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Executive Compensation and Income Inequality

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EXECUTIVE COMPENSATION AND INCOME INEQUALITY

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ABSTRACT

This Article explores the connection between exorbitant executive compensation and the growing income inequality in our country. It discusses the traditional legal attempts to rein in corporate remuneration as well as the more recent "Say-on-Pay" right given to shareholders in the Dodd-Frank Wall Street Reform Act of 2010. The Article concludes that negative stockholder votes can be evidence that directors have breached their fiduciary duties by granting overly generous pay hikes to their top officials.

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INTRODUCTION

Executive compensation has reached scandalous levels at many public companies, making it the number one problem in corporate law.[1] As a major factor in the growing income inequality in America, it is even more significantly a threat to the economic well-being of our nation.[2] Things were not this way especially during the widespread prosperity that followed the Second World War.[3] During the last several decades, however, as the living standards of most Americans have remained stagnant or gone backwards, top corporate pay has grown to outrageous proportions.[4] This Article will first present statistical evidence on this soaring remuneration and its consequences on the general quality of life in our country.[5] It will then discuss the classic legal treatment of this problem under both state corporate law and the federal securities laws,[6] and describe why leading scholars and public commentators believe it is inadequate.[7]

The Article will then address the most current legislative response to this problem: the Say-on-Pay section of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).[8] This provision requires all public companies to afford their shareholders a nonbinding advisory vote on the compensation they pay to their top officials.[9] The Article will then present the results of those plebiscites during 2011, the measure's first year of operation. The results have dismayed a number of corporate critics since the majority of shareholders of only a few firms disapproved of their executives' pay packages.[10]

Despite this overall disappointment, more than 50% of the shareholders did cast negative ballots at firms whose officers were afforded lush compensation despite poor performance.[11] When boards did not rescind their

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1 *See* discussion *infra* Part V.

2 *See infra* notes 17–18 and accompanying text.

3 *See infra* notes 18–21 and accompanying text.

4 *See infra* notes 22–32 and accompanying text.

5 *See* discussion *infra* Parts I–V.

6 *See* discussion *infra* Part VI.A–B.

7 *See* discussion *infra* Part VI.C.

8 *See* discussion *infra* Part VII.

9 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010).

10 *See* discussion *infra* Part VIII.

11 Edward F. Greene, *Say-on-Pay and the Business Judgment Rule*, THE HARVARD L. SCH. FORUM ON CORP. GOVERNANCE AND FIN. REG. (Nov. 26, 2011, 9:52 AM), http://blogs.law.harvard.edu/corpgov/2011/11/26/say-on-pay-and-the-business-judgment-rule/ (highlighting a few of the over forty companies in which the majority shareholder vote was negative); *see also* Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy, No. 2011-CV-197841,

officers' compensation packages, stockholders at several of the companies brought derivative suits citing their "No" votes as evidence that there was no justification for those pay hikes.[12] They therefore alleged that the board of directors should be held liable for their waste of corporate assets and breach of their fiduciary duties.[13] As of early 2012, one federal court has sustained such a claim by placing the allegations of excessive pay in the context of the exorbitant income inequality that it fosters.[14]

The Article will conclude by pointing out the beneficial effects of such a judicial decision.[15] Such a ruling will not only restrain outlandish corporate remuneration, which is virtually theft from shareholders, but it can also benefit our society in other ways. If those payments to executives, along with other sizeable amounts that corporations are now hoarding,[16] were either distributed to shareholders or put to other productive uses, they would expedite our country's economic recovery. The economy would then promote prosperity for the large part of its citizens by expanding output and creating good paying jobs.

I. ECONOMIC DISPARITIES AND WEALTH CONCENTRATION IN AMERICA

The gap between wealthy Americans and the rest of its citizens is now a daunting reality. Study after study confirms that the current disparity of wealth in America is frightening[17]—much more of a factor than at any time since the Great Depression.[18] As this gulf has continued to widen in the last

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2011 WL 4836230, at *2–3 (Ga. Super. Ct. Sept. 15, 2011) (showing that shareholders have shown their disapproval of high compensation for executives despite the company's poor performance by casting negative ballots in Dodd-Frank votes).

[12] Gordon v. Goodyear, No. 12 C 369, 2012 WL 2885695, at *1, *4 (N.D. Ill. July 13, 2012); *see also* Laborers' Local v. Intersil, No. 5:11-CV-04093 EJD, 2012 WL 762319, at *1–2 (N.D. Cal. Mar. 7, 2012); Plumbers Local No. 137 Pension Fund v. Davis, No. 03:11-633-AC, 2012 WL 104776, at *2 (D. Or. Jan. 11, 2012); Teamsters, 2011 WL 4836230, at *2–3.

[13] *Gordon*, 2012 WL 2885695, at *1, *4; *Laborers' Local*, 2012 WL 762319, at *1–2; *Plumbers Local*, 2012 WL 104776, at *1; *Teamsters*, 2011 WL 4836230, at *2–3.

[14] NECA-IBEW Pension Fund *ex rel.* Cincinnati Bell, Inc. v. Cox, 1:11-CV-451, 2011 WL 4383368, at *3 (S.D. Ohio Sept. 20, 2011); *see also* discussion *infra* Part IX.B.

[15] *See* discussion *infra* Part X.

[16] *See* John Carney, *Solving the Mystery of Corporate Cash Hoarding*, CNBC (June 6, 2011, 10:28 AM), http://www.cnbc.com/id/43293840/Solving_the_Mystery_of_Corporate_Cash_Hoarding (discussing corporate hording of cash as opposed to paying out dividends).

[17] *See* CSEA Monroe County, N.Y. Local 828, *Income Inequality Is America's 21st Century Monster*, THE VOICE REPORTER (May 6, 2011, 1:28 PM), http://voiceforthememberslate.blogspot.com/2011/05/income-inequality-is-americas-21st.html (citing reports that suggest "that income inequality in the United States equals that of Uganda").

[18] *Id.* (citing statistics published by the Central Intelligence Agency, *available at* https://www.cia.gov/library/publications/the-world-factbook/geos/us.html (follow "Select a Country

several years, it has become increasingly apparent that a large part of it is a result of exorbitant compensation paid to top corporate officials.[19]

Things were not always this way, particularly in the immediate post-war era. Throughout the 1950s and 1960s, the American economy was growing at a rapid clip and the incomes of all families increased on average by about 3%.[20] Yet a recent study by economists from the Massachusetts Institute of Technology (M.I.T.) and the Federal Reserve shows that the pay of top corporate executives during those decades remained steady, increasing by less than 1% per year.[21] Business leaders of that time period did not have to be overpaid to lead their companies to larger profits.

Around 1970, however, things began to change. In the next three decades, earnings of the top 1%, the "working rich,"[22] increased by three times, while the growth of the average family's real income during those thirty years was below 15%.[23] Corroborating these numbers was a study by the Congressional Budget Office that showed the after-tax income, adjusted for inflation, of the top 1% of American families jumped 139% from 1979 to 2001.[24] By contrast, "[t]he income of the middle fifth rose by just 17 percent, to $43,700, and the income of the poorest fifth rose only 9 percent."[25]

By 2007 even President George W. Bush acknowledged this disparity, stating: "[t]he fact is that income inequality is real—it's been rising for more than 25 years."[26] In that year the top 10% of American earners garnered

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or Location" hyperlink, select "UNITED STATES"; then click "Economy : UNITED STATES" to expand those statistics)).

[19] Peter Whoriskey, *With Executive Pay, Rich Pull Away from Rest of America*, WASH. POST (June 18, 2011), http://www.washingtonpost.com/business/economy/with-executive-pay-rich-pull-away-from-rest-of-america/2011/06/13/AGKG9jaH_story.html.

[20] *See* Jordan Weissman, *60 Years of American Economic History, Told in 1 Graph*, THE ATLANTIC (Aug. 23, 2012, 3:17 PM), http://www.theatlantic.com/business/archive/2012/08/60-years-of-american-economic-history-told-in-1-graph/261503/ (discussing a graph created as part of a study undertaken by the Pew Research Center).

[21] Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936–2005*, at 7 (Fin. & Econ. Discussion Series, Working Paper No. 35, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 972399.

[22] The term "working rich" is borrowed from Emmanuel Saez, Striking it Richer: The Evolution of Top Incomes in the United States, 4 (last updated by author Mar. 2012) (unpublished manuscript), *available at* http://elsa.berkeley.edu/~saez/saez-UStopincomes-2010.pdf.

[23] Robert H. Frank, *Gauging the Pain of the Middle Class*, N.Y. TIMES, Apr. 3, 2011, at BU7.

[24] Janny Scott & David Leonhardt, *Shadowy Lines That Still Divide*, N.Y. TIMES, May 15, 2005, http://www.nytimes.com/2005/05/15/national/class/OVERVIEW-FINAL.html?pagewanted=all.

[25] *Id.*

[26] Michael Abramowitz & Lori Montgomery, *Bush Addresses Income Inequality*, WASH. POST, Feb. 1, 2007, at A4 (quoting President George W. Bush) (internal quotation marks omitted).

almost 50% of the country's total wages, a level higher than any time since the start of World War I.[27] Statistics on wealth distribution from then were even more alarming. "As of 2007, the top 1% of households (the upper class) owned 34.6% of all privately held wealth, and the next 19% (the managerial, professional, and small business stratum) had 50.5%."[28] Just one-fifth of our citizens therefore controlled over 85% of the country's wealth. The bottom two quintiles, by contrast, owned only 0.3%.[29] The effects of that prosperity gap were harshest on children whose poverty rate was twice that of adults.[30]

Yet social scientists were unsure of what was driving that growing gap because, until recently, they did not have the data to determine who really comprised the upper echelon of America's earners. A new study by leading economists has established that most of the income gain during those decades was reaped by corporate executives and financiers.[31] "The top 0.1 percent of earners make about $1.7 million or more, including capital gains."[32]

The current Great Recession has finally put this disturbing situation in the public spotlight.[33] Average Americans have been hurt much more severely by the recent financial meltdown than wealthy Americans, thus making the maldistribution of society's resources even more acute. The net worth of the median family has dropped an "astounding" 36.1% since 2008 whereas the asset values of the top 1% have fallen off by only 11%—widening the prosperity gap even more.[34]

Even though most Americans may not know the full extent of income inequality in the country,[35] economists, pundits, and bloggers are now writing and commenting at length on this injustice.[36] Comparing America to other countries with stratified social classes, *New York Times* columnist Nicholas Kristof wrote, "[m]aybe that's why the growing inequality in America pains me so. The wealthiest 1 percent of Americans already have

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[27] Saez, *supra* note 17, at 2.

