half of the salaries of executives makes them look strong.¹¹⁴ Obviously, if everybody wants to be in the top fifty percent, that top will continue to get higher and higher every year.¹¹⁵

Commentators have stated that even though high levels of pay may

¹⁰⁵ KAY & VAN PUTTEN, *supra* note 98, at 12.

¹⁰⁶ *See id.* at 8 ("[P]ay levels are highly sensitive to fluctuations in corporate performance.").

¹⁰⁷ *See id.* at 9 (discussing the myth of the failed pay-for-performance model).

¹⁰⁸ *Id.* at 19.

¹⁰⁹ *Id.* at 15.

¹¹⁰ Hawkins, *supra* note 38, at 464.

¹¹¹ KAY & VAN PUTTEN, *supra* note 98, at 3.

¹¹² Hawkins, *supra* note 38, at 464–65.

¹¹³ *See supra* Part I.

¹¹⁴ Telman, *supra* note 50, at 871.

¹¹⁵ This is what results in the so-called "ratcheting effect." *See infra* Part II.C.

have “allowed U.S. corporations to attract and motivate perhaps the greatest managerial generation in economic history,”¹¹⁶ it is also the case that “[s]ince the advent of the modern corporation, executive pay has been vilified by the media, targeted for reform by activists, and regulated by the government.”¹¹⁷ Some have argued that one rarely hears about the evils of high executive compensation when things are going well, but when there is a downturn in the economy, activist shareholders and politicians complain about “corporate greed run amok.”¹¹⁸ Regulators also try to achieve increased government control during economic and stock market declines, but then slow these efforts once recoveries take place.¹¹⁹

Some commentators hold the position that since the corporate governance system of the United States has essentially worked well, we should be leery of any significant changes to the balance of power between boards and shareholders.¹²⁰ This again bolsters my proposal of a modest improvement that targets the outliers with a tested method unlikely to cause dramatic negative consequences. Even optimal contract theorists admit that outliers exist where executive pay packages are too large and in fact reward mediocre or even poor performance.¹²¹ Furthermore, even the commentators who think that courts should have a minimal role in internal corporate governance believe that it would be appropriate for courts to act in outlier or extreme cases.¹²² Finally, whether there is a problem with executive compensation or not, the perception of a problem seems to persist, which creates a possible issue in and of itself. As a former SEC chairman stated, “the restoration of public confidence in our markets is fundamental to ensuring that we retain the primacy of America as the foremost capital market in the world.”¹²³ History, however, is full of lessons of how government regulation of business—in particular executive compensation—can backfire. With this in mind, I turn to the next section in which I discuss some of the failed attempts to address the question of executive compensation.

C. *Past Attempts to Regulate Executive Compensation*

One basic reason to avoid government action in setting pay packages is

¹¹⁶ KAY & VAN PUTTEN, *supra* note 98, at 10.

¹¹⁷ *Id.* at 47.

¹¹⁸ *Id.* at 48.

¹¹⁹ *Id.* at 52.

¹²⁰ Hawkins, *supra* note 38, at 471.

¹²¹ KAY & VAN PUTTEN, *supra* note 98, at 2.

¹²² See Thomas & Martin, *supra* note 43, at 572–73 (“[C]ourts should have only a limited role in monitoring the procedural aspects of the executive compensation process and in policing the substance of outlier pay packages.”).

¹²³ Arthur Levitt, Jr., *Corporate Culture and the Problem of Executive Compensation*, 30 J. CORP. L. 749, 753 (2005).

that it is basically impossible for the government to evaluate the specific value of a particular CEO at a particular firm during a particular moment in time. For example, if a firm sees an outgoing CEO as a failure, his salary could be reduced to one dollar and the firm still would not want to keep him (even if he looks good “on paper”), but conversely, an incoming CEO may be able to negotiate a salary that seems exorbitant from the outside and yet, to the shareholders who view him as capable of fixing a sinking ship, it may feel like a bargain.¹²⁴ Given this state of affairs, many would argue that the government should not take on the endeavor of setting CEO salaries. In fact, the legislature has shown some reluctance until now to impose caps on payment and in other contexts has explicitly declined to do so when it avoided introducing rate regulation or authorizing courts to second-guess directors in the area of management fees.¹²⁵ As Professor Epstein has argued, every business “operates in its own distinctive environment in which compensation formulas have to interact with the patterns of shareholder control, the type of direct regulation in place and the rapid movement in product markets.”¹²⁶ At the same time, even with the generally acknowledged limitations of government intervention in this arena, the government has tried to indirectly influence executive compensation in myriad ways.

In recent years, many attempts have been made to slow executive compensation, to seemingly little avail. For example, President Clinton led the effort to change IRS regulations to define individual employee compensation of over one million dollars as excessive and not deductible by corporations.¹²⁷ The impact of this attempt was a threefold increase in executive compensation in the following eight years¹²⁸ because of the way that the change was structured. Indeed, in 1993, the IRS implemented Section 162(m), which limited tax deductions for executive pay over one million dollars; a significant exception to the law, however, was the fact that pay linked to performance remained deductible.¹²⁹ The primary effect was a substantial shift by corporations to increase the amount of anything resembling “performance-based” stock options as opposed to flat salaries, potentially contributing to the increase in executive compensation.¹³⁰ Furthermore, in circumstances where the government tried to reduce the attractiveness of practices like golden parachutes by imposing higher taxes on them, some corporations increased the amount of compensation to

¹²⁴ Yablon, *supra* note 74, at 125–26.

¹²⁵ *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*, 528 F. Supp. 1038, 1045 & n.7 (S.D.N.Y. 1981).

¹²⁶ Epstein, *supra* note 42.

¹²⁷ Simmons, *supra* note 17, at 304.

¹²⁸ *Id.*

¹²⁹ *Id.* at 346.

¹³⁰ *Id.* at 346–47.

offset the increased tax burden.¹³¹ Commentators have noticed that when the government has tried to limit corporate payment plans, corporations have generally found a way around the limitations through alternative means,¹³² which has usually resulted in the shareholders paying even more than they had before the government intervened.

Another legislative attempt to control executive compensation originated many decades ago in the form of disclosure obligations.¹³³ In fact, the SEC has been dealing with disclosure of executive compensation for the last seventy years, and in 2006, it adopted even more extensive compensation disclosure requirements.¹³⁴ Scholars have claimed that social pressure applied to executives would be sufficient to limit excessive compensation and therefore all we really need is effective disclosure requirements.¹³⁵ Yet, given the so-called ratcheting effect, this does not seem like a viable solution. The ratcheting effect is due to the fact that “a third of companies want their CEO’s pay package to be in the top 25%, and no company wants to pay their CEO below the industry average.”¹³⁶ Consequently, disclosure actually results in higher executive salaries since effectively “an increase for one will create increases for all.”¹³⁷ As scholars have pointed out, the SEC’s expanded disclosure requirements made detailed comparisons of CEO pay packages possible and exacerbated the ratcheting effect.¹³⁸ There is also some evidence that people feel empowered to take even more advantage of a situation once their conflicts of interest have been revealed,¹³⁹ so disclosure requirements can further increase the likelihood that a CEO will ask for a very high salary.

Some commentators have also suggested that since shareholders do not have much recourse after they are informed of large compensation packages, disclosure is unlikely to have strong effects.¹⁴⁰ Even more

¹³¹ Susan Lorde Martin, *supra* note 18, at 148.

¹³² *Id.*

¹³³ See Simmons, *supra* note 17, at 342 (“Since 1938, the SEC has promulgated rules on compensation disclosure to give investors a meaningful impression of executive compensation in corporate reports, proxy statements, and registration statements.”).

¹³⁴ *Id.*

¹³⁵ See Sandeep Gopalan, *Shame Sanctions and Excessive CEO Pay*, 32 DEL. J. CORP. L. 757, 758–59 (2007) (arguing that social sanctions including “shaming, withholding of esteem, shunning, and negative voting by investors and other market participants . . . have the potential to influence CEOs and corporate directors in positive ways”).

¹³⁶ Susan Lorde Martin, *supra* note 18, at 163.

¹³⁷ *Id.*

¹³⁸ Yablon, *supra* note 74, at 114.

¹³⁹ Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1039 (2005).

¹⁴⁰ See Jennifer S. Martin, *supra* note 8, at 519 (explaining that because “shareholders do not have a major role in establishing executive compensation packages and have little ability to challenge decisions afterwards,” the disclosure requirements will not be effective).

recently, through the Dodd-Frank Act, public corporations are now required to give their shareholders a vote to either approve or disapprove pay packages given to specific executives,¹⁴¹ which is also known as “say on pay” legislation. This vote, however, neither binds the corporation nor implies any additional duties.¹⁴² Some scholars have commented that at least in some contexts, the “say on pay” requirements will make directors more attentive and could deter some of the more egregious abuses of executive compensation.¹⁴³ Nonetheless, given the failures of the previous disclosure regulations, I am dubious that any significant success will result.

