

Articles

“CLEAN HANDS” AND THE CEO: EQUITY AS AN ANTIDOTE FOR EXCESSIVE COMPENSATION

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Greed is good. Greed is right. Greed works.

We make the rules, pal. The news, war, peace, famine, upheaval, the price of a paper clip. We pick that rabbit out of a hat while everybody sits around wondering how the hell we did it. Now you're not naïve enough to think that we're living in a democracy, are you, Buddy? It's the free market, and you're part of it.

-- Gordon Gecko, *Wall Street*

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I. INTRODUCTION

At the top of the corporate pyramid sits the chief executive officer (“CEO”). Along with the board of directors, the CEO is primarily responsible for the success of the company. When companies fail due to a breakdown in governance or financial misconduct, shareholders lose. Other stakeholders lose as well, including competitors, employees, and ultimately the public at large.

It turns out that naked greed is not so good or right. The economic and social costs of unmitigated greed include the failure of some of the largest financial and insurance institutions in the world, government bailouts on a scale previously unimaginable, crisis in the credit markets, numerous corporate bankruptcies, and a badly demoralized stock market.¹ Over-leveraged and unregulated risk taking, fueled by greed, has become business as usual for some of the most revered companies in the United States.² The fall of these publicly traded companies has crippled the U.S. economy and spawned a worldwide recession.³

The “culture of corporate greed” decried almost a decade ago by then Federal Reserve Board Chairman Alan Greenspan following the collapse of Enron has continued unchecked.⁴ Then, as now, management

1. For a detailed discussion and description of events precipitating the present financial crisis, see *Inside the Meltdown* (PBS television broadcast Feb. 17, 2009), available at <http://www.pbs.org/wgbh/pages/frontline/meltdown/view/> (last visited July 7, 2010).

2. See RICHARD BOOKSTABER, *A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION* 156 (2007) (observing that it is more likely that an unanticipated crisis will arise when market participants have a self-interest in gaming the system); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 206 (2008) (explaining that market participants have insufficient incentive to internalize their externalities because the benefits of exploiting finite capital resources accrue to individual market participants whereas the costs of exploitation, which affect the real economy, are distributed among an even wider class of persons); see also Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long Term*, 26 YALE J. ON REG. 359 (2009) (linking pay packages to excessive risk-taking in the financial system). Coverage of the financial disaster was spread across the front pages of every major U.S. newspaper as well as documented in live broadcasts. The media described the disaster that not only included the failure of companies like Merrill Lynch, Lehman Brothers, and Bear Stearns, but also of Fanny Mae and Freddie Mac, arguably the two largest companies on earth, which collectively held \$5 trillion in mortgages. *Inside the Meltdown*, *supra* note 1.

3. See Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373 (2008) (examining the causes of the subprime crisis and its devolution into a larger global financial crisis); Fabrizio Ferri & James Weber, *AFSCME vs. Mozilo...and "Say on Pay" for All! (B)*, Harvard Business School Case No. 9-109-157, at 1 (Boston: Harvard Business School Publishing, Mar. 18, 2009) (summarizing the sequence of events).

4. Richard S. Stevens, *Culture of Corporate Greed*, N.Y. TIMES, July 17, 2002, at C8; see also Louis Lavelle, *The Best & Worst Boards: How the Corporate Scandals are*

irresponsibility produced a ripple effect on multiple stakeholders.⁵ At that time, innumerable news headlines revealed corporate fraud, accounting scandals, restatements of corporate earnings, and a shaken market.⁶ Yet the greed precipitating the demise of Arthur Andersen, Tyco, Merrill Lynch, Adelphia, and other failures in governance and ethics were but a shadow of things to come.⁷

History repeated itself despite corporate corrections and claims of moral and social obligations. Promises of ethical administration, however, were often honored in their breach.⁸ Management deviance was likewise

Sparking a Revolution in Governance, BUSINESSWEEK, Oct. 7, 2002 (describing Enron as the “biggest governance failure in modern corporate history”). More recently, Harvard professors Rakesh Khurana and Andy Zelleke advised that “contemporary business culture has distorted the spirit of traditional American capitalism—ill at ease with unearned wealth—by rewarding mediocrity and even failure.” *You Can Cap The Pay, But The Greed Will Go On*, WASH. POST, Feb. 8, 2009, at B4.

5. See Patty M. DeGaetano, *The Shareholder Direct Access Teeter-Totter: Will Increased Shareholder Voice in the Director Nomination Process Protect Investors?*, 41 CAL. W. L. REV. 361, 361 (2005) (“Enron and its progeny . . . cause[d] an unimaginable ripple effect on the market, as tens of billions of dollars of market capital was destroyed, workers’ retirement plans were devastated, shareholders’ dreams were ruined, and individual investors’ trust in the stock market was shattered.”); Faith Stevelman Kahn, *Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 TUL. L. REV. 1579, 1585 (2002) (discussing the impact of the Enron collapse in the aftermath of the September 11, 2001 terrorist attacks and noting “[l]ike that of the Twin Towers, Enron’s collapse was sudden, devastating, and horribly unjust in its effect”).

6. Enron’s fraud cost shareholders around \$70 billion when the company’s stock price collapsed. Bruce S. Schaeffer, *Shelter from the Storm*, THE DAILY DEAL (Aug. 11, 2003). When WorldCom collapsed, it took the entire sector with it. Worldcom’s investors lost \$180 billion, competitors’ investors lost \$7.8 billion, and overall social welfare costs were estimated to be \$49 billion. Gil Sadka, *The Economic Consequences of Accounting Fraud in Product Markets: Theory and a Case from the U.S. Telecommunications Industry (WorldCom)*, 8 AM. L. & ECON. REV. 439, 463 (2006).

7. See, e.g., *Year of Scandal, Year of Shame*, CHI. TRIB., Dec. 23, 2002, at 6 (citing the senior executives of companies involved in Enron and other financial debacles that were charged with fraud and other crimes); Citizen Works, *The Corporate Scandal Sheet*, <http://www.citizenworks.org/corp/corp-scandal.php> (last visited Feb. 27, 2010) (listing companies investigated for dishonesty and fraud from 2001-2005). See generally Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (and It Might Just Work)*, 35 CONN. L. REV. 915 (2003) (reviewing big four frauds and reading Sarbanes-Oxley reforms as modest at best); Cary Coglianese et al., *The Role of Government in Corporate Government*, Regulatory Policy Program Report RPP-08 (Cambridge, MA: Center for Business and Government, John F. Kennedy School of Government, Harvard University, 2004) (summarizing conference dialogue concerning potential reforms to restore corporate integrity and market confidence).

8. See WILLIAM S. LAUFER, CORPORATE BODIES AND GUILTY MINDS: THE FAILURE OF CORPORATE CRIMINAL LIABILITY 158-59 (2006) (listing an array of corporate ethical representations from companies (or their senior executives) that