[28] G. William Domhoff, *Wealth, Income, and Power*, WHO RULES AMERICA?, http://sociology.ucsc.edu/whorulesamerica/power/wealth.html (last updated Feb. 2013).

[29] *Id.*

[30] Gregory Acs & Megan Gallagher, *Income Inequality Among America's Children*, NEW FEDERALISM: NATIONAL SURVEY OF AMERICA'S FAMILIES 1 (Jan. 2000).

[31] *See* Whoriskey, *supra* note 19, at A16.

[32] *Id.*

[33] *See* Maxwell Strachan, *15 Facts About U.S. Income Inequality That Everyone Should Know*, HUFFINGTON POST (Apr. 5, 2011, 4:05 PM), http://www.huffingtonpost.com/2011/04/05/us-inequality-infographic_n_845042.html#s261411&title=Wage_Inequality (last updated June 5, 2011, 6:12 AM).

[34] Domhoff, *supra* note 28.

[35] *See id.*

[36] Strachan, *supra* note 33.

a greater net worth than the bottom 90 percent, based on Federal Reserve data."[37] As Nobel Prize winning economist Joseph E. Stiglitz commented in May 2011 in an article for Vanity Fair: "Americans have been watching protests against oppressive regimes that concentrate massive wealth in the hands of an elite few. Yet in our own democracy, 1 percent of the people take nearly a quarter of the nation's income—an inequality even the wealthy will come to regret."[38]

Contrasting the better productivity of American workers with those in European countries, labor lawyer Thomas Geoghegan notes:

> Technically, we seem far ahead, but don't drool. The U.S. superrich gobble well over two-thirds of the increase. In 2005, the real hourly wage for production workers in America was approximately 8 percent lower than it was in 1973, while our national output per hour is 55 percent higher. So it's dubious whether most Americans have gained even a penny in purchasing power since 1989.[39]

In short, much of the gain in productivity by American workers has gone not to the folks who actually generated the wealth but to the upper echelon of the managerial class.

Along the same lines, Cornell University economist Robert H. Frank has created a "toil index" to measure the real costs of consumption such as paying the rent on a median priced home.[40] The hours of work needed by the average American to meet that expense declined slightly from 1950 to 1970 to just 41.5 per month.[41] By 2000, however, that figure had risen to 67.4 hours per month.[42] While the rise in Gross Domestic Product (GDP) showed a general increase in wealth during the last several decades,[43] average Americans were going backward in the hours of labor they had to expend to meet their basic needs.

By fall 2011, the general discontent with this widespread unfairness gave rise to a spontaneous populist protest. It "began with a few dozen demonstrators pitching tents on Wall Street in front of the New York Stock Exchange .... Soon hundreds that included union activists joined them in a nearby park and the movement spread to a number of cities

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[37] Nicholas D. Kristof, *Our Fantasy Nation?*, N.Y. TIMES, June 5, 2011, at WK9.

[38] Joseph E. Stiglitz, *Of the 1%, by the 1%, for the 1%*, VANITY FAIR (Apr. 5, 2011), http://www.vanityfair.com/society/features/2011/05/top-one-percent-201105.

[39] THOMAS GEOGHEGAN, WERE YOU BORN ON THE WRONG CONTINENT? 13 (2010).

[40] *See* Frank, *supra* note 23.

[41] *Id.*

[42] *Id.*

[43] *See id.*

around the country."[44] One organizer in Los Angeles said, "the protesters were united in their desire for a more equal economy."[45] If the Occupy Wall Street Movement accomplished nothing else, it has "brought that stark unfairness to the full attention of the American public."[46]

II. THE REASONS FOR THE RISE IN WEALTH CONCENTRATION

One academic commentator observing this situation put it aptly: "the rising tide of economic growth no longer lifts all boats."[47] There seems to be a consensus among economists and others as to why this is so. As President George W. Bush explained, "[t]he reason is clear: We have an economy that increasingly rewards education and skills because of that education."[48]

As a report on National Public Radio (NPR) put it, "[n]ew technology has made many jobs obsolete, while creating dramatic opportunities for wealth in computers, finance, and media and entertainment."[49] A study on world trade also concluded that "innovations ... have favored workers with greater skill and reduced the value of unskilled labor.... Liberal trade with the newly industrializing countries of the world has certainly played a part in worsening the job prospects of America's unskilled workers."[50]

Professor Stiglitz thus summed up similar conclusions by a number of his colleagues in the dismal science:

> [L]aborsaving technologies have reduced the demand for many "good" middle-class, blue-collar jobs. Globalization has created a worldwide marketplace, pitting expensive unskilled workers in America against cheap unskilled workers overseas. Social changes have also played a role—for instance, the decline of unions, which once represented a third of American workers and now represent about 12 percent.[51]

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[44] Christopher Ram, *It Is 0.01%, Not 1%—Part 1*, CHRISRAM.NET (June 24, 2012, 12:00 AM), http://www.chrisram.net/?p=959.

[45] Erick Eckholm & Timothy Williams, *Anti-Wall Street Protests Spreading to Cities Large and Small*, N.Y. TIMES, Oct. 4, 2011, at A18 (internal quotation marks omitted).

[46] Ram, *supra* note 44.

[47] Hugh Heclo, *Growing Income Inequalities in America?*, 111 POL. SCI. Q. 523, 524 (1996).

[48] Abramowitz & Montgomery, *supra* note 26, at A4. For a fine recent piece making that same point, see Adam Davidson, *Making It in America*, THE ATLANTIC, Jan. 2012, at 70.

[49] Uri Berliner, *Haves and Have-Nots: Income Inequality in America*, NPR (Feb. 5, 2007, 1:04 PM), http://www.npr.org/templates/story/story.php?storyId=7180618.

[50] Gary Burtless, *Worsening American Income Inequality: Is World Trade to Blame?*, 14 THE BROOKINGS REV., 26, 31 (1996).

[51] Stiglitz, *supra* note 38; *see also* Davidson, *supra* note 48, at 70 ("[Because of] the double shock we're experiencing now—globalization and computer-aided industrial productivity ...

But Stiglitz was also quick to add another, less excusable cause: "[b]ut one big part of the reason we have so much inequality is that the top 1 percent want it that way .... Wealth begets power, which begets more wealth."[52] Stiglitz went on to cite low tax rates, particularly on gains from investments, as a principal reason why America's rich have become richer while most of their countrymen have stagnated or slid lower in terms of economic well-being.[53]

As the NPR report noted, wealthy people own stocks and upper echelon corporate employees often get a good portion of their compensation in stock options.[54] Since the Bush Tax Changes of 2003, the appreciation of shares, which has been substantial during the past ten years, has been taxed at only 15%—much lower than the top bracket on earned income.[55]

As Professor Stiglitz also noted, corporate wealth evidenced in share prices has been augmented by relaxed antitrust enforcement and by international competition for businesses, which has weakened environmental laws and labor rights.[56] He also points out how manipulation of our financial system has generated much of the recent, immense wealth.[57] The government, through lax regulation, condoned much of that manipulation and then came in to rescue banks like Goldman Sachs and Morgan Staley with expensive bailouts that were deemed necessary to ward off an even greater recession.[58]

III. VANISHING ECONOMIC MOBILITY

Hand-in-hand with concentration of wealth and the decline in the living standards of most Americans has gone the demise of one important part of the American dream: the promise of rising social and material benefits for

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income inequality is growing, as the rewards for being skilled grow and the opportunities for unskilled Americans diminish.").

[52] Stiglitz, *supra* note 38.

[53] *See id.*; *see also* Editorial, *The 1% and That 15%*, N.Y. TIMES, Jan. 19, 2012, at A22 (comparing the 15% cap on the taxation of investment income with the 25%–35% rate applied to the wage and salary income of American workers).

[54] *See* Berliner, *supra* note 49.

[55] *The 1% and That 15%*, *supra* note 53, at A22. The tax reforms enacted in early 2013 have raised the long term capital gains tax now to 20% for high income taxpayers. Laura Sanders, *High Earners Facing First Major Tax Increase in Years,* WALL ST. J., Jan. 2, 2013, at A1.

[56] *See* Stiglitz, *supra* note 38.

[57] *See id*. For the author's description of how that fraudulent conduct brought about the economic debacle of 2008, see Daniel J. Morrissey, *After the Meltdown*, 45 TULSA L. REV. 393, 397–400 (2010).

[58] *See* Paul M. Barrett, *Bubble Beater*, N.Y. TIMES, May 1, 2011, at BR13 (reviewing WILLIAM D. COHAN, MONEY AND POWER (2011)).

the next generation. As two *New York Times* reporters described this traditional belief: "There are poor and rich in the United States, of course, the argument goes; but as long as one can become the other, as long as there is something close to equality of opportunity, the differences between them do not add up to class barriers."[59] The renowned social historian Francis Fukuyama has recently made much the same point:

> Inequality per se has never been a big problem in American political culture, which emphasizes equality of opportunity rather than of outcomes. But the system remains legitimate only as long as people believe that by working hard and doing their best, they and their children have a fair shot at getting ahead, and that the wealthy got there playing by the rules.[60]

Professor Fukuyama continues, however, with this chilling assessment:

> The fact is, however, that rates of intergenerational social mobility are far lower in the United States than many Americans believe them to be, and lower than in many other developed countries that traditionally have been regarded as rigid and stratified. Over time elites are able to protect their positions by gaming the political system, moving their money offshore to avoid taxation, and transmitting these advantages to their children through favored access to elite institutions.[61]

Studies of inheritance patterns at elite colleges bear out this disappointing conclusion about the lack of social and economic mobility. "According to a study published by the Federal Reserve Bank of Cleveland, only 1.6% of Americans receive $100,000 or more in inheritance."[62] "Another 1.1% receive $50,000 to $100,000," but an astonishing 91.1% have older relatives who cannot leave them anything.[63] A 2010 study by Georgetown University of the country's most selective colleges found that "only 15 percent of students came from the bottom half of the income distribution," whereas over two-thirds came from the wealthiest quarter of households.[64]

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[59] Scott & Leonhardt, *supra* note 24.

[60] FRANCIS FUKUYAMA, THE ORIGINS OF POLITICAL ORDER 8–9 (2011).