A number of experts have called for more significant substantive regulation from the government in the form of a greater role for the SEC.¹⁴⁴ The possibility of the SEC becoming more involved with corporate governance is not new. It dates back over seventy-five years, to at least the time of Justice William O. Douglas, who advocated for increased SEC regulation of corporate affairs.¹⁴⁵ Furthermore, as previously mentioned,¹⁴⁶ the possibility of federal intervention in corporate law becomes important in times “when systemic change is seen as generating a significant populist payoff,”¹⁴⁷ which may currently be the case. At the same time, increased substantive regulation does have large difficulties even beyond its potential undesirability, ranging from the extensive study required to adequately design it to the increased costs for implementation and monitoring.¹⁴⁸ Another worry associated with increased regulation is that enhancing the SEC’s powers is potentially problematic due to the agency’s tendency to further expand its jurisdiction in times of economic crises or scandal.¹⁴⁹ Even a former chairman of the SEC has stated that it is not the government’s role, but rather the role of shareholders and the board of directors to determine how much an executive should be paid.¹⁵⁰ Given these limits of legislation and agency regulation, it is important to understand the function of the court system in the area of executive compensation.

¹⁴¹ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, 15 U.S.C.A. § 78n-1(a) (West 2012).

¹⁴² 15 U.S.C.A. § 78n-1(c).

¹⁴³ Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers’ Pay*, 98 GEO. L.J. 247, 276 (2010).

¹⁴⁴ See, e.g., Jennifer S. Martin, *supra* note 8, at 529 (“The federal government could address remaining problems with executive compensation by enacting substantive regulation and vesting the SEC with greater authority over these areas.”).

¹⁴⁵ *Id.* at 532.

¹⁴⁶ See *supra* Part I (describing the history of economic interventions during times of crisis).

¹⁴⁷ Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1576 (2005).

¹⁴⁸ Jennifer S. Martin, *supra* note 8, at 527.

¹⁴⁹ *Id.* at 531–32.

¹⁵⁰ *Id.* at 487.

Many commentators have argued that if courts would even occasionally hold boards liable and review compensation awards, this would encourage directors (and their legal advisers) to bargain more forcefully with executives, incentivize directors to request more defensible initial packages, and ultimately reduce the packages themselves.¹⁵¹ Furthermore, the traditional argument that courts lack the ability to influence executive compensation is at least partially countered by the courts' known ability to evaluate pay in the context of insolvent corporations, closed corporations, and partnerships.¹⁵² As I will delineate in the next section, however, there are limitations to having courts address the problem of executive compensation.

D. *The Court System and Executive Compensation*

As described previously, the hurdles encountered by prospective litigants in the current system are numerous and include overcoming both a demand requirement and the business judgment rule and/or attempting to establish a waste claim.¹⁵³ All of these obstacles are potentially fatal on their own and, collectively, they spell almost-certain death for prospective litigation.

The demand requirement is the condition in a derivative lawsuit that a plaintiff shareholder must first demand that the board of directors take action before she is allowed to start litigation.¹⁵⁴ The plaintiff must show that demand was "futile" by showing that either the board was not disinterested or that it did not exercise proper business judgment in the making of the decision.¹⁵⁵ The demand requirement exists for very legitimate reasons. As the Supreme Court of Delaware has stated, "A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation."¹⁵⁶ Frequent investor involvement in corporate affairs is not the model under which the U.S. corporation has thrived and could in fact lead to disruption in "the very mechanism that makes the public corporation practicable—namely, the vesting of authoritative control in the board of directors."¹⁵⁷ In light of the intended limited role of shareholders, "the demand requirement . . . exists at the threshold, first to insure that a

¹⁵¹ Thomas & Martin, *supra* note 43, at 599–600.

¹⁵² *Id.* at 601–02.

¹⁵³ See *supra* Part II.A.

¹⁵⁴ Grimes v. Donald, 673 A.2d 1207, 1216 (Del. 1996), *overruled in part by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (overruling language suggesting an abuse of discretion scope of review).

¹⁵⁵ *Id.*

¹⁵⁶ Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984), *overruled in part by* Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000) ("To the extent Aronson and its progeny contain dicta expressing or suggesting an abuse of discretion scope of review, that language is overruled.").

¹⁵⁷ Bainbridge, *supra* note 54, at 1654.

stockholder exhausts his intracorporate remedies, and then to provide a safeguard against strike suits.”¹⁵⁸ In *Aronson v. Lewis*,¹⁵⁹ the court held that the fact that a self-interested individual selected the directors was not sufficient to overcome the presumption of independence.¹⁶⁰ In the context of demand futility, under the test in *Aronson*, it is virtually impossible for a plaintiff to make a showing sufficient to litigate the question of compensation in a publicly held corporation.¹⁶¹

Even if she meets the demand requirement, a potential plaintiff would face the business judgment rule. Pursuant to the business judgment rule, courts will generally defer to decisions made by boards of directors in relation to executive compensation.¹⁶² The business judgment rule is often invoked in the executive compensation context.¹⁶³ In *Brehm v. Eisner*,¹⁶⁴ the Supreme Court of Delaware stated: “It is the essence of business judgment for a board to determine if a particular individual warrants large amounts of money, whether in the form of current salary or severance provisions.”¹⁶⁵ Delaware’s application of the business judgment rule to executive compensation has established that “irrationality” is the outer bound of the evaluation and, hence, no more detailed evaluation of the directors’ decision is to be conducted.¹⁶⁶ The essential questions are whether the board committed “waste” in its decision making and whether it acted “in good faith”; specifically, this is a “process” evaluation only, and the precise substantive outcome is not relevant.¹⁶⁷

Therefore, potential litigants in executive compensation contexts are left with the option of attempting to prove “waste.” The Supreme Court of New Jersey recently reaffirmed the high threshold imposed by the waste requirement. In *Seidman v. Clifton Savings Bank*,¹⁶⁸ the court stated that “to prove waste, plaintiff must show that compensation is so one sided that

¹⁵⁸ *Aronson*, 473 A.2d at 811–12.

¹⁵⁹ 473 A.2d 805 (Del. 1984).

¹⁶⁰ *Id.* at 816–17.

¹⁶¹ Thomas & Martin, *supra* note 43, at 578.

¹⁶² See Telman, *supra* note 50, at 831–32 (illustrating courts’ deference to decisions made by corporate directors “as long as: (1) a business decision was made, (2) in good faith, (3) after the director reasonably informed herself, and (4) the director had no financial interest in the decision at issue”).

¹⁶³ See Simmons, *supra* note 17, at 311 (explaining that free market competition between corporations for highly competent managerial talent can be so aggressive that “the board’s primary concern . . . is securing the top candidate” and, as a result, the compensation decision “is most likely a secondary concern” and is “generally protected under the business judgment rule”).

¹⁶⁴ 746 A.2d 244 (Del. 2000).

¹⁶⁵ *Id.* at 263 (internal quotation marks and brackets omitted).

¹⁶⁶ *Id.* at 264.

¹⁶⁷ *Id.* In *re Walt Disney* supports the position that this “process” evaluation does not afford much protection to shareholders. Jennifer S. Martin, *supra* note 8, at 494. For further discussion of the case, see *infra* Part III.E.

¹⁶⁸ 14 A.3d 36 (N.J. 2011).

no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.”¹⁶⁹ The court repeatedly referred to the idea that for a compensation package to be classified as waste, it had to be totally without value to the corporation and essentially equivalent to a gift.¹⁷⁰ The court further pointed to other decisions in which both New Jersey and Delaware courts had decided that to establish waste, a plaintiff had to show that “an expense served absolutely no corporate benefit whatsoever.”¹⁷¹ An earlier opinion from Delaware stated: “The standard for a waste claim is high and the test is ‘extreme [and] very rarely satisfied by a shareholder plaintiff.’”¹⁷² As an example of how difficult this standard can be to meet, in *Seidman*, the court held that even though the directors that had testified could not explain their actions, and even though they awarded themselves the maximum amount available, they were still not liable for waste.¹⁷³ Specifically, the court stated that although the plans appeared unreasonable to the plaintiffs, there was a basis for them and they were “not so far outside the norm as to require this Court to step in and modify them.”¹⁷⁴ Ultimately, the position was upheld that a court had to be persuaded “that no person of sound business judgment would have found that the benefits conferred were completely unreasonable based on the services performed.”¹⁷⁵ Essentially, where the payment was made in a rational attempt to acquire or keep a talented executive, there would be no waste.¹⁷⁶ This is clearly a very high hurdle. The U.S. Senate has even pointed out in similar settings that “the standard of corporate waste was unduly restrictive.”¹⁷⁷

Scholars have commented that going back over a century, courts have almost never overturned board decisions regarding executive compensation¹⁷⁸ even though there would have been some advantages to doing so. For example, while the business judgment rule should be used “when the prospect of litigation genuinely threatens the wellbeing of the corporation,” it sometimes effectively “prevents shareholder derivative

¹⁶⁹ *Id.* at 43 (internal quotation marks and brackets omitted).

¹⁷⁰ *Id.*

¹⁷¹ *Id.* at 44.

¹⁷² In re 3Com Corp. Shareholders Litig., No. C.A. 16721, 1999 WL 1009210, at *4 (Del. Ch. Oct. 25, 1999) (citation omitted).

¹⁷³ See *Seidman*, 14 A.3d at 44, 56 (holding that a factual finding that “the [d]irectors who testified . . . lacked a certain amount of sophistication and ability to explain their actions” was insufficient to prove that the contested compensation packages amounted to corporate waste).

¹⁷⁴ *Id.*

¹⁷⁵ *Id.* at 45 (emphasis omitted).

¹⁷⁶ Jennifer S. Martin, *supra* note 8, at 499.

¹⁷⁷ *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*, 528 F. Supp. 1038, 1046 (S.D.N.Y. 1981) (internal quotation marks and brackets omitted) (quoting S. REP. NO. 91-184, at 5 (1970), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4901).

¹⁷⁸ Telman, *supra* note 50, at 872.

suits from serving their purpose as a check on management.”¹⁷⁹ Furthermore, when there are conflicts between a board of directors and managers, even though legally the board should always prevail, practically it often does so only in response to outside pressures like shareholder derivative suits.¹⁸⁰ Finally, the facts that litigation is expensive and that shareholder derivative litigation is especially expensive¹⁸¹ should be used to tailor any such litigation to maximize its benefits rather than eliminate it altogether.

III. CORPORATE 36(B): A NEW PROPOSAL TO LIMIT EXECUTIVE COMPENSATION

A. *Adopting the Lessons from the Investment Company Act to Fashion a Remedy for Executive Compensation*

When the question is asked of who decides corporate questions, there is no doubt that the answer should be the “the board of directors.”¹⁸² Nevertheless, that does not mean that shareholders should never be able to influence decisions. Bebchuk and Fried point out that “[i]ndependence, even coupled with incentive schemes, cannot secure shareholder interests unless there is some mechanism at the end of the chain that makes the designers of incentive schemes . . . accountable to shareholders,”¹⁸³ and “the most effective way to improve board performance is to increase the power of shareholders vis-à-vis directors.”¹⁸⁴ Fortunately, there is already a mechanism that would begin to accomplish this goal without disruptive changes and that has been tested for over three decades. Section 36(b) of the ICA as amended in 1970¹⁸⁵ could provide a key tool in addressing the issue of executive compensation.

Congress should adopt legislation regarding executive compensation packages in public corporations that is similar to and incorporates the court decisions dealing with Section 36(b) of the ICA as amended. As mentioned, this new legislation would be referred to as Corporate 36(b). The proposed language—with alterations incorporating my proposal—reads as follows:

The [CEO and top five officers]¹⁸⁶ of a [publicly traded corporation] shall be deemed to have a fiduciary duty with

¹⁷⁹ *Id.* at 865.

¹⁸⁰ *Id.* at 856.

¹⁸¹ *Id.* at 866.

¹⁸² Bainbridge, *supra* note 54, at 1619.

¹⁸³ BEBCHUK & FRIED, *supra* note 7, at 206.

¹⁸⁴ *Id.* at 207.

¹⁸⁵ 15 U.S.C. § 80a-35(b) (2006).

¹⁸⁶ This can be determined by who earns the five highest salaries at any given corporation.

respect to the receipt of compensation for services, or of payments of a material nature, paid by such [corporation], or by the security holders thereof, to such [CEO or officers] or any affiliated person of such [CEO or officers]. An action may be brought under this subsection by the Commission, or by a security holder of such [corporation] on behalf of such [corporation], against such [CEO or officer], or any affiliated person of such [CEO or officer], or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such [corporation] or by the security holders thereof to such [CEO or officer] or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such [corporation] of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such [corporation], shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such [corporation], or the security holders thereof, by such recipient.¹⁸⁷

The purposes behind the ICA can be useful to see how they fit with the

¹⁸⁷ Investment Company Act, 15 U.S.C. § 80a-35(b) (2006).

context of public corporation executive compensation. These purposes were discussed in the legislative history of the ICA:

1. What *is* intended: (a) That the investment adviser is entitled to make a profit.

2. What is *not* intended: (a) That a cost-plus type of contract is required[;] (b) That general concepts of rate regulation as applies to public utilities are to be introduced[;] (c) That the standard of “corporate waste” is to be applied[;] (d) That management fees should be tested on whether they are “reasonable”[;] (e) That a congressional finding has been made that the present industry level or that the fee of any particular adviser is too high[;] (f) That the Court is authorized to substitute its business judgment for that of the directors[;] (g) That the responsibility for management is to be shifted from directors to the judiciary[;] (h) That economies of scale are necessarily applicable at every stage of growth of the Fund.

3. The test of fairness is *to be made* by the Court, in part: (a) By reference to industry practice[;] (b) By reference to industry level of management fees.

4. The Court shall determine *whether*[;] (c) The attention of directors was fixed on their responsibilities[;] (d) The directors requested and obtained information reasonably necessary to evaluate the terms of the management contract[;] (e) The directors having the primary responsibility for looking after the best interests of the Fund’s shareholders, have evaluated such information accordingly.¹⁸⁸

In sum, “Section 36(b) represents a political compromise of a highly emotional nature which eschews rate regulation for personal services but nonetheless caps compensation at market acceptability accompanied by good faith and fair disclosure of that range.”¹⁸⁹

A unanimous Supreme Court upheld the validity of this application of the ICA as it relates to executive compensation of mutual fund advisors.¹⁹⁰ Scholars have suggested that to affect executive compensation, either the federal government or states should act to empower shareholders to take action when necessary.¹⁹¹ This proposed legislation would accomplish that

¹⁸⁸ *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*, 528 F. Supp. 1038, 1422, (S.D.N.Y. 1981), *aff’d*, 694 F.2d 923 (2d Cir. 1982).

¹⁸⁹ *Id.*

¹⁹⁰ *Jones v. Harris Assocs.*, 130 S. Ct. 1418, 1430 (2010).

¹⁹¹ *See* Jennifer S. Martin, *supra* note 8, at 534.

objective while guarding against the dangers of illegitimate strike suits and other dangers arising from the self-interests of the parties involved.

In addition to the pre-existing requirement that a board be independent, Section 36(b) provides an extra requirement to ensure that boards will conduct arm's-length bargaining, namely the obligation that an "investment advisor assume the status of a fiduciary of the fund and its investors with respect to compensation received for its services."¹⁹² Nonetheless, the burden established by Section 36(b) and the cases interpreting it is not very high when one considers the fact that since the law was implemented in 1970, there have been over one hundred cases claiming a breach of the fiduciary duty but not a single plaintiff has won; thus, no court has ever held that a mutual fund advisor has breached his fiduciary duty.¹⁹³ This does not mean, however, that Section 36(b) serves no purpose. The existence of the possible litigation could prevent truly egregious instances from occurring. The law could also help directors keep investment advisor wages down by giving them an argument during negotiations.

Scholars have previously suggested that there would be benefits in applying fiduciary duties to compensation package analysis, but through the Delaware state court system.¹⁹⁴ While I think that this suggestion is laudable, it is inferior to my proposal for two reasons. First, due to the increased public pressure on the federal government to act, Delaware is unlikely to make a substantial change quickly enough to preempt federal intervention. Given Delaware's reluctance to ultimately hold executives or corporations accountable in compensation cases, the trend on the part of the State's courts to move more in the direction of imposing these types of fiduciary duties is unlikely to prove sufficient. Second, even if Delaware courts did impose this kind of obligation, that would still not account for the majority of corporations in the country. While Delaware is significantly more likely than any other state to serve as the place of incorporation, a lot of companies are not incorporated there.

B. *The Parallels Between Investment Advisers and CEOs*

There are differences between a general corporation and a mutual fund, and one could argue that the relationship between an investment company and its fund manager, as opposed to that between a corporation and its executive, is different.¹⁹⁵ When discussing the relationship between a

¹⁹² M. Todd Henderson, *Justifying Jones*, 77 U. CHI. L. REV. 1027, 1033 (2010).

¹⁹³ *Id.*

¹⁹⁴ See Thomas & Wells, *supra* note 20, at 849–50 ("With Delaware's new emphasis on officers' fiduciary duties, courts can and should assume such a role [of imposing heightened scrutiny on executive pay] again.").