[61] *Id.* at 9 (citation omitted); *see also* Timothy Noah, *The Mobility Myth*, NEW REPUBLIC, Mar. 1, 2012, at 14 (elaborating on the thesis that "[m]ost of Western Europe today is both more equal in incomes *and* more economically mobile than the United States").

[62] Domhoff, *supra* note 28.

[63] *Id.*

[64] David Leonhardt, *Top Colleges, Largely for the Elite*, N.Y. TIMES, May 25, 2011, at B1, B9. As one social critic recently put it, "[t]he haves in our society are increasingly cocooned in a system that makes it easy for their children to continue to be haves." Charles Murray, *Narrowing the New Class Divide*, N.Y. TIMES, Mar. 8, 2012, at A31.

IV. THE CONSEQUENCES OF INEQUALITY

There is some debate about the ramifications of this vanishing economic mobility. One author comments that the possibility of disparate economic results can motivate people to work harder.[65] If everyone was compensated the same amount regardless of what they did for society, many folks might not feel compelled to be productive.[66] Another supposed benefit of lower wages, at least in the global economy, is that they allow Americans to purchase goods cheaper, which can contribute to a higher standard of living.[67]

From the perspective of psychology and cognitive science, Professor Tyler Cowen adds insight about the causes of inequality. It results less, he suggests, from the low-paid workers at the bottom of the economic ladder than from the small population of brilliant inventors and business people situated at the top.[68] "The root cause of income inequality, viewed in the most general terms," he says, "is extreme human ingenuity, albeit of a perverse kind. That is why it is so hard to control."[69]

Yet one does not have to be a radical egalitarian to see the adverse consequences that such a state of affairs will ultimately have for American society. Professor Fukuyama notes, "the rising levels of populist anger on both the Right and Left ... contribute to polarization and reflect a social reality at odds with the country's own legitimating principles."[70] The title of

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[65] *See* Catherine Rampell, *Thy Neighbor's Wealth*, N.Y. TIMES, Jan. 28, 2011, at BR17 (reviewing BRANKO MILANOVIC, THE HAVES AND THE HAVE-NOTS (2010)).

[66] *Id.* (discussing Milanovic's suggestion that "[t]he possibility of unequal economic outcomes motivates people to work harder ... although at some point it can lead to the preservation of acquired positions, which causes economies to stagnate").

[67] *See* Strachan, *supra* note 33.

[68] *See* Tyler Cowen, *The Inequality That Matters*, THE AM. INTEREST, Jan.–Feb. 2011, at 37.

[69] *See id.*; *see also* ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 10 (5th ed. 2011). To sum up the root cause of income inequality, it states:

> Before the creation of the corporate structure, there were few opportunities for individuals to make dramatic changes in status and wealth. However, corporate history is filled with people like Henry Ford, Walt Disney, Bill Gates, Steve Jobs, and Facebook's Mark Zuckerberg, who changed the world and made themselves and their investors rich. The American system has provided opportunity for immigrants from Andrew Carnegie to Google's Sergey Brin to create almost unimaginable wealth.

Id.

[70] FUKUYAMA, *supra* note 60, at 8. For trenchant comments about how hard times have brought about a resurgence of right-wing politics, see generally THOMAS FRANK, PITY THE BILLIONAIRE (2012).

Professor Stiglitz's recent piece, *Of the 1%, by the 1%, for the 1%*,[71] is a play on that point. Economic inequality could even affect the physical health of American society, as columnist David Brooks cites Richard Wilkinson and Kate Pickett for the finding that, "[i]nequality and a feeling of exclusion causes social pain, which leads to more obesity, worse health outcomes, fewer social connections, more depression and anxiety."[72]

Others see a similar threat to the general welfare. Conservative former Federal Reserve Chairman, Alan Greenspan, has recently noted that our unequal economy is "very distorted."[73] Another commentator has pointed out the disturbing lack of empathy among its winners for those who are less fortunate.[74] The plutocrats, she says, who have emerged from this winner-take-all system, are now increasingly a global class to themselves, without any particular allegiance to citizens from their homeland.[75] Many seem to suggest that the trials of the American working class are their own fault.[76]

Caveats about the corrosive effects of great wealth are as old as the Scriptures. There is a corresponding lesson that we are all in this together. As Dr. Stiglitz writes, "looking out for the other guy isn't just good for the soul—it's good for business."[77] Consumer demand and purchasing power drive our economy and make it possible for businesses to flourish.[78]

Along those lines, fears abound about the rise of a new, very large underclass comprised of white men.[79] This group has grown in the post-industrial economy as wages for working people have been going down since 1983 and longer than that for blue-collar males.[80] This startling decline was compounded by "the Great Recession, during which three-quarters of the 8 million jobs lost were lost by men."[81] As David Brooks summed up this alarming state of affairs, "[t]he American working class—those without a college degree—is being decimated, economically and socially."[82]

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[71] Stiglitz, *supra* note 38, at 6.

[72] DAVID BROOKS, THE SOCIAL ANIMAL 330 (2011).

[73] Chrystia Freeland, *The Rise of the New Global Elite*, THE ATLANTIC, Jan.–Feb. 2011, at 44, 46.

[74] *See id.* at 46.

[75] *See id.*

[76] *Id.* at 52.

[77] Stiglitz, *supra* note 38.

[78] *See* Robert B. Reich, Op-Ed., *The Limping Middle Class*, N.Y. TIMES, Sept. 4, 2011, at SR6.

[79] For a study that attributes this more to the breakdown of civic values than to economic concerns, see CHARLES MURRAY, COMING APART 12–13 (2012).

[80] *See* David Brooks, Op-Ed., *Pundit Under Protest*, N.Y. TIMES, June 14, 2011, at A25.

[81] Hanna Rosin, *The End of Men*, THE ATLANTIC, July–Aug. 2010, at 60.

[82] Brooks, *supra* note 80.

V. SOARING EXECUTIVE COMPENSATION

Contrast the stark reality of difficult economic times for many Americans with the current good fortune enjoyed by business leaders. In 1965, the typical American CEO made 24 times the average worker.[83] By 2007, that differential had increased by more than tenfold to 275,[84] and it has continued to grow. According to a study by the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), the compensation of CEOs at America's 300 largest companies in 2010 was 343 times the average worker's pay.[85] While the average American worker earned $46,742 in 2010, a 2% rise from 2009, and unemployment remained shockingly high, the compensation of Standard & Poor (S&P) 500 CEOs was $12 million, up 18% over the same time period.[86] Commenting on this huge pay differential, Eleanor Bloxham from the Value Alliance stated, "[i]t's insane .... Corporate boards have bought into the idea that they have to pay up for performance. There'll be more of the same until institutional investors decide CEOs aren't worth what they're being paid."[87]

As has been said, executive pay has not always surged so far beyond the wages of working people.[88] Even during the fast-growing post-war decades, it remained level.[89] Since the 1980s, it has zoomed upward,[90] fueled in large part by the increased use of incentive pay comprised of stock options and bonus awards allegedly tied to firm performance.[91] Those mechanisms for compensation became dominant in 1992 when Congress, alarmed that the average CEO's pay had risen to what today

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[83] David Owen, *The Pay Problem: What's to Be Done About CEO Compensation*, THE NEW YORKER, Oct. 12, 2009, at 58.

[84] *Id.*

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

[86] Gary Strauss, *Stock Options Help CEOs Cash In*, USA TODAY, July 8, 2011, at 1A; *see also* Joann S. Lublin, *CEO Pay in 2010 Jumped 11%*, WALL ST. J., May 9, 2011, at B1.

[87] Strauss, *supra* note 86 (quoting Eleanor Bloxham). Outrage over exorbitant executive pay is not limited to the United States. Recently the conservative prime minister of Great Britain, David Cameron, said that large pay packages awarded to executives in Great Britain during a time of general austerity, "made people's blood boil." Julia Werdigier, *In Britain, Rising Outcry over Executive Pay That Makes 'People's Blood Boil,'* N.Y. TIMES, Jan. 23, 2012, at B5.

[88] *See* Owen, *supra* note 83, at 58 and accompanying text.

[89] Frydman & Saks, *supra* note 21, at 2.

[90] *Id.* at 1.

[91] Carole Frydman & Dirk Jenter, *CEO Compensation*, 2 ANN. REV. FIN. ECON. 75 (2010), *available at* http://web.mit.edu/frydman/OldFiles/www/COMP%20SURVEY%2008-02-10.pdf.

seems a very modest $750,000,[92] capped the deductibility of executive compensation at $1 million.[93] Then, according to Nell Minow, the leader of a research firm dedicated to improving corporate governance,[94] "[t]he first thing that happened was that everybody got a raise to a million dollars. The second was that companies started issuing bazillions [sic] of options."[95]

Minow continued her critique: "[o]ptions are intended to reward executives for increasing their company's market capitalization—a benefit for all shareholders. But executives have turned out to be ingenious at eliminating any personal risk, turning options into corporate play money, and helping to inaugurate the ongoing proliferation of American billionaires."[96] Compensation by options has been easy to game, most notoriously by the widespread practice of executives backdating the grant dates of their options.[97] Even leaving aside that patently illegal practice, there are plenty of other ways that corporate officials can manipulate those awards in order to engineer exorbitant compensation for themselves. For instance, they need only have their firms issue them stock and options when the prices of those financial instruments are historically depressed. Just recently, during the market's low point in late 2008 and late 2009, more than 90% of the CEOs at S & P's top 500 companies received large amounts of those securities.[98] When stock prices rebounded in spring 2011, those awards netted them $3 billion.[99] In addition, that surge gave American executives more billions in gains on the stocks and options they already held. Commenting on that remuneration,

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[92] Owen, *supra* note 83, at 59.

[93] 26 U.S.C. § 162(m) (2011).

[94] She is also the co-author of a fine book on that subject. *See generally* MONKS & MINOW, *supra* note 69.

[95] Owen, *supra* note 83, at 59.

[96] *Id.* Minow has elaborated on her critique and brought it up-to-date with scandalous examples of exorbitant, unearned compensation by CEOs like Countrywide's Angelo Mozilo whose company suffered massive losses during the financial meltdown. *See* Nell Minow, *Executive Decisions: Why CEO pay spun out of control*, THE NEW REPUBLIC, Mar. 1, 2012, at 9.

[97] For an article by the author on this pernicious practice, see Daniel J. Morrissey, *The Path of Corporate Law: Of Options Backdating, Derivative Suits, and the Business Judgment Rule*, 86 OR. L. REV. 973, 975 (2007).