¹⁹⁵ As the Supreme Court observed:

mutual fund and its investment adviser, one court has stated: “[T]he fund often cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm’s-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.”¹⁹⁶ The investment adviser context is, however, not the only type of relationship in which arm’s-length bargaining can break down.¹⁹⁷ Judge Easterbrook of the Seventh Circuit Court of Appeals has argued: “Things work the same way for business corporations, which though not trusts are managed by persons who owe fiduciary duties of loyalty to investors Publicly traded corporations use the same basic procedures as mutual funds: a committee of independent directors sets the top managers’ compensation.”¹⁹⁸ Furthermore, the Supreme Court has recognized the similarities between investment companies and corporations. Specifically, with respect to their shared origins, the Court emphasized that investment companies and corporations alike are incorporated under state rather than federal law.¹⁹⁹

The ICA was created to protect shareholders from significant conflicts of interest.²⁰⁰ Some of these protections increased the similarities between a mutual fund and a corporation. For example, one of the ways in which the ICA attempts to achieve its goal is through the requirement that “no more than 60 percent of a fund’s directors could be affiliated with the adviser.”²⁰¹ Publicly traded corporations have a similar requirement for director independence.²⁰² Section 36(b) in the ICA was originally drafted because of public concern regarding fees charged in a specific type of investment fund and was applied to other types of funds²⁰³ due to the

Unlike most corporations, an investment company is typically created and managed by a pre-existing external organization known as an investment adviser. Because the adviser generally supervises the daily operation of the fund and often selects affiliated persons to serve on the company’s board of directors, the relationship between investment advisers and mutual funds is fraught with potential conflicts of interest.

Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 536 (1984) (citations omitted) (internal quotation marks omitted).

¹⁹⁶ Jones v. Harris Assocs., 130 S. Ct. 1418, 1422 (2010) (internal quotation marks omitted).

¹⁹⁷ See *supra* Part II.A.

¹⁹⁸ Jones v. Harris Assocs., 527 F.3d 627, 632–33 (7th Cir. 2008), *vacated*, 130 S. Ct. 1418 (2010).

¹⁹⁹ Burks v. Lasker, 441 U.S. 471, 478 (1979).

²⁰⁰ Jones, 130 S. Ct. at 1422.

²⁰¹ *Id.*

²⁰² NEW YORK STOCK EXCHANGE, CORPORATE GOVERNANCE RULES 4 (2003), *available at* <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>.

²⁰³ The two different types of funds are the closed-ended and open-ended fund. The Seventh Circuit Court of Appeals described the difference:

similar possibility of abuse of the fiduciary relationship in matters of fees.²⁰⁴ This same potential for abuse exists in public corporations. Therefore, even though there are important distinctions between typical corporations and mutual funds,²⁰⁵ the similarities when it comes to matters of compensation are striking.

If we focus on the problem—i.e., potential excessive compensation caused by conflicts of interest as opposed to the distinctions in the forms of the entities—it is easy to recognize the similarities. Experts commonly accept that the concern regarding conflicts of interest in the mutual fund industry is what led Congress to the “large-scale federalization” of that industry in 1940.²⁰⁶ The basic conflict at issue in both public corporate settings and investment fund adviser settings is a conflict between those wishing to sell at the highest price (here, employees wanting high compensation) and those wishing to buy at the lowest price (here, employers wanting to keep pay low). This conflict is usually settled in a “market economy by ensuring that competition prevails.”²⁰⁷ As previously mentioned, however, this approach may not work optimally in the executive compensation setting.²⁰⁸ In the ICA context, the Supreme Court pointed out that “Congress added § 36(b) to the [Act] in 1970 because it concluded that the shareholders should not have to rely *solely* on the fund’s directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of the board.”²⁰⁹ The intention behind the provision was to correct a market failure, and a similar instrument could fulfill that function for CEOs.

When Congress originally passed Section 36(b) of the ICA, it was not

A closed-end investment company, unlike a traditional open-end mutual fund, has fixed capitalization and may sell only the number of shares of its own stock as originally authorized. It does not redeem its securities at the option of the shareholder. Shares of a closed-end fund are traded on a secondary market; that is, its stock, like that of any publicly owned corporation, is usually listed on a national exchange. The most pertinent difference between open- and closed-end investment companies is that closed-end funds are authorized under the ICA to use leverage to increase the stream of current income through the sale of preferred stock so long as there is 200% asset coverage for these securities.

Green v. Nuveen Advisory Corp., 295 F.3d 738, 740 n.1 (7th Cir. 2002).

²⁰⁴ *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*, 694 F.2d 923, 930 (2d Cir. 1982) *superseded in part by statute*, 59 Fed. Reg. 52,689, 52,691 (Oct. 19, 1994) (requiring separate categorization of management fees, distribution fees, and other fees).

²⁰⁵ *See Langevoort*, *supra* note 139, at 1031 (discussing the differences between mutual funds and corporations).

²⁰⁶ *Id.* at 1020.

²⁰⁷ John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 158–59 (2007).

²⁰⁸ *See supra* Part II.A.

²⁰⁹ *Jones v. Harris Assocs.*, 130 S. Ct. 1418, 1428 (2010) (alteration in original) (emphasis added).

trying to “fundamentally revise the system itself,” but rather to “diminish the risk of adviser self-dealing.”²¹⁰ Congress was attempting to provide a federal remedy that was significantly narrower than common law fiduciary duty doctrines.²¹¹ In the 1970s, a study commissioned by the SEC identified problems with the independence of investment company boards and the compensation being paid to advisers.²¹² In an attempt to correct these perceived problems, Congress amended the ICA, primarily by adding two shareholder protections.²¹³ The first attempted to require more independence from the directors and impose additional responsibilities upon them.²¹⁴ Some of these additional responsibilities include an annual review of advisers’ compensation and require that a majority of the directors must approve of the compensation.²¹⁵ The second amendment designed to protect shareholders was a requirement that advisers be subject to a “fiduciary duty” in relation to their compensation and gave individual investors a right of action in case of breach of that duty.²¹⁶ Similar to public corporations today, before the 1970 amendments, shareholders in investment companies had a very limited set of options: “[S]hareholders challenging investment adviser fees under state law were required to meet common-law standards of corporate waste, under which an unreasonable or unfair fee might be approved unless the court deemed it ‘unconscionable’ or ‘shocking.’”²¹⁷ To address the problems surrounding investment advisers, Congress had to craft a delicate compromise between the SEC’s proposal that shareholders be empowered to bring actions against fees they deemed “unreasonable” and the industry’s fear that this type of statute would effectively give the commission ratemaking authority.²¹⁸ The Supreme Court pointed out that the final “fiduciary duty” standard enacted was somewhere in between the two; it was more favorable than the previous remedies for the shareholders (i.e., waste-based litigation), but it did not permit courts to determine if a rate was “reasonable.”²¹⁹

In *Jones v. Harris Associates*,²²⁰ the Supreme Court explained that something of a consensus had developed over the previous twenty-five years between the SEC, many federal courts, and scholarly commentators, all who supported the analysis in *Gartenberg v. Merrill Lynch Asset*

²¹⁰ *Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 743 (7th Cir. 2002).

²¹¹ *Id.*

²¹² *Jones*, 130 S. Ct. at 1422.

²¹³ *Id.* at 1423.

²¹⁴ *Id.*

²¹⁵ 15 U.S.C. §§ 80a-15(a), (c) (2006).

²¹⁶ 15 U.S.C. § 80a-35(b).

²¹⁷ *Jones*, 130 S. Ct. at 1423 (internal quotation marks omitted).

²¹⁸ *Id.*

²¹⁹ *Id.*

²²⁰ 130 S. Ct. 1418 (2010).

*Management, Inc.*²²¹ The previous decisions pointed out that Congress had not made it clear what was meant by “fiduciary duty,” but they still established a basic test to be employed in the determination. The Court stated: “[T]he test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s-length in the light of all of the surrounding circumstances.”²²² The Second Circuit continued by explaining that to be guilty of violating this provision, “the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining”²²³ and that when courts made this determination, all pertinent factors had to be taken into account.²²⁴ The Court pointed out in other contexts how fiduciary duty principles are appropriately used across different sets of circumstances.²²⁵ Whether it is in a bankruptcy proceeding, investment advisor compensation context, or as I propose in a public corporation executive compensation situation, the standard should be the same. As the Court stated, “The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm’s length bargain. If it does not, equity will set it aside.”²²⁶ It should be noted that some commentators have argued that an arm’s-length bargain is a theoretical construct made impossible in practice by frictions like contracting and transaction costs, and that such a bargain is therefore an inappropriate benchmark.²²⁷ One could, however, have an “optimal” or “efficient” contract that maximizes the net expected value after transaction costs or “frictions” are taken into account.²²⁸ Using these criteria, some defend the current U.S. corporate structure as possibly the best in light of various costs, including those imposed by the U.S. legal and regulatory system.²²⁹ Nonetheless, this does not preclude the possibility that the system could be made more efficient with changes to the legal or regulatory structure.²³⁰

²²¹ *Id.* at 1425; *see also* *Jones v. Harris*, 537 F.3d 728, 729–30 (7th Cir. 2008) (Posner, J., dissenting) (noting a “slew of positive citations” to *Gartenberg*).

²²² *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*, 694 F.2d 923, 928 (2d Cir. 1982); *see also* *Jones*, 130 S. Ct. at 1426 (agreeing with *Gartenberg*’s interpretation of “fiduciary duty” under § 36(b)).

²²³ *Gartenberg*, 694 F.2d at 928.

²²⁴ *Id.* at 929.

²²⁵ *See Jones*, 130 S. Ct. at 1427 (explaining how fiduciary duty principles apply in bankruptcy and trusts).

²²⁶ *Id.* (emphasis omitted) (quoting *Pepper v. Litton*, 308 U.S. 295, 306–07 (1939)).

²²⁷ Core et al., *supra* note 92, at 1159.

²²⁸ *Id.* at 1160.

²²⁹ *See id.* at 1161 (“U.S. corporate governance may in fact be extremely good given the existence of information costs, transactions costs, and the existing U.S. legal and regulatory system.”).

²³⁰ *Id.*

C. *Corporate 36(b) and Applying the Gartenberg Standard to Corporations*

The ICA was clarified in 1982 in *Gartenberg*, whose reasoning was then upheld by the Supreme Court in *Jones*. Many of the factors that the *Gartenberg* court held should be applied to investment fund advisers²³¹ can be directly applied to all public corporations. For example, factors that should be taken into account include the nature and quality of the services provided, comparative fee structures of other executives, and the independence, expertise, care, and conscientiousness of the board in evaluating adviser compensation. The *Gartenberg* court made it clear that, in accordance with the legislative history of the ICA, the “fiduciary duty” obligation is not to be equated with an evaluation of the “reasonableness” of the fee.²³² In fact, the *Gartenberg* court pointed out that the Senate report explicitly stated that the court is not authorized “to substitute its business judgment for that of a mutual fund’s board of directors in the area of management fees.”²³³ The shift from demanding “reasonable” behavior to imposing a “fiduciary duty” seems to have been relatively small, with the main distinction being a focus on the conduct of the investment adviser as opposed to that of the fund directors, which resulted in the ultimate test of “whether the fee schedule represents a charge within the range of what would have been negotiated at arm’s-length in the light of all the surrounding circumstances.”²³⁴ In the analogous situation of a public corporation, that would mean an increased focus on the executive who is to receive the compensation, as well as on the board that is giving it to him. Most litigation to date has focused on the breach of duty by the board; the occasional claims that have been brought against the executive have been even more expeditiously dismissed than the ill-fated suits against the board.²³⁵

Finally, the *Jones* Court asserted that in evaluating a board’s determination of an executive compensation award, a court needs to consider both procedural and substantive considerations.²³⁶ The Court went on to say, “[w]here a board’s process for negotiating and reviewing

²³¹ These factors include: (1) the nature and quality of the services provided to the fund and shareholders; (2) the profitability of the fund to the adviser; (3) any “fall-out financial benefits,”—those collateral benefits that accrue to the adviser because of her relationship with the mutual fund; (4) comparative fee structure (meaning a comparison of the fees with those paid by similar funds); and (5) the independence, expertise, care, and conscientiousness of the board in evaluating adviser compensation. *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*, 694 F.2d 923, 929–32 (2d Cir. 1982); see also *Jones v. Harris Assocs.*, 130 S. Ct. 1418, 1426 (2010) (citing three of the *Gartenberg* factors).

²³² *Gartenberg*, 694 F.2d at 928.

²³³ *Id.*

²³⁴ *Id.*

²³⁵ See *infra* Part III.E.

²³⁶ *Jones*, 130 S. Ct. at 1429.

investment-adviser compensation is robust, a reviewing court should afford commensurate deference to the outcome of the bargaining process.”²³⁷ This is not to say that a well-deliberated compensation plan is automatically acceptable. As the Court indicated, even a board in possession of all the relevant information may award an excessive fee, “but such a determination must be based on evidence that the fee is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm’s-length bargaining.”²³⁸ The “‘so disproportionately large’ standard reflects this congressional choice to rely largely upon independent director ‘watchdogs’ to protect shareholders interests.”²³⁹ Thus, there is still supposed to be a recognition that the board of directors is responsible for the decisions of the corporation and that shareholders are only able to step in via the courts when the board is clearly not doing its job. On the other hand, if the procedures used by the board were deficient or if significant pieces of information were withheld, then the court should look more thoroughly at the results.²⁴⁰ This establishes a sliding scale where the more thorough a decision is, the more credibility it is given, while an evaluation of the substance of the decision still takes place. This evaluation is intended to take into account all of the pertinent information,²⁴¹ even if the information itself is flawed. For example, as I alluded to previously, one of the problems with recent attempts to lower executive compensation is the issue of ratcheting up salaries.²⁴² This can make using other corporations as examples in the context of appropriate salaries a less-than-trustworthy measure. The Second Circuit indicated a similar problem in the investment fund industry when it explained that using other compensation plans as benchmarks may not be helpful due to the fact that competition could be virtually nonexistent.²⁴³ Given the ratcheting effect, while more competition may exist for public corporations than in the investment management field, prices below the ever-increasing norm may equally be near non-existent. It should be noted, however, that even with such an acknowledged limitation, the *Gartenberg* court did specify that this factor can still be “taken into account.”²⁴⁴

With this totality-of-the-circumstances approach, it may seem that there are few rigid guidelines, which is true and a benefit of the proposal, but there are some clear rules. For example, the Court has specified that

²³⁷ *Id.*

²³⁸ *Id.* at 1429–30 (internal quotation marks omitted).

²³⁹ *Id.* at 1430 (citation omitted) (internal quotation marks omitted).

²⁴⁰ *Id.*

²⁴¹ *Id.* at 1428.

²⁴² *Id.*

²⁴³ *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*, 694 F.2d 923, 929 (2d Cir. 1982).

²⁴⁴ *Id.*

“[j]udicial price setting does not accompany fiduciary duties”²⁴⁵ and that courts are ill-equipped to make price rate calculations; plus Congress explicitly rejected this possibility when it refused to adopt a “reasonableness” standard.²⁴⁶ Furthermore, it is clear that it would not be necessary to show any attempt to defraud or even allege that a defendant engaged in personal misconduct.²⁴⁷ In fact, it would not even be enough to show that a better bargain may have been possible; rather it must be demonstrated that compensation was paid under an agreement that was “unfair.”²⁴⁸ This standard may lead some to think that the bar is set too low and will result in too many judgments against seemingly innocent defendants, but that has not been the outcome in the investment advisor setting. The *Gartenberg* standard has not been overly burdensome on fund advisers, and the vast majority of litigation in excessive fee cases has been resolved in favor of the defendants, with a few settlements taking place in which the defendants agreed to a reduction in their fee agreements.²⁴⁹ These rules that have been applied to investment fund advisers for over thirty years could be used for public corporations, but to what result? What would be gained from implementing this proposal?

D. *Benefits of Corporate 36(b)*

There are three primary benefits to this proposal: (1) lower initial compensation demands; (2) the empowerment of compensation committees; and (3) the avoidance of possible preemption by the federal government.

Holding CEOs to a fiduciary duty will provide not only remedies but will act as a prophylactic in that it will induce CEOs to request a lower compensation package in the first place.²⁵⁰ In this case, this prophylactic purpose will be achieved in two ways. First, executives will be on notice that they are considered fiduciaries when negotiating their own pay packages and that they will not be able to approach the situation with the sole goal of maximizing their personal salary. Obviously, part of their objective will still be to maximize their compensation, but this will now be accomplished by having pay packages that are essentially beyond reproach, such as to avoid not only the loss of some of the pay itself, but also the cost in time and money of having to go through protracted litigation.

²⁴⁵ *Jones v. Harris Assocs.*, 130 S. Ct. 1418, 1430 (2010) (internal quotation marks omitted).

²⁴⁶ *Id.*

²⁴⁷ *Gartenberg*, 694 F.2d at 930.

²⁴⁸ *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*, 528 F. Supp. 1038, 1047 (S.D.N.Y. 1981).

²⁴⁹ *Jones v. Harris Assocs.*, 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting).

²⁵⁰ “An action for breach of fiduciary duty is a prophylactic rule intended to remove all incentive to breach—not simply to compensate for damages in the event of a breach.” *ABKCO Music, Inc. v. Harrisongs Music, Ltd.*, 722 F.2d 988, 995–96 (2d Cir. 1983).

Therefore, the payment that CEOs will seek will be the one that best balances the cost of potential litigation and the actual pay received. The second way that the initial compensation demand will be lowered is simply due to the increased attention that pay packages will receive. Once the plaintiffs' bar is aware of this new source of work, some attorneys will begin to target it. This means that practiced attorneys and their staffs will constantly be on the lookout for inappropriate pay packages and for corporations whose shareholders they may be able to represent. Given this increased and possibly constant scrutiny, executives will have a strong incentive to request packages that will be unlikely to turn into the source of litigation, justified or otherwise.