[98] *See* Scott Thurm, *Options Given During Crisis Spell Large Gains for CEOs*, WALL ST. J., Apr. 27, 2011, at A1.

[99] *Id.* This "windfall for hundreds of executives" also gave a big tax break to their companies. Those firms got to deduct any gain their officers made from the stock's appreciation as an expense even though the companies paid out no actual cash. *Id.* According to the *New York Times*, "[t]his tax break will deprive the federal government of tens of billions of dollars in revenue over the next decade." David Kocieniewski, *Tax Benefits from Options as Windfall for Business*, N.Y. TIMES, Dec. 30, 2011, at A1.

Paul Hodgson, a compensation expert, said "[s]ome of the gains are humongous" and predicted that they would continue in 2011.[100]

Companies that issue huge amounts of stock and options to their executives dilute the wealth left over for their shareholders. As one astute investment adviser put it, "[w]hen compensation is excessive, that should be a red flag .... Does the company exist for the benefit of shareholders or insiders? ... Stock-based compensation plans are often nothing more than legalized front-running, insider trading and stock watering all wrapped into one package."[101]

By that standard, shareholders and the investing public are particularly ill-served today by the stewards of their wealth. While many businesses that were hard hit by the recession have been doing better lately, top corporate officers seem to be raking off a larger and larger share of that increased wealth, getting hefty raises and multimillion-dollar paychecks. Philippe P. Dauman of Viacom, Ray R. Irani of Occidental Petroleum, and Lawrence J. Ellison of Oracle were near the top of that list with compensation last year of $84.5 million, $76.1 million, and $70.1 million respectively.[102] John Hammergren the CEO of McKesson Corp., a healthcare services firm, was at its head taking down $150.7 million.[103]

In addition, nearly obscene severance arrangements compound these outrageous annual payments. The aforementioned Mr. Hammergren will get $469 million from his company if there is a change in managerial control.[104] In September 2011, Leo Apotheker, Hewlett-Packard's CEO, resigned after serving just eleven months.[105] Even though the company's stock dropped 50% during his tenure,[106] he took with him a golden parachute of $13.2 million in severance pay on top of a signing package worth $10 million.[107] That however was chump change compared to relatively recent golden parachutes in excess of $200 million each for Hank McKinnell of Pfizer

[100] Strauss, *supra* note 86.

[101] Gretchen Morgenson, *Enriching a Few at the Expense of Many*, N.Y. TIMES, Apr. 10, 2011, at BU1 (quoting Albert Meyer of Bastiat Capital).

[102] Daniel Costello, *The Drought Is Over (At Least for C.E.O.'s)*, N.Y. TIMES, Apr. 10, 2011, at BU1, BU6.

[103] *See* Strauss, *supra* note 86. With health costs soaring, it is significant that three of the ten best paid CEOs in 2010 were in the health care industry. Alain Sherter, *Highest-Paid CEOs: Top Earner Takes Home $145 Million*, CBS NEWS MONEYWATCH (Dec. 15, 2011, 2:56 PM), http://www.cbsnews.com/8301-505123_162-57343611/highest-paid.

[104] Sherter, *supra* note 103.

[105] Eric Dash, *The Lucrative Fall from Grace*, N.Y. TIMES, Sept. 30, 2011, at B1.

[106] Joann S. Lublin & Ben Worthen, *H-P Puts Limits on Severance Pay*, WALL ST. J., Dec. 15, 2011, at B6.

[107] Dash, *supra* note 105.

and Robert Nardelli of Home Depot,[108] and a $46 million bonus in advance of $3.4 million in severance awarded to Adam Metz last year after just two years at General Growth Properties, a land trust.[109] This past year, General Growth Properties collapsed in one of our country's largest commercial real estate bankruptcies.[110]

One also cannot overlook the lush benefits these emperors of industry receive. The most notorious perquisite was the estimated $700,000 worth of unreported corporate jet usage by Eugene Isenberg, the CEO of Nabors Industries during 2009–2010.[111] The Wall Street Journal discovered that he often flew on the company plane to his homes in Palm Beach, Florida and Martha's Vineyard, Massachusetts.[112]

VI. LEGAL RESPONSES BEFORE SAY-ON-PAY

A. Case Law

Opponents of excessive executive compensation scored an early victory at the U.S. Supreme Court in the celebrated case of *Rogers v. Hill*.[113] In 1930, during the Great Depression, the president of the American Tobacco Company was paid salary and bonuses over $1 million based on a provision in the company's by-laws that entitled him to 2.5% of the firm's profits.[114] While the compensation arising from that formula had not been excessive when it was adopted two decades earlier, in subsequent years there had been what the court called an "enormous increase in the company's profits" that resulted in what for that time was exorbitant remuneration.[115] Because the top executive's pay had gotten so large, the Court held that the complaining shareholder had successfully stated a claim of waste.[116] In justification for that holding it quoted these remarks from Judge Thomas Swan, a distinguished jurist of that era, who dissented in the lower court's opinion: "If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift in part and the majority stockholders have no power to give away corporate property against the protest of the minority."[117]

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[108] *Id.* at B4.
[109] Sherter, *supra* note 103.
[110] *Id.*
[111] *See* Mark Maremont & Tom McGinty, *Corporate Jet Set: Leisure vs. Business*, WALL ST. J., June 16, 2011, at A1, A16.
[112] *Id.*
[113] *See* Rogers v. Hill, 289 U.S. 582, 591–92 (1933).
[114] *See id.* at 584–85 nn.1–2.
[115] *Id.* at 591.
[116] *See id.* at 592.
[117] *Id.* at 591–92 (quoting Rogers v. Hill, 60 F.2d 109, 113 (2d Cir. 1932)).

A later case arising out the same situation however set quite a different tone for those actions and proved, until recently, to be the more influential.[118] There, the Court called those same payments

> munificent. To the person of moderate income they would be princely—perhaps something unattainable; to the wage earner eking out an existence they would be fabulous and the unemployed might regard them as fantastic, if not criminal. To others they would seem immoral, inexcusably unequal and an indictment of our economic system.[119]

Yet noting that a majority of the shareholders had recently ratified the payments,[120] the Court cited its "reluctance ... to interfere with the internal management of a corporation."[121] Stating that "[c]ourts are ill-equipped to solve or even to grapple with these entangled economic problems,"[122] it dismissed the action.

In the post–World War II era the influential Delaware Supreme Court followed this approach showing little interest in overturning a compensation plan that had been approved by disinterested and independent directors as beneficial to the company and ratified by its shareholders.[123] In the 2006 *Disney* case,[124] the Delaware High Court refused to set aside a lucrative severance deal for the dismissed president of the company, Michael Ovitz. *Disney* however involved payments made under an employment contract entered into before Mr. Ovitz went to work for the company, not big jumps in pay given to an already-employed corporate official.[125]

By contrast, in a more recent case from Delaware,[126] Chancellor Chandler refused to dismiss a waste claim against Citigroup's CEO, Charles Prince, who was responsible for billions of dollars of losses by that company during the financial meltdown. After stating the general authority of boards to set executive compensation, the Chancellor made this telling comment:

> It is also well settled in our law, however, that the discretion of directors in setting executive compensation is not unlimited. Indeed, the Delaware Supreme Court was clear when it stated that "there is an outer

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[118] *See* Heller v. Boylan, 29 N.Y.S.2d 653, 660, 680 (N.Y. Sup. Ct. 1941).
[119] *Id.* at 669.
[120] *Id.* at 674.
[121] *Id.* at 667.
[122] *Id.* at 680.
[123] *See, e.g.*, Beard v. Elster, 160 A.2d 731, 738 (Del. 1960) (finding that adoption of the compensation plan was an exercise of business judgment by the corporation's board).
[124] *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 35–36 (Del. 2006).
[125] *See id.* at 48–49.
[126] *See In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 112 (Del. Ch. 2009).

> limit" to the board's discretion to set executive compensation, "at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."[127]

The Chancellor went on to examine the allegations that Mr. Prince had been paid $68 million upon departing from his top position at Citigroup in 2007 after the housing market had crashed.[128] The Chancellor found that the shareholders raised reasonable doubt as to whether Citi's board was well-informed, careful, and rational in approving that compensation plan.[129]

B. SEC Disclosure Requirements

On the federal front, since its beginnings in the 1930s the Securities and Exchange Commission (SEC) has used its regulatory power under the securities laws[130] to compel disclosure of executive and director compensation by public companies. Acting on its mandate to provide helpful information to investors, the Commission has amended its requirements for public company reporting periodically in response to changing forms of corporate remuneration.[131]

In 2006, shortly after options-backdating scandals became public, the SEC issued a revision of its compensation rules, changing previous requirements for disclosing backdating.[132] To promote annual and intercompany comparisons, in 1992 the Commission mandated a tabular format for disclosing backdating.[133] The 2006 standards refined that approach and required that company officials explain their remuneration policies in a narrative analysis called Compensation Discussion and Analysis (CD&A).[134] Other new SEC provisions called for tabular presentations of senior executive compensation over a three-year period, which must include equity-based awards and amounts realized from those holdings as well as potential post-employment payments.[135] When publishing those regulations, the Director of the SEC's Division of Corporate Finance gave this reason for those rules:

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[127] *Id.* at 138 (quoting Brehm v. Eisner, 746 A.2d 244, 262 n.56 (Del. 2006)).
[128] *See id.* at 137–38.
[129] *See id.* at 138.
[130] The Securities Act of 1933, Pub. L. No. 73-22,48 Stat. 74, 78–79; The Securities and Exchange Act of 1934, Pub. L. No.73-291, 48 Stat. 881, 892.
[131] *See, e.g.*, Executive Compensation and Related Party Disclosure, 71 Fed. Reg. 6542, 6542–43 (Feb. 8, 2006) (to be codified at 17 C.F.R. 228, 229, 239, 240, 245, 249, 274).
[132] *See id.* at 6542.
[133] *Id.* at 6543.
[134] Executive Compensation Disclosure, 71 Fed. Reg. 78,338, 78,340–41 (Dec. 29, 2006) (codified at 17 C.F.R. 228–29).
[135] *See id.* at 78,338–39, 78,350.