The second advantage of this proposal is to give executive compensation committees more leverage to resist if the executives are still requesting exorbitant pay. As things stand now, a committee can point to the "say on pay" measure and the issue of bad press, but there are no significant likely consequences and both sides know it. If it were possible for a lawsuit to be successful, the committee would not only feel encouraged to resist the executives' demands to avoid the suit, but would also have a very plausible argument during negotiations. They could effectively say, "Mr. Smith, we would love to give you two hundred million dollars for three months' work, but doing so would result in a lawsuit under Corporate 36(b)." Therefore, this proposal will not only reinforce the incentives of boards to limit executive compensation, but it will also increase their ability to do so.

The third advantage of this proposal is the decreased possibility of government usurpation. As previously pointed out, the federal government is most likely to intervene in corporate governance issues during times of economic turmoil and scandal.²⁵¹ The last few years have been some of the most tumultuous years for the economy since the Great Depression. It seems likely that the government is going to act, and this proposal allows executive compensation to be addressed in a more effective way while leaving matters in the hands of the boards of directors. If the boards fail, the proposal puts the issue in the hands of the shareholders, who are in the best position to find a tailored solution.

E. Possible Objections to Corporate 36(b)

Like all legislative proposals, Corporate 36(b) is likely to face opposition for a variety of reasons. There are several arguments against involving the courts in the compensation question. Some of them include the claims that courts are ill-suited to evaluate compensation packages, that boards and not courts should be addressing this issue, that it may increase

²⁵¹ See *supra* Part I.

shareholder litigation,²⁵² and that it may jeopardize federalism. First, I will address the federalism concern, which amounts to the argument that corporate law should be left to the states and that the federal government should not interfere. Second, I will examine the objection concerning strike or nuisance suits, i.e., that legislation will open the door for massive amounts of litigation solely aimed at extorting sums of money from corporations. Finally, I will respond to the criticism that boards and not courts should be answering these questions.

Many scholars and commentators believe that state competition has helped to maximize the value of American corporations and that because any federal intervention will not have a competitive component, it is undesirable.²⁵³ General incorporation statutes have existed since at least 1811, but before the twentieth century there was no federal corporate law; rather, all corporate law was local.²⁵⁴ Historically, a belief dominated that market forces would be a more effective driver of corporate behavior than legislative intervention and that the desire for corporate charters would motivate states to implement optimal laws, which would not occur in the federal legislative process.²⁵⁵ The argument is that we want states to fashion laws between which corporations and shareholders can choose. This position has both supporters and detractors. The supporters argue that this decentralization will promote a race to the top in which states will produce the best laws to attract companies for incorporation, while detractors believe that it will cause a race to the bottom because states will pander to executives who choose where to incorporate.²⁵⁶ These theories rely on the premise that states compete for corporate charters and that the only key difference is the direction of the race. Other scholars have argued, however, that the competition is basically over, which they support by the observation that of the companies that incorporate outside their home state, eighty-five percent do so in Delaware.²⁵⁷ Early commentators trusted the benefits of state corporate law in part based upon the premise that states would be innovative in their laws, and thus the best solutions would result when corporations would choose from among them.²⁵⁸ It appears, however, that little innovation occurs because most states have

²⁵² Jennifer S. Martin, *supra* note 8, at 539 (citation omitted).

²⁵³ See Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 561–62 (2002) (discussing how state competition has worked to benefit shareholders).

²⁵⁴ Jack B. Jacobs, *The Reach of State Corporate Law Beyond State Borders: Reflections upon Federalism*, 84 N.Y.U. L. REV. 1149, 1151–52 (2009).

²⁵⁵ Langevoort, *supra* note 139, at 1030.

²⁵⁶ See Roe, *supra* note 19, at 593 (discussing both the benefits and drawbacks of having states enact varying laws).

²⁵⁷ Bebchuk & Hamdani, *supra* note 253, at 555–56.

²⁵⁸ *Id.* at 605.

similar laws, with possibly only Delaware serving as an exception.²⁵⁹

After the market crash of 1929, there was recognition of the impact that corporations could have on the entire country and of the possible need for federal regulation, a sentiment that resulted in the 1933 Securities Act and 1934 Securities Exchange Act.²⁶⁰ These laws marked the beginning of federal regulation of corporations,²⁶¹ a trend whose final point is yet to be seen. It may be true that there is officially no federal corporate law, but there is clearly a vast amount of federal law both targeted at and affecting corporations, ranging from insider trading laws to disclosure laws and to regulations regarding accounting.²⁶² In some ways, the federal government already partially controls executive compensation; for example, under the Sarbanes-Oxley Act, particular executive bonuses are subject to forfeiture under some circumstances.²⁶³ Therefore, regardless of whether one thinks that government control is a welcome trend, the fact remains that federal usurpation of significant aspects of corporate control has already occurred in areas such as securities trading, proxy statement and solicitation, and various types of fiduciary duty breaches prosecuted frequently as part of 10b-5 fraud claims.²⁶⁴

Even if it was an incontrovertible fact that states need not maintain authority in this domain because they do not truly compete, and even though the federal government already controls large sections of corporate governance, further encroachment by the federal government into state corporate law remains unjustified. The Supreme Court recognized the desirability of limiting federal intrusion on state law in the area of mutual funds and deferred to state law when the ICA did not specifically address a litigated question.²⁶⁵ The Supreme Court has also stated that “[c]orporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.”²⁶⁶ My proposal tries to minimize the intrusion of the federal government into state corporate law and to maintain as much control in the hands of corporations and individual states as possible.

The second objection I will address is the claim that this proposal will cause a surge in nuisance lawsuits, to the detriment of both corporations

²⁵⁹ *Id.* at 606.

²⁶⁰ Jacobs, *supra* note 254, at 1153.

²⁶¹ *Id.*

²⁶² See Simmons, *supra* note 17, at 328 (providing examples of several federal laws and how they affect corporations).

²⁶³ Roe, *supra* note 19, at 633.

²⁶⁴ *Id.* at 614.

²⁶⁵ Langevoort, *supra* note 139, at 1026.

²⁶⁶ Cort v. Ash, 422 U.S. 66, 84 (1975).

and the judicial system. There are several mechanisms in place to limit this possibility. Significantly, the original ICA modifies the traditional formulation of the fiduciary duty such as to require that the plaintiff bear the burden of proving that “the fee is outside the range that arm’s-length bargain would produce.”²⁶⁷ This will help to limit the number of strike suits. Further mechanisms that reduce the number are courts’ explicit insistence that all factors be taken into account (including all relevant circumstances of the board’s review), and the use of benchmarking from other executive compensation packages.²⁶⁸ At the same time, the Court recognized the difficulty of using comparable executive compensation plans when it said: “By the same token, courts should not rely too heavily on comparisons with fees charged to mutual funds by other advisers. These comparisons are problematic because these fees, like those challenged, may not be the product of negotiations conducted at arm’s length.”²⁶⁹ Additionally, the Supreme Court has made it clear that differences in compensation packages alone are insufficient reasons for the launch of litigation.²⁷⁰

A further disincentive against strike suits is the cap on damages to one year of an executive’s salary.²⁷¹ In fact, given the limitations of the lawsuit, one could argue that the damages of a possible lawsuit are unlikely to act as a deterrent.²⁷² In this setting, however, the monetary payout is just one and possibly the smaller of the true deterrent effects because not only is the litigation process unpleasant and to be avoided, but reputational harms to both the directors and CEOs are potentially much greater than any monetary award. The intended result is that threatening reputational damage increases the potential impact on executives without producing an equal increase of the incentives for strike suit plaintiffs. The harm to the reputation only results if the case is successful. Meanwhile, in a typical strike suit, the way that a corporation calculates whether to settle takes into account the harm from the process itself. A nuisance plaintiff could calculate that there is a ten percent chance of prevailing and winning a judgment of \$1,000,000, and the litigation will cost the corporation \$50,000 to defend whether it wins or loses. Therefore, the suit is worth

²⁶⁷ *Jones v. Harris Assocs.*, 130 S. Ct. 1418, 1427 (2010).

²⁶⁸ *Id.*

²⁶⁹ *Id.* at 1429.

²⁷⁰ *Id.* at 1429 n.8 (“Comparisons with fees charged to institutional clients, therefore, will not doom any fund to trial. First, plaintiffs bear the burden in showing that fees are beyond the range of arm’s-length bargaining. Second, a showing of relevance requires courts to assess any disparity in fees in light of the different markets for advisory services. Only where plaintiffs have shown a large disparity in fees that cannot be explained by the different services in addition to other evidence that the fee is outside the arm’s-length range will trial be appropriate.” (citations omitted) (internal quotation marks and brackets omitted)).

²⁷¹ 15 U.S.C. § 80a-35(b)(3) (2006).

²⁷² Henderson, *supra* note 192, at 1046.