> Investors will now be provided with one number for total annual compensation for each named executive officer. The clarity and comparability of this one number will be complemented by the principles-based narrative disclosures in our new Compensation Discussion and Analysis section and by the requirement that these disclosures be made in plain English.[136]

Some commentators thought that more extensive disclosure requirements for compensation would shame corporate officials into showing some restraint, but that hardly seems to have been the result.[137] Rather, greedy executives now appear to be using that disclosure as a benchmark to ratchet up their own pay by arguing that their remuneration should be at that level or better.[138] As one commentator put it:

> Chief executives tend to view themselves as residents of Lake Wobegon, where all children are above average .... The compensation details of their counterparts provides them with the leverage to request a higher amount from boards. The result: each year executive pay rises ever higher and the industry average is reset.[139]

C. Comments by Scholars and Public Officials

Two prolific and renowned scholars of business law, Professor Lucian Bebchuk and Judge Richard Posner, have also weighed in with very critical comments on the current state of corporate remuneration, as has the respected Troubled Asset Relief Program (TARP) Special Master, Kenneth Feinberg.[140] In a 2004 book with Professor Jesse Fried, *Pay Without Performance*, Bebchuk attacked what he called the "official view" that directors

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[136] Press Release, Securities and Exchange Commission, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), *available at* http://www.sec.gov/news/press/2006/2006-123.htm.

[137] *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 5, 8–9 (2004) (describing public outrage as a factor directors and executives consider when approving executive compensation packages); Sandeep Gopalan, *Shame Sanctions and Excessive CEO Pay*, 32 DEL. J. CORP. L. 757, 758–60, 762, 768 (2007).

[138] *See* Richard A. Posner, Essay, *Are American CEOs Overpaid, and, if So, What if Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1024, 1035 (2009).

[139] Steven M. Davidoff, *Efforts to Rein in Executive Pay Meet with Little Success*, N.Y. TIMES, July 13, 2011, at B7.

[140] *See* Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1917 (2010) (arguing that the 2008–2009 financial crisis prompted recognition of the problems with current executive pay schemes); Posner, *supra* note 138, at 1013–14; Louise Story, *Pay Czar Doubts Cuts Will Make Bankers Leave*, N.Y. TIMES, Oct. 23, 2009, at B8 (discussing Kenneth Feinberg's work in this area and quoting him as saying he had "concluded that anybody making $100 million a year is engaged in excessive risk").

fix executive pay in arm's-length negotiations with executives in order to provide incentive for those officials to increase shareholder wealth.[141] In reality, Bebchuk and others argue, corporate leaders set their own pay through captured boards.[142]

While Bebchuk declined to pass judgment on the high levels of executive pay, he levied heavy fire on their failure to provide any real incentives to corporate management. They are, he said, "compensation practices that obscure the amount and performance insensitivity of pay ...."[143] His point was thus a modern restatement of economist John Kenneth Galbraith's famous dictum, "[t]he salary of the chief executive of the large corporation is not a market award for achievement. It is frequently in the nature of a warm personal gesture by the individual to himself."[144]

In 2008, the country suffered a devastating financial meltdown brought on by the collapse of debt obligations collateralized by inflated real estate values.[145] The federal government stepped in with an enormously expensive bailout of banks that had created and dealt in those speculative securities.[146] In October 2009, Kenneth Feinberg, the special master appointed to oversee executive compensation for banks receiving these so-called TARP funds, ruled that the twenty-five most highly paid executives at those institutions would have their pay capped at $500,000.[147] When asked if he anticipated that his ruling would more broadly change the practices of executive pay,

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[141] BEBCHUK & FRIED, *supra* note 137, at 2, 15.

[142] *Id.* at 2–4. As two other corporate scholars have recently put it with mild understatement,

> [i]n light of the recent deluge of academic and popular criticism of executive pay as well as recent legislation in this area, the belief that the American executive compensation system works well is a distinctly minority position. Far more popular is the well-worn Board Capture theory of American corporate governance, which claims that corporations' executives—particularly the chief executive officer (CEO)—dominate their boards of directors and, in essence, set their own pay.

Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 MINN. L. REV. 846, 847–48 (2011) (footnote omitted).

[143] BEBCHUK & FRIED, *supra* note 137, at 9.

[144] Owen, *supra* note 83, at 60 (quoting Galbraith's famous comment).

[145] *See* Edward Wyatt, *S.E.C. Is Pursuing More Inquiries Tied to the Financial Crisis, Chairwoman Says*, N.Y. TIMES, July 21, 2010, at B2.

[146] *See* Gretchen Morgenson, *Secrets of the Bailout, Now Told*, N.Y. TIMES, Dec. 4, 2011, at B1.

[147] Aaron Lucchetti, David Enrich & Joann S. Lublin, *Fed Hits Banks With Sweeping Pay Limits*, WALL ST. J., Oct. 23, 2009, at A1 (adding that across the board, the pay level of these top executives would be 50% lower than the previous year).

Feinberg replied, "I hope so."[148] That advice, however, has not been heeded by corporate America.

In the wake of the financial crisis, Bebchuk and co-authors presented evidence that executive pay arrangements such as stock options encouraged excessive risk taking that ultimately had deleterious effects on the economy.[149] Executives at two large financial firms that collapsed in the meltdown, Bear Sterns and Lehman Brothers, cashed out and kept large, so-called performance-based compensation that they garnered in the decade before the crash.[150] Bebchuk and Fried followed up with another article discussing ways that executives' compensation can be genuinely tied to the long-term performance of their firms by generally requiring that management hold equity grants for the long term.[151] Another commentator suggested that the same result is currently achieved by firms that substitute grants of restricted stock for options.[152]

Judge Posner, the father of Law and Economics, made similar critical comments recently, stating, "[t]he problem of executive compensation is not only real; it is more serious than I believed it to be ...."[153] First he saw it as a problem of agency costs, that is, excessive amounts paid by owners of a business to those who manage it.[154] With "the uncertainty that surrounds success in business,"[155] it is very difficult, Posner said, to evaluate the performance of a CEO and therefore to say that she has really earned her pay.

Even if there was a reliable method of sizing up the work of a top corporate official, Posner said, boards generally would be unable to apply it

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[148] Joe Nocera, *Pay Cuts, But Little Headway in What Matters Most*, N.Y. TIMES, Oct. 23, 2009, at B1.

[149] *See* Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008*, 27 YALE J. ON REG. 257, 274–76 (2010). Another commentator made the same comments even more bluntly:

> An officer with stock options has an incentive to move corporate assets from stable, low-volatility investments into high-risk investments because that enhances the value of his options. An option holder does not participate in losses, although the underlying assets of the corporation collapse. A corporation that has given its managers substantial options has given them incentives to invest in highly volatile, even suicidal, investments, which should scare the pants off shareholders.

Calvin H. Johnson, *Corporate Meltdowns Caused by Compensatory Stock Options*, TAX NOTES, May 16, 2011, at 738.

[150] *See* Bebchuk, Cohen & Spamann, *supra* note 149, at 276.

[151] *See* Bebchuk & Fried, *supra* note 140, at 1919–20.

[152] *See* David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 VAND. L. REV. 611, 667–68 (2011).

[153] Posner, *supra* note 138, at 1014.

[154] *See id.* at 1015–16.

[155] *Id.* at 1018.

to the CEO at their firms.[156] Directors generally come from the ranks of executives at other companies and thus have a vested interest in keeping the compensation of similarly situated officials high.[157] In addition, since CEOs influence the choice and pay of directors, "there is evidence of mutual back scratching—the directors authorizing generous compensation for the CEO and the CEO supporting generous fees for the directors."[158]

Posner also found that so-called incentive compensation for executives, such as stock options, are not well aligned with the CEO's performance because "[m]any things move a company's stock besides the decisions of its CEO."[159] He also cited the common practice of repricing executive options when a company's stock has fallen and compared it to backdating, which, he said, is only a clandestine approach to achieve the same result.[160] Both allow the recipients to reap large gains from stock appreciation.

Judge Posner concluded that the social costs of excessive compensation are very disturbing, stating that "[t]he redistributive effects are obvious and are troubling from an ethical standpoint because, by definition, overcompensation is a kind of theft from shareholders."[161] Another current commentator echoed those sentiments and expressed similar doubts about the validity of top corporate pay, in whatever form it takes:

> I believe that interactions between executives and companies can be characterized as struggles between hyper-interested and very well organized minorities, i.e., the executives, and relatively disinterested and extremely disorganized majorities, i.e., the shareholders as represented by boards of directors. Executives will prevail in such struggles every time. Inevitably, the end products of such struggles will be contracts that have more to do with optimal looting than with optimal incentive creation.[162]

VII. THE COMING OF SAY-ON-PAY

The famed study of Professors Berle and Means published in 1932 established that the control of public companies is effectively separated from its far-flung shareholder-owners and is lodged in a self-perpetuating managerial

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[156] *See id.*

[157] *See id.* at 1023.

[158] *Id.* at 1024.

[159] *Id.* at 1026.

[160] *See id.* at 1027–28.

[161] *Id.* at 1042.

[162] Herwig Schlunk, Response, *Some Thoughts on the Evolution of Executive Equity Compensation*, 64 VAND. L. REV. EN BANC 73, 73–74 (Mar. 31, 2011, 11:55 AM), http://www.vanderbiltlawreview.org/content/articles/2011/03/Schlunk-Some-Thoughts-on-the-Evolution-of-Executive-Equity-Compensation-64-Vand.-L.-Rev.-En.-Banc.-73-2011.pdf.

class.[163] As one leading corporate critic put it, "[i]t's one of the great anomalies of our ownership society: shareholders own companies, but executives can easily slap them down. The hired help, in other words, holds the cards."[164] Starting from at least the Watergate scandals of the 1970s, there have been widespread movements to reform corporate governance practices so that officers and directors are held more accountable to their shareholders and the public.[165] Yet those efforts seem to have produced little success.

As public awareness of this exorbitant compensation grew, however, investor groups and other activists began demanding shareholder input on those decisions.[166] Under pressure, a few firms voluntarily afforded stockholders a Say-on-Pay vote. Congressional action to mandate Say-on-Pay measures at all public companies began with a bill introduced by Congressman Barney Frank in 2007.[167] In 2009, that Congressional action morphed into a law requiring all firms receiving TARP assistance to hold such a vote.[168] Finally, after a lengthy legislative process to address the causes of the financial meltdown, Congress included a provision in the omnibus Dodd-Frank Act giving shareholders in all public companies a nonbinding vote on the compensation received by their executives.[169] With President Obama's signature, it became law in July 2010.[170]

The Dodd-Frank Say-on-Pay measure added a new subsection to the Securities Exchange Act of 1934 entitled "Shareholder Approval of Executive Compensation."[171] It requires that public companies hold shareholder advisory votes on the executive compensation described in their proxy statements at least once every three years.[172] This resolution in the proxy statements does not need any special language. The Dodd-Frank Say-on-Pay measure also mandates that at the first annual meeting after its enactment, the shareholders elect how frequently they will take these votes—at

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[163] *See* William W. Bratton, Essay, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 751–52 (2001).