\$150,000 (ten percent of a million + \$50,000). If the nuisance plaintiff offers a settlement for less than \$150,000, there are strong incentives for the corporation to settle. Given that we are looking for legal solutions that benefit corporations, a law in this situation is only efficient if it benefits the corporation by more than \$150,000. Or, in other words, the value of the law has to be above \$150,000; otherwise, that law is inefficient and would better be replaced with a different one. In the case of Corporate 36(b), the defense against a nuisance lawsuit still costs \$50,000, but the cost of losing is low due to the damages cap of one year's salary combined with the extremely low likelihood of prevailing (approaching zero) for a true nuisance lawsuit. Given these facts, the value of the suit is close to \$50,000. Nevertheless, the value of the reputation of the directors and CEOs is potentially very large to them, but it is not a value on which a nuisance plaintiff can capitalize as it only kicks in if he wins, which will not take place. Hence, the value of a lawsuit under Corporate 36(b) is low for socially undesirable lawsuits (i.e., \$50,000 for nuisance suits) but potentially very large for socially desirable lawsuits where plaintiffs have legitimate claims. This all makes Corporate 36(b) a valuable and efficient law.

The possibility of nuisance suits or strike suits was actually considered by the legislature in connection with the original ICA; at one point, to further discourage these types of suits, lawmakers even considered raising the standard of proof that a plaintiff would need to meet a requirement of "clear and convincing" evidence.²⁷³ Ultimately, the legislature determined this to be unnecessary, possibly because the standard for application of Section 36(b) is quite high. It is almost as high as requiring the existence of "waste," and in fact some commentators have equated the two even though Congress specified that the standard in Section 36(b) was supposed to be lower.²⁷⁴ Although no facts have yet resulted in liability for market fund investment advisers,²⁷⁵ the success of Section 36(b) may lie in the fact that the lingering possibility of a lawsuit reduces the starting point of the still very large pay packages of investment advisers. Finally, although the cost of defending against litigation can be high,²⁷⁶ there is no evidence about how high or how much cost may be saved by encouraging lower pay packages in the first place. It is difficult to put a price on the avoidance of litigation, but it appears that the benefits from the ICA of reducing investment adviser compensation outweigh that cost.

The final objection that I want to address is the claim that executive compensation decisions should not be made by the court, but rather by the

²⁷³ *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 528 F. Supp. 1038, 1044 n.6 (S.D.N.Y. 1981).

²⁷⁴ *Langevoort*, *supra* note 139, at 1024.

²⁷⁵ *Henderson*, *supra* note 192, at 1038.

²⁷⁶ *See id.* at 1041 (citing the high cost of defending the suit in *Jones*).

boards of directors. One reason for not wanting courts to conduct this type of evaluation is the complexity of the compensation negotiation, which can easily involve more than half a dozen different types of benefits, ranging from a base cash salary to jets and charitable donations.²⁷⁷ Standing alone, the existence of complexity is not a very compelling argument since, as I pointed out previously, courts often deal with similarly complex issues in other contexts.²⁷⁸ A better argument against courts making this determination was given by Judge Easterbrook when he said that salary, bonus, and stock options are:

[C]onstrained by competition in several markets—firms that pay too much to managers have trouble raising money, because net profits available for distribution to investors are lower, and these firms also suffer in product markets because they must charge more and consumers turn elsewhere. Competitive processes are imperfect but remain superior to a “just price” system administered by the judiciary. However weak competition may be at weeding out errors, the judicial process is worse—for judges can’t be turned out of office or have their salaries cut if they display poor business judgment.²⁷⁹

Judge Posner responded to this point when he stated that Judge Easterbrook’s “economic analysis . . . is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation.”²⁸⁰

While addressing Judge Easterbrook’s objection, Judge Posner’s response does not fully answer the criticism that we prefer for boards to make these determinations and that effectively “the power to review is the power to decide. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B.”²⁸¹ The argument about boards amounts to saying that we actually want the authority to remain with A. I agree that the board should be making determinations within a corporation, and for this reason my proposal is severely restricted and only the most egregious situations would be reviewed. The goal of the original ICA and of this proposal is for the directors to control conflicts of interest.²⁸² Congress wanted the directors

²⁷⁷ Simmons, *supra* note 17, at 312.

²⁷⁸ See *supra* Part III.B.

²⁷⁹ Jones v. Harris Assocs., 527 F.3d 627, 633 (7th Cir. 2008).

²⁸⁰ Jones v. Harris Assocs., 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting).

²⁸¹ Bainbridge, *supra* note 54, at 1650 (internal quotation marks omitted).

²⁸² Jones v. Harris Assocs., 130 S. Ct. 1418, 1427 (2010).

to work as “independent watchdogs” in the contentious relationship between investment advisers and their employers.²⁸³ In light of this, Section 36(b) specifically instructed courts to give board approval of an adviser’s compensation “such consideration . . . as is deemed appropriate under all the circumstances.”²⁸⁴ The two mechanisms for controlling this conflict were meant to be both independent and mutually reinforcing.²⁸⁵ This proposal has the same goal.

By allowing shareholders to have the right to file a federal lawsuit, both the incentive and ability of directors to maintain this “watchdog” status will be strengthened. The possibility of suits will result in more attention and immediate action when compensation packages are particularly egregious. This will cause board members to be even more mindful of their duties. Furthermore, by having the ability to tell the executive that they cannot approve a compensation package because they could be sued will give board members more leverage in negotiations. Corporate 36(b) recognizes the tension between assisting the board with the fulfillment of its duties and removing authority from it. The Supreme Court in *Jones* agreed with the Second Circuit’s view in *Gartenberg* of the importance of the board’s role when the Court stated that “the expertise of the independent trustees of a fund, whether they are fully informed about all facts bearing on the [investment adviser’s] service and fee, and the extent of care and conscientiousness with which they perform their duties” should all be considered when determining whether the trustees and the adviser breached their fiduciary duties under Section 36(b).²⁸⁶ This same analysis would apply under my Corporate 36(b) proposal. Corporate 36(b) intends for the board of a public corporation to act as a “watchdog” to ensure that the amount of compensation paid to executives is appropriate and properly balances an executive’s desire to maximize his income with a corporation’s desire to minimize its expenses.

After having pointed out the benefits of this proposal in the previous section and addressing foreseen criticisms in this section, I will now give a brief description of how Corporate 36(b) could have affected an actual case that many feel entailed excessive executive compensation.

F. *Corporate 36(b) and Michael Ovitz of the Walt Disney Company*

In *Brehm v. Eisner*, one of several cases prompted by the hiring and firing of Michael Ovitz at The Walt Disney Company, the Delaware Supreme Court explicitly stated that in matters of executive compensation,

²⁸³ *Id.*

²⁸⁴ 15 U.S.C. § 80a-35(b)(2) (2006).

²⁸⁵ *Jones*, 130 S. Ct. at 1427–28.

²⁸⁶ *Id.* at 1428 (alteration in original) (citing *Gartenberg v. Merrill Lynch Asset Mgmt. Inc.*, 694 F.2d 923, 930 (2d Cir. 1982)).

a board's decision is entitled to "great deference."²⁸⁷ The court went on to state: "It is the essence of business judgment for a board to determine if a particular individual warrant[s] large amounts of money."²⁸⁸ But what happened in this case, and would the outcome have been any different if Corporate 36(b) had already been adopted?

Michael Ovitz and The Walt Disney Company entered into an employment agreement in August of 1995 that was intended to establish Ovitz as the President of Disney for a term of at least five years; fourteen months later, Ovitz was terminated without cause, entitling him to a severance package worth approximately \$130 million.²⁸⁹ Ovitz had been socially acquainted and professionally familiar with Disney's CEO Michael Eisner for almost twenty-five years.²⁹⁰ Eisner had personally called all of the board members to tell them about Ovitz when the latter was under employment consideration, and Eisner discussed both his qualifications and their friendship.²⁹¹ The chairman of the compensation committee cautioned that Ovitz's salary would be above Disney's CEO's and at the top for any corporate officer, that the stock options he would receive were more generous than the standards routinely authorized at Disney, and that "corporate America would raise very strong criticism."²⁹² Ovitz was also given a \$7.5 million bonus (which was rescinded later after "more deliberate consideration") for the services he performed during fiscal year 1996—the same services that led to his termination.²⁹³ In September of 1995, the compensation committee met for a total of one hour to consider, among other things, the terms of Ovitz's employment, during which meeting a term sheet was distributed but without a copy of Ovitz's employment agreement.²⁹⁴ The shareholders filed a lawsuit claiming in part "that Ovitz breached his fiduciary duties of care and loyalty to Disney by (i) negotiating for and accepting the NFT (Non-Fault Termination) severance provisions of the OEA (Ovitz Employment Agreement), and (ii) negotiating a full NFT payout in connection with his termination."²⁹⁵ The Chancellor established on summary judgment that Ovitz had not breached any fiduciary duty to Disney because he did not become a fiduciary until he formally started his position on October 1, 1995, and by then the key conditions of the NFT provision had been negotiated; hence, the Court of Chancery held that Ovitz's actions before

²⁸⁷ *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000) (internal quotation marks omitted).

²⁸⁸ *Id.* (internal quotation marks omitted).

²⁸⁹ *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 35 (Del. 2006).