[164] Gretchen Morgenson, *When Two-Thirds Isn't Enough*, N.Y. TIMES, June 12, 2011, at BU1.

[165] *See* Robert W. Hamilton, *Corporate Governance in America 1950–2000: Major Changes but Uncertain Benefits*, 25 J. CORP. L. 349, 359 (2000).

[166] *See, e.g.*, Andrew C.W. Lund, *Say on Pay's Bundling Problems*, 99 KY. L.J. 119, 120 (2010–2011).

[167] *See id.* at 123.

[168] *See id.*

[169] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899–1900 (2010).

[170] Lund, *supra* note 166, at 124.

[171] § 951, 124 Stat. at 1899.

[172] *Id.*

a one-, two-, or three-year interval.[173] This is the so-called "Say-When-on-Pay" vote. A separate advisory vote is also required on severance arrangements under a golden parachute provision.[174]

The law also includes a "Rule of Construction."[175] It may not be interpreted:

> (1) as overruling a decision by such issuer or board of directors;
> (2) to create or imply any change to the fiduciary duties of such issuer or board of directors;
> (3) to create or imply any additional fiduciary duties for such issuer or board of directors; or
> (4) to restrict or limit the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation.[176]

The SEC followed up with its own regulations implementing Say-on-Pay.[177] It requires that the results of those votes be reported promptly to the public on Form 8-K.[178] It also mandates that each firm's narrative disclosure in future proxy statements must explain when those results were taken into account in future compensation decisions.[179]

A similar Say-on-Pay provision has existed since 2004 in the United Kingdom where it has constrained executive pay at poorly performing firms.[180] This led one commentator to propose that such a vote would be more effective if taken ex ante, that is, as a review of the pay package of a prospective CEO rather than ex post, as a referendum on whether performance warranted the already awarded pay package.[181]

Shareholders under the regime established by Dodd-Frank, he argued, also might be reluctant to cast a negative vote on exorbitant compensation at a well-performing firm for fear of offending its management.[182] The commentator also surmised that in its present form as an after-the-fact advisory vote, the principal harm to directors of a negative Say-on-Pay vote would

173 *Id.*
174 *See id.* at 1899–1900.
175 *Id.* at 1900.
176 *Id.*
177 *See* Jessica Holzer, *Split SEC Adopts 'Say on Pay' Rule*, WALL ST. J., Jan. 26, 2011, at C3 (discussing the SEC's implementation of Dodd-Frank).
178 *See* SEC Office of Investor Education and Advocacy, *Investor Bulletin: How to Read an 8-K*, SEC (May 2012), https://www.sec.gov/investor/pubs/readan8k.pdf (explaining that a company must use form 8K to disclose the compensation arrangements of any new director or high-level executive, along with any changes to existing director or officer compensation).
179 *See* Ben Protess, *In Split Vote, S.E.C. Adopts Corporate Pay Rules*, N.Y. TIMES (Jan. 25, 2011, 1:26 PM), http://dealbook.nytimes.com/2011/01/25/s-e-c-adopts-say-on-pay-rules.
180 *See* Lund, *supra* note 166, at 127–28.
181 *See id.* at 120–23.
182 *Id.* at 149.

be reputational, although it could also signal an implicit threat to remove directors at their re-elections or through a proxy contest.[183]

VIII. SAY-ON-PAY: THE FIRST YEAR AND BEYOND

When Say-on-Pay went into effect in early 2011, one commentator assessed some of its early votes and predicted that the measure would have "a transformative impact on the relationship between chief executives and institutional investors."[184] After a full year's operation, however, the results are more mixed. By June, at the end of the spring proxy season in which a large majority of public companies held their annual meetings, shareholders casting Say-on-Pay votes had overwhelmingly approved the executive compensation at their companies.[185] Institutional Shareholder Services (ISS), a leading shareholder advocate, recommended a negative vote at 293 companies.[186] Yet a majority of voting shareholders from over 2,500 firms signaled their approval of the pay packages at all but 39.[187] This amounted to a "Yes" vote at 98.5% of the companies.[188]

An editorial therefore called Say-on-Pay "a disappointment" and cited this comment on the process from Robert A.G. Monks, a corporate governance expert: "[y]ou only have the appearance of reform, and it's a cruel hoax."[189] In the same vein, another commentator said, "[t]he latest 'say on pay' endeavor has turned into a costly exercise that validates almost every companies' [sic] pay practices."[190]

Yet the same expert noted that the reforms were not futile.[191] Some companies foresaw shareholder criticism and changed their pay arrangements ahead of the votes.[192] Almost 80% of companies on the Russell 3000 index endorsed annual votes rather than every 2 or 3 years, and there was also evidence that instead of "the country club back-slapping of earlier years," pay scales were being more closely tied to company performance.[193]

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[183] *Id.* at 124–25.

[184] Ronald D. Orol, *Say-on-Pay Vote Gives CEOs Early Trouble in 2011*, MARKETWATCH (Feb. 3, 2011, 6:01 AM), http://www.marketwatch.com/story/say-on-pay-vote-gives-ceos-early-trouble-in-2011-2011-02-03.

[185] *See* John Helyar, *Investor 'Say on Pay' Is a Bust*, BLOOMBERG BUSINESSWEEK (June 16, 2011, 6:30 PM), http://www.businessweek.com/magazine/content/11_26/b4234023747122.htm.

[186] *Id.*

[187] Davidoff, *supra* note 139, at B7.

[188] *Id.*; Jessica Holzer, *A 'Yes' In Say on Pay*, WALL ST. J., July 8, 2011, at B1.

[189] Editorial, *Pay for Performance*, MILWAUKEE J. SENTINEL, June 24, 2011, at A10.

[190] Davidoff, *supra* note 139, at B7.

[191] *See id.*

[192] *See id.* (discussing changes to executive compensation made by General Electric and Disney as a result of negative shareholder reaction).

[193] *Id.*

Other observers cited similar promising outcomes. Some companies, like General Electric, that had originally received negative recommendations from ISS changed their compensation policies and secured its approval,[194] and many companies made changes in their compensation programs in anticipation of the first round of Say-on-Pay votes.[195] Additionally Lynn Turner, former chief accountant for the SEC, explained the positive ballots by noting that "mutual funds, which own 70 percent of U.S. equities and are many companies' biggest shareholders," often have contracts with corporations to manage their employees' 401(k) plans.[196] As such, "[t]he big mutual fund companies 'won't vote against management on compensation unless they're really bad.'"[197]

Another observer counseled firms not to take the wrong message from this first year of voting because "institutional investors said they reserved their 'No' votes for particularly egregious compensation practices. They felt that too many 'No' votes would 'dilute the effectiveness of voting against the pay plans ....'"[198]

Along the same lines, recent polling data demonstrates that "an overwhelming majority [of institutional investors] expect[] the number of companies with majority 'No' votes to increase in 2012."[199] With that in mind, a large majority of companies are reviewing the results of the 2011 vote to see if they should make changes in their compensation plans in anticipation of the 2012 ballot.[200] PricewaterhouseCoopers LLP determined that shareholders had particular concerns that led them to vote "No" in Say-on-Pay votes in 2011, including "'cherry-picking' of performance metrics from year to year[,] '[m]ake-up' cash and equity awards when the plans do not pay out because executives didn't reach performance targets[,] [e]xecutive perquisites[, and] [c]ompensation levels that are facially 'too high.'"[201]

Negative votes may also increase in 2012 because of new SEC disclosure rules expected to go into effect during the year.[202] Chief among them

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[194] Helyar, *supra* note 185.

[195] *See* Davidoff, *supra* note 139, at B7; Kathleen Koster, *Companies Bolster Pay-for-Performance in Executive Comp Due to 'Say on Pay,'* EMPLOYEE BENEFIT NEWS (Dec. 12, 2011), http://ebn.benefitnews.com/news/executive-compensation-say-pay-performance-sec-2720581-1.html.

[196] Helyar, *supra* note 185.

[197] *Id.*

[198] Koster, *supra* note 195 (quoting PricewaterhouseCoopers Director Steven Slutsky).

[199] *Id.*

[200] *See id.*

[201] *Id.*

[202] Danielle Douglas, *Banks Still Waiting on most Dodd-Frank Rules*, WASH. POST, Dec. 26, 2011, at A10.

will be a requirement that companies state the ratio of their CEO's pay to that of their median employee.[203] This will quite bluntly mandate that firms "put in black-and-white that the CEO makes umpteen [sic] times more than the median total compensation for all employees in the organization."[204]

Republicans in Congress, however, and their allies who lobby for Wall Street, have made a strong push to repeal or cut back the reforms of Dodd-Frank. One former senator called their support "the most uneven battle since Little Big Horn."[205] Business groups, emboldened by a judicial decision in July 2011 striking down the SEC's proxy access rule, might also bring to court challenges to all or parts of Dodd-Frank.[206] By contrast, a senior Obama official speaking of the upcoming presidential election said that the President would make the legislation "one of the central elements of the campaign."[207] "One of the main elements of the contrast will be that the president passed Wall Street reform and our opponent and the other party want to repeal it."[208]

IX. SAY-ON-PAY VOTES AS EVIDENCE OF BREACH OF FIDUCIARY DUTIES

A. Preliminary Considerations

Under the internal affairs doctrine, officers and directors owe duties to their shareholders. These duties are determined by the states where the firm is incorporated.[209] In addition, all states place the power to manage a

[203] *See id.*; Mike Armstrong, *Why It's Good at the Top*, PHILA. INQUIRER (Aug. 14, 2011), http://articles.philly.com/2011-08-14/news/29886747_1_shareholders-companies-financial-reform-law.

[204] *Id.*

[205] Ben Protess, *Wall Street Lobbyist Aims to 'Reform the Reform,'* N.Y. TIMES (July 14, 2011, 11:06 AM), http://dealbook.nytimes.com/2011/07/14/wall-street-lobbyists-try-to-reform-the-reform (quoting former Delaware Sen. Ted Kaufman).

[206] *See* Ben Protess, *Court Ruling Offers Path to Challenge Dodd-Frank*, N.Y. TIMES (Aug. 17, 2011, 8:41 PM), http://dealbook.nytimes.com/2011/08/17/court-ruling-offers-path-to-challenge-dodd-frank.

[207] Mona Charen, *Obama's Tactics Court Few*, SPOKESMAN-REV., Oct. 18, 2011, at 11A (quoting senior Obama campaign advisor David Plouffe).

[208] *Id.* President Obama, of course, was re-elected. For the author's view on how that might impact corporate law, see generally Daniel J. Morrissey, *A New Corporate Model,* NAT'L L.J., (Jan. 7, 2013), http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1202583322316&slreturn=20130022233525.

[209] *See* Edgar v. MITE Corp., 457 U.S. 624, 645 (1982) (characterizing the internal affairs doctrine as "a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs ... because otherwise a corporation could be faced with conflicting demands").

corporation under the supervision of its board of directors.[210] Congress, therefore, had to make Say-on-Pay votes advisory or else it would be impinging on the prerogative of state jurisdiction.

One conservative legal scholar, Steven Bainbridge, thus went on the record with this dismissive view of potential lawsuits based on such negative votes:

> In state law, executive compensation decisions by the board of directors is [sic] subject to the business judgment rule, making shareholder pay lawsuits extremely hard to win .... The act and its legislative history further make clear that the votes shall not be deemed either to effect or affect the fiduciary duties of directors. ... It'll be interesting to see what legal theories these plaintiffs [sic] lawyers come up with .... Surely they won't have the brass balls to claim that say on pay is binding, will they?[211]

Despite Professor Bainbridge's comments doubting the resolve of shareholder lawyers, by September 2011 at least seven derivative suits were filed against senior executives, directors, and their compensation consultants over negative Say-on-Pay votes.[212] They all alleged that courts should excuse as futile the preliminary requirement for pre-suit demand on the board, because those directors had already approved the questionable compensation.[213]

The suits did not challenge the directors' and officers' duty of care which would be protected by the business judgment rule and exculpatory provisions such as Section 102(b)(7) of the Delaware Corporate Code.[214] Instead, they

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[210] *See, e.g.*, MODEL BUS. CORP. ACT § 8.30 (2011); DEL. CODE ANN. tit. 8, § 144 (2010).

[211] Stephen Bainbridge, *Say on Pay Litigation*, PROFESSORBAINBRIDGE.COM (Apr. 26, 2011, 11:49 AM), http://www.professorbainbridge.com/professorbainbridgecom/2011/04/say-on-pay-litigation.html. Some may argue that shareholders that are dissatisfied with the executive pay at their firms can always sell their stock. If enough of that occurs, it might significantly decrease the company's market capitalization and thus send a powerful message of discontent to management. This, of course, is not an adequate response if executives have already taken excessive compensation, nor is it likely to change matters much. As one commentator responded concerning this tactic, "while it may lessen the market price of shares, [it] will not dislodge management—or even threaten it. On the contrary, if dissident shareholders leave, it may even bring about further entrenchment of management—especially if management can pass new bylaws in the interim." MONKS & MINOW, *supra* note 69, at 119 (quoting Edward Jay Epstein). The only real result therefore would be to weaken the overall economy by perpetuating such wasteful use of corporate resources.

[212] *Defending Against Shareholder "Say-on-Pay" Suits*, DECHERTONPOINT, 1 (Sept. 2011), http://www.dechert.com/files/Publication/5312a5d9-c3ac-4911-9b40-04007f14fe6e/Presentation/PublicationAttachment/bf7b8249-a2d7-4372-ba70-2e35b79d2785/C%26S_WCSL%20update_09-11_Defending_Against_Shareholder_Say-On-Pay%20Suits.pdf [hereinafter *Defending Against*].

[213] *See id.* at 2; *see also* Aronson v. Lewis, 473 A.2d 805, 809 (Del. 1984).

[214] *See Defending Against*, *supra* note 212, at 2. Section 102(b)(7), is the so-called Delaware "raincoat" because by adopting it as a provision of a company's certificate of

alleged that the "No" votes reflected the "independent business judgment" of shareholders that the pay was not in the interest of their firms and they attacked the compensation decisions as breaches of the duties of loyalty and good faith owed by corporate officials to their shareholders.[215]

Astute commentators pointed out that recent Delaware decisions had laid the groundwork for such claims.[216] In *Gantler v. Stephens*, Delaware's High Court ruled that corporate officers have the same fiduciary duties as directors.[217] A few years earlier, the Chancellor had found that a CEO violated his duty of loyalty when negotiating a compensation agreement with his company.[218] Unlike Mr. Ovitz in *Disney* who was bargaining for his first employment contract,[219] the CEO here was already the top official of the firm and thus likely to receive a sweetheart deal.[220]

B. Cincinnati Bell

Commentators therefore should not have been so quick to call these Say-on-Pay suits frivolous.[221] On the contrary, it should have been apparent that they had the potential to really "shake up a boardroom."[222] In September 2011, a U.S. District Court refused to dismiss a Say-on-Pay suit by automatically acceding to the business judgment of directors.[223] Instead, confirming the potential of Say-on-Pay suits, the court ruled that whether such deference was warranted would be a question for trial. The court also excused the requirement that shareholders make a pre-suit demand.[224]

The case involved $4 million in bonuses given to the CEO of Cincinnati Bell, Inc., "on top of $4.5 million in salary and other compensation."[225] Cincinnati Bell's board took that action despite "a $61.3 million decline in

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incorporation it holds the officials of those firms harmless for any damage claims that they have breached their fiduciary duties of care. *See also* MODEL BUS. CORP. ACT § 8.30 (2011).

[215] *Defending Against*, *supra* note 212, at 2.

[216] *See* Thomas & Wells, *supra* note 142, at 884–85 (discussing the implications of *Gantler v. Stephens*).

[217] Gantler v. Stephens, 965 A.2d 695, 709 (Del. 2009).

[218] Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, No. Civ.A. 20228-NC, 2004 WL 1949290, at *16 (Del. Ch. Aug. 24, 2004).

[219] *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 36 n.4 (Del. 2006).

[220] *Elkins*, 2004 WL 1949290, at *16.

[221] *See, e.g.*, Broc Romanek, *Whoa! First Say-on-Pay Lawsuit to Survive a Motion to Dismiss*, THECORPORATECOUNSEL.NET (Sept. 23, 2011, 8:08 AM), http://www.thecorporatecounsel.net/Blog/2011/09/tweeting-away-a-fake-sec.html.

[222] *Id.*

[223] *See* NECA-IBEW Pension Fund ex rel. Cincinnati Bell, Inc. v. Cox, 1:11-CV-451, 2011 WL 4383368, at *3 (S.D. Ohio Sept. 20, 2011).

[224] *Id.*

[225] *Id.* at *1.

net income, a drop in earnings per share from $0.37 to $0.09, a reduction in share price from $3.45 to $2.80, and a negative 18.8% annual shareholder return."[226] In light of that poor performance it should have been no surprise that the company's shareholders registered a 66% "No" vote against the CEO's increased pay package.[227]

The shareholder plaintiff brought the suit alleging that the directors had breached their duty of loyalty in awarding the bonuses.[228] To establish liability, a shareholder has to meet a high standard of culpability under Ohio law. It requires a showing of "a deliberate intent to cause injury to the corporation or reckless disregard for the best interests of the corporation."[229] Even though informed decisions on compensation by disinterested directors are presumed to be the product of a valid business judgment, the *Cincinnati Bell* court found that the plaintiff had adequately pled facts showing that protection might not be available in that case.[230]

The court justified its ruling by citing the company's own pay-for-performance policy.[231] It held that there was therefore a plausible claim the "multi-million dollar bonuses approved ... in a the time of the company's declining financial performance ... were not in the best interests of Cincinnati Bell's shareholders and therefore constituted an abuse of discretion and/or bad faith."[232]

In its lengthy first footnote, the court gave an indication of how the negative Say-on-Pay suit impacted its decision.[233] There the court observed that some commentators have identified excessive executive compensation as the "[n]o. 1 problem in corporate governance."[234] It then went on to cite various statistics describing how CEO pay has far outstripped average wages and how the misdistribution of earnings and wealth in our country has grown to alarming proportions.[235]

It then noted that Congress had passed Dodd-Frank with its Say-on-Pay provision "against this backdrop."[236] Next it noted that,

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[226] *Id.*
[227] *Id.*
[228] *Id.*
[229] *Cincinnati Bell, Inc.*, 2011 WL 4383368 at *2 (internal quotation marks omitted) (quoting OHIO REV. CODE ANN. § 1701.59(D) (2011)).
[230] *Id.* at *3.
[231] *Id.*
[232] *Id.* (footnote omitted).
[233] *See id.* at *1 n.1.
[234] *Id.* (quoting Daniel J. Morrissey, *Courts Should Curb Executive Pay*, NAT'L L.J. (Aug. 15, 2011)).
[235] *Cincinnati Bell, Inc.*, 2011 WL 4383368 at *1.
[236] *Id.*

> [a]lthough Dodd-Frank states that those [votes] are not binding and do not alter the fiduciary duties of directors, some commentators opine that "[a] negative say-on-pay vote gives the court evidence that there's been a breach of duty. It doesn't mean there's been a breach of duty, but it can support a finding of breach."[237]

Finally, turning the fear of frivolous litigation on its head, the court cited a report that as of June 2011 shareholders had disapproved of executive pay in only 1.6% of public companies that took Say-on-Pay votes.[238] In a terse following comment the court stated, "Cincinnati Bell is one of those companies," signaling that it considered the shareholders' negative vote as evidence of misconduct.[239]

C. Beazer Homes

A Georgia trial court, however, has dismissed a similar shareholder suit.[240] The case involved Beazer Homes USA Inc. (Beazer), whose four most highly compensated executives received pay raises even though the company suffered a $34 million loss and a -17.23% share price return for fiscal year 2010.[241] That continued in a three-year pattern of poor performance, during which Beazer lagged behind peer companies.[242] Yet the firm's CEO received total remuneration of $6,893,362 in 2010, up approximately $450,000 from the previous year.[243] That compensation package drew a 54% negative Say-on-Pay vote at the company's annual meeting of shareholders in February 2011.[244]

In reporting the vote, Beazer stated: "[o]ur core compensation objective continues to be that we will pay for performance—we believe that we should pay higher compensation when our management team succeeds and lower compensation when it does not."[245] Yet the company went on to justify the greater pay in 2010 by citing "the highly unique set of circumstances facing the Company at the start and during most of fiscal 2009."[246]

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237 *Id.* (quoting Danielle Myles, *Experts Disagree on Validity of Say-on-Pay Lawsuits*, INT'L FIN. L. REV. (Aug. 2011)).