²⁹⁰ *Id.* at 36.

²⁹¹ *Id.* at 39.

²⁹² *Id.* at 38 (internal quotation marks omitted).

²⁹³ *Id.* at 45 n.34.

²⁹⁴ *Id.* at 40.

²⁹⁵ *Id.* at 47 (definitions added).

October 1 were not subject to fiduciary duty obligations.²⁹⁶ And once he was terminated without cause, Ovitz had the contractual right to obtain the benefits that the OEA specified for this type of termination, which were benefits negotiated at arm's length before Ovitz became a fiduciary.²⁹⁷

The court stated that, under Delaware law, neither future nor former directors owed any fiduciary duties, and so Ovitz could not have breached fiduciary duties after December 27, 1996.²⁹⁸ The OEA was the richest pay package ever offered to a corporate officer.²⁹⁹ In response to the claim that Disney had engaged in waste, the court explained:

To recover on a claim of corporate waste, the plaintiffs must shoulder the burden of proving that the exchange was so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration. A claim of waste will arise only in the rare, unconscionable case where directors irrationally squander or give away corporate assets. This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be attributed to any rational business purpose.³⁰⁰

Therefore, the Disney case did not amount to waste.³⁰¹

After the decision was released, commentators said that the Delaware Supreme Court had effectively stated that while fiduciary duty, good faith, and waste theories apply in executive compensation situations, in the majority of cases the court will only make a procedural inquiry into compensation determinations as opposed to an actual evaluation of the substance of compensation packages.³⁰² Basically, as long as proper procedures are observed and the directors act in good faith, liability is at best a remote possibility.³⁰³ But these procedural safeguards do little to protect shareholders from directors who may use their discretion in favor of executives.³⁰⁴ There seems to be a common impression that the payment to Ovitz of \$130 million for fourteen months' work was excessive, but the Delaware Supreme Court's refusal to conduct a substantive rather than procedural inquiry left the shareholders with

²⁹⁶ *Id.*

²⁹⁷ *Id.* at 49.

²⁹⁸ *Id.* at 51.

²⁹⁹ *Id.* at 61 n.86.

³⁰⁰ *Id.* at 74 (citations omitted) (internal quotation marks omitted).

³⁰¹ *Id.* at 75.

³⁰² Jennifer S. Martin, *supra* note 8, at 488–89.

³⁰³ Simmons, *supra* note 17, at 341.

³⁰⁴ *Id.* at 342.

virtually no opportunity for a remedy.³⁰⁵ To potentially make matters worse, after cases like this one, corporate boards are encouraged to simply follow the procedural steps delineated by the courts to insulate themselves from possible liability. This results in a repeated lack of evaluation of the substance, which may mean that future shareholders would be left without recourse in cases of excessive executive compensation.³⁰⁶

In the Disney case, the Court pointed out that Ovitz was not a fiduciary when he negotiated his contract, and therefore the Court would not apply much judicial scrutiny to those negotiations.³⁰⁷ This is exactly what adopting Corporate 36(b) would change. Under Corporate 36(b), the prospective executive would be considered a fiduciary in matters of pay packages, thereby allowing a court to examine not only the procedural aspects surrounding compensation but its substantive nature as well. As I have described at length, the substantive examination will in part depend on the strength of the procedural steps,³⁰⁸ and since the Disney case was quite deficient in that area (although not enough to warrant judgment under the current standards), a court would look at the substance in such a case with skepticism. This does not necessarily mean that the court would come to the opposite conclusion and hold the executive liable,³⁰⁹ but at least that possibility would exist, and the shareholders would have the opportunity to be heard on the substance of the grievance. As part of a fiduciary's obligation in the negotiation, there would be a requirement that the negotiation committee be informed of all pertinent information, including any connection that the fiduciary has to those with whom she is negotiating and any other information that may undermine the process.³¹⁰ This obligation would be carried over to outside prospects if Corporate 36(b) applied to them. This would give the compensation committee both the necessary incentive and relevant information to uphold its duty to the shareholders and ensure a reasonable value for the agreed-upon payment package.

In conclusion, as Charles Yablon and other scholars have pointed out, "most legal regulation of corporate behavior does not take place in court, but in the lawyers' offices, as corporate lawyers counsel their clients as to what they must do to avoid legal 'problems' in connection with the actions

³⁰⁵ Jennifer S. Martin, *supra* note 8, at 499–500.

³⁰⁶ *Id.* at 519.

³⁰⁷ Thomas & Wells, *supra* note 20, at 886.

³⁰⁸ See *supra* Part III.C.

³⁰⁹ One could argue, for example, that the severance plan was justified given the fact that Ovitz was making over twenty million dollars per year in his prior position and he had concerns about working with Eisner (a worry that turned out to be well-founded). KAY & VAN PUTTEN, *supra* note 98, at 143.

³¹⁰ Thomas & Wells, *supra* note 20, at 887.

they want to take.”³¹¹ If Corporate 36(b) had been in place at the time of the Disney case, the directors likely would have been advised that the merits of the package were going to be reviewed and they may have developed a more equitable package.

IV. CONCLUSION

The federal government can and will act in regard to the popular opinion that executive compensation is excessive and a contributing factor to some of the economic difficulties that the country has endured over the last few years.³¹² According to Professor Steven Bainbridge, “No one seriously doubts that Congress has the power under the Commerce Clause, especially as it is interpreted these days, to create a federal law of corporations if it chooses.”³¹³ And, as Judge Posner put it: “In the wake of the financial crisis there is almost certainly going to be some regulation of executive compensation—it has begun in the form of conditions in the recent bailouts of insolvent financial firms. The question is not whether, but how best, to limit executive compensation.”³¹⁴ That leaves this unanswered question as to “how.” Professor Epstein explains that while the current situation is not perfect, direct government intervention in the area of executive compensation is likely to confuse matters further.³¹⁵ Additionally, Dean Thomas Cooley of the NYU Stern School of Business has said: “Congress has gotten into the business of dictating executive pay now, and they shouldn’t be in that business. What they should be doing is turning the light on the committees.”³¹⁶

Corporate 36(b) may be the best alternative available. While the establishment of excessive compensation as a possible breach of fiduciary duties may not eliminate the problem (in fact, in many executive contracts, breaching fiduciary duties is not even listed as grounds for terminating for cause³¹⁷) it will achieve many of the goals necessary for a long-term solution. For example, it has been suggested that “[i]t is the perception of abuse that will have a much larger effect on businesses than strict compliance with economic theory”³¹⁸ and that “[t]here are few, if any, countervailing incentives to encourage directors to oppose unwarranted executive compensation.”³¹⁹ If these two observations are correct,

³¹¹ *Id.* at 895 (brackets omitted).

³¹² *See supra* Part I.

³¹³ Bainbridge, *supra* note 15, at 26.

³¹⁴ Posner, *supra* note 5, at 1047.

³¹⁵ Epstein, *supra* note 42.

³¹⁶ Heather Landy, *Executives Took, but Directors Gave*, N.Y. TIMES, Apr. 5, 2009, at BU1.

³¹⁷ Schwab & Thomas, *supra* note 53, at 249.

³¹⁸ Susan Lorde Martin, *supra* note 18, at 157.

³¹⁹ *Id.* at 160.

Corporate 36(b) could have a substantial impact. It will empower “the courts to overturn outlier compensation agreements produced by illegitimate managerial power [and thereby] will attack a perceived major weakness in our corporate governance system.”³²⁰ Further, the creation of viable legal consequences for some decisions made by compensation committees will force these committees to be more conservative³²¹ and ultimately save the corporations and hence shareholders money. The problem of excessive executive compensation will be even more effectively attacked through a statute passed by the legislature rather than through a purely court-fashioned remedy. If courts are involved as part of the process, however, this could prove beneficial as it has in similar settings in the past. In close corporations, there has been some indication that increased judicial monitoring has led to improved contracting between boards and executives, in addition to some success by shareholders litigating compensation claims.³²²

Scholars have indicated that it is often easier to say that courts should pay greater attention to the conduct of directors and executives, but they have struggled to define what this would mean in practice.³²³ The solution that I propose, by contrast, has the following advantages: it has been tested for over thirty years in the investment adviser context with minimal negative consequences; it was recently upheld in its application by a unanimous Supreme Court; it confers the power upon shareholders to bring lawsuits; it addresses the wide and growing sense of inequity expressed by the popular media and activist groups such as “Occupy Wall Street”; and it will likely forestall a general usurpation of compensation decisions by the federal government. Therefore, Corporation 36(b) should be adopted as soon as practicable.

³²⁰ Thomas & Wells, *supra* note 20, at 849.

³²¹ KAY & VAN PUTTEN, *supra* note 98, at 144. Kay and Van Putten consider the fact that compensation committees will be more conservative a possible negative consequence. *Id.* I think, however, that it could also be a benefit.

³²² Thomas & Wells, *supra* note 20, at 856.

³²³ Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 749 (2005).