238 *Id.*

239 *Id.*

240 *See* Teamsters Local 237 Additional Sec. Benefit Fund v. McCarthy, No. 2011-CV-197841, 2011 WL 4383368, at *1 (Ga. Super. Sept. 15, 2011).

241 *Id.*

242 *Id.*

243 *Id.*

244 *Id.*

245 *Id.*

246 Beazer Homes USA, Inc., Proxy Statement (Feb. 25, 2010), *available at* http://edgar.sec.gov/Archives/edgar/data/915840/000119312510040945/ddef14a.htm.

Beazer also explained the jump in pay by noting that the executives' compensation had been frozen for some time, that their bonuses had been reduced in recent years, and that no equity awards had been made to them in the last two years.[247]

According to the Company's 2010 proxy, however, Beazer was under criminal and civil investigations by the Department of Justice that precluded it from offering such equity-based grants.[248] Since the company's top officials were presumably responsible for those potential law violations, shareholders, as evidenced by their negative vote, may well have felt that Beazer's leaders suffered no injustice in being deprived of those awards and there was no need that the awards be given now.

Beazer was an egregious situation of unearned compensation, and management's justifications for it were disingenuous. The company's shareholders therefore quite logically signaled their disapproval. Yet in contrast to the *Cincinnati Bell* decision, the *Beazer* Court refused to excuse pre-suit demand, finding that the complaint failed to allege particularized facts raising doubt that "the challenged compensation decisions were made in good faith and in [sic] directors' honest belief that the decisions were in Beazer's best interests."[249] In other words, according to the Court, the allegations had not raised "a reasonable doubt that the Beazer directors' decisions ... reflected valid business judgments."[250] The *Beazer* Court also supported its decision by noting that Delaware law had long granted "wide discretion" to boards to set executive compensation and Dodd-Frank had specifically preserved that "fiduciary duty framework concerning directors' executive compensation decisions."[251]

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[247] *Id.*
[248] *Id.*
[249] *McCarthy*, 2011 WL 4383368, at *10.
[250] *Id.*
[251] *Id.* Like *Beazer*, a U.S. Magistrate Judge in Oregon recently recommended a dismissal of a suit involving Umpqua Holdings Corporation where 62% of the shareholders cast "No" "Say-on-Pay" votes on their executives' pay packages. Plumbers Local No. 137 Pension Fund v. Davis, Civ. No. 03:11-633-AC, 2012 WL 104776, at *2 (D. Or. Jan. 12, 2012).There each officer's compensation increased from 60% to 160% in 2010 despite a negative 7.7% return to shareholders. *Id.* That Magistrate Judge however declined to follow *Cincinnati Bell* and questioned whether it would remain viable legal authority because there could have been lack of subject matter jurisdiction and the plaintiff may have failed to disclose contrary authority in response to an inquiry by the Court. *Id.* The author's understanding is that the *Cincinnati Bell* court has since resolved those issues in favor of the plaintiff. In any event, the case's reasoning remains persuasive. A negative Say-on-Pay vote should be evidence of possible breaches of fiduciary duty by corporate officials. It can then negate the use of the business judgment rule as a defense to excessive executive compensation.

X. SAY-ON-PAY'S BROADER IMPACT ON THE NATIONAL ECONOMY

According to a recent survey of investors, executive pay continues to be one of their top concerns—particularly when that remuneration is significantly higher than peer levels and disproportionate to the company's performance.[252] Suits against boards for authorizing excessive compensation therefore will continue, bolstered by the *Cincinnati Bell* decision, which cites negative Say-on-Pay votes as prime evidence of such a breach of fiduciary duty.

Facing such a specter of potential liability, one commentator starkly advised that directors might finally "sit down and do the math."[253] Up until now, he noted, they have not been evaluating what options-awards might cost the company when the stock price goes up.[254] Even more significantly, he said, directors "who typically owe their position on the board to the chief executive"[255] might finally have a countervailing incentive to do their job and check their top executives' demands for exorbitant compensation.

Underlying this legal change is the moral sense that these huge executive pay packages are a grave injustice, a real theft of our productive resources. All religious traditions condemn the evil that results when great wealth is misappropriated, and American history is full of lessons that we all rise or fall together as a people. As President Kennedy put it, "[i]f a free society cannot help the many who are poor, it cannot save the few who are rich."[256]

Closely related to the misuse of corporate wealth by excessive compensation is the equally troubling phenomenon of corporations hoarding large amounts of cash and not distributing those funds to shareholders or putting them to other productive uses.[257] Two trillion dollars of these funds currently lie in corporate treasuries, with firms showing little interest in spending them to create jobs for workers[258] that would spur economic recovery.[259] In addition, the revival of the American manufacturing base requires expenditures in science, engineering, and technology.[260] With debt issues paramount in

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[252] INST. S'HOLDER SERVS., INC., 2011–2012 POLICY SURVEY SUMMARY OF RESULTS (2011), http://www.issgovernance.com/files/PolicySurveyResults2011.pdf.

[253] Sherter, *supra* note 103 (quoting GMI senior research associate, Paul Hodgson).

[254] *Id.*

[255] *Id.*

[256] President John F. Kennedy, Address at the Presidential Inauguration (Jan. 20, 1961).

[257] *See* Becky Yerak, *Sitting Tight on Big Cushions*, CHI. TRIB., Sept. 25, 2011, at Sec. 2 p.1.

[258] Rana Foroohar, *Don't Hold Your Breath*, TIME (June 8, 2011), http://www.time.com/time/nation/article/0,8599,2076568,00.html.

[259] Tom Campbell, *Hiring Would Spur Recovery*, SPOKESMAN REV., Aug. 25, 2011, at O2.

[260] *See* Susan Hockfield, Op-Ed., *Manufacturing a Recovery*, N.Y. TIMES, Aug. 29, 2011, at A23.

Washington, experts expect a 10% cut in federal grants for research and development,[261] making private sector spending even more imperative.

In short, the underuse of firm resources, along with their blatant misuse by excessive executive compensation, is robbing companies and their shareholders of funds that should be working to expand the profitable capacities of the nation and giving productive work to its citizens. As a leading treatise on corporate governance puts it when discussing the proper purposes of those firms, "[t]he accountability we still seek ... is that which is most likely to result in corporate choices that best benefit society over the long term."[262]

A prime example of that beneficial attitude comes from one of the great geniuses of American business, Henry Ford. By the second decade of the 20th century, Ford's Motor Company had already become quite profitable.[263] Ford planned to use some of those funds as a reserve so he could lower the price of his cars, but some of his early shareholders, the Dodge brothers, objected.[264] They sued Ford, charging that they were getting insufficient dividends. Ford offered this defense of his business plan: "[m]y ambition ... is to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this, we are putting the greatest share of our profits back into the business."[265] This defense of his business plan was in line with Ford's oft-stated aspiration to pay everyone who worked at his plant well enough to purchase one of the cars they helped make.[266]

The court however seemed to find Ford's rhetoric too philanthropic. In holding that Ford must pay more dividends to the Dodge Brothers it stated, "[t]here should be no confusion .... A business corporation is organized and carried on primarily for the profit of the stockholders."[267] Yet the court also acknowledged the discretion that the law would allow to directors to accomplish that purpose.[268] If Ford had thus justified his price-reduction policies as a way of creating a permanent market for his product, the result would most likely have been different. His statement about the broader corporate purposes would then have been very acceptable when

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[261] *Id.*

[262] MONKS & MINOW, *supra* note 69, at 14.

[263] Dodge v. Ford Motor Co., 170 N.W. 668, 683 (Mich. 1919) (finding that in 1916 Ford could reasonably expect a profit of over $60 million, had assets of over $132 million, and a surplus of approximately $112 million).

[264] *Id.* at 682.

[265] *Id.* at 671.

[266] HENRY FORD, MY LIFE AND WORK 116 (1922).

[267] *Dodge*, 170 N.W. at 684.

[268] *See id.* at 682.

seen as creating wide desire for a product that only well-paid consumers could satisfy.[269]

The need for such broad based buyer demand is even greater today when our nation's recovery staggers along. As economist Robert Reich stated, "The economy cannot possibly get out of its current doldrums without a strategy to revive the purchasing power of America's vast middle class."[270] Economic growth will thus come when corporate funds are used for job-creating investments, rather than hoarded or lavishly paid out to overcompensated executives.

CONCLUSION

Cases like *Citigroup* and *Cincinnati Bell* are evidence of a renewed judicial willingness to find boards of directors liable for breaches of their fiduciary duty if they have granted overly generous pay hikes to top officials. This may be particularly so when shareholders have stated their disapproval of those awards by negative Say-on-Pay votes, especially when those lush raises have been granted despite losses and in derogation of corporate policy that executive pay be based on performance.

Although the negative Say-on-Pay votes are not legally binding on boards, they are nevertheless probative evidence that directors have violated their duty to act in the best interest of their shareholders. Courts can act with rulings that will send a much-needed message to boards that they must curb excessive pay packages for top management. Then, by distributing those funds to shareholders or putting them to other productive uses, business leaders can roll back some of the outlandish income inequality that is plaguing our nation.

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[269] Most recently a new business form has been established by the laws of several states—the Benefit Corporation. It allows a company to explicitly embrace a dual purpose, profitability, and other more altruistic goals that further the public good. By putting potential shareholders on notice that it may have other motives in addition to profit maximization, a corporation can shelter its altruistic leaders from shareholder suits such as *Dodge v. Ford*. *See* Stephen J. Haymore, *Public(ly Oriented) Companies: B Corporations and the Delaware Stakeholder Provision Dilemma*, 64 VAND. L. REV. 1311, 1313 (2011); Rakhi I. Patel, *Facilitating Stakeholder-Interest Maximization: Accommodating Beneficial Corporations in the Model Business Corporation Act*, 23 ST. THOMAS L. REV. 135, 140–41 (2010). Along the same lines, former Vice President and environmental activist Al Gore has recently created a blueprint for what he calls "sustainable capitalism" which would lead companies away from "irresponsible short-term investment." Sinead Cruise, *Al Gore Takes Aim at "Unsustainable" Capitalism*, REUTERS (Feb. 16, 2012, 1:19 PM), http://www.reuters.com/article/2012/02/16/sustainablecapitalism-idUSL5E8DG45E20120216.

[270] Robert B. Reich, *The Limping Middle Class*, N.Y. TIMES, Sept. 4, 2011, at SR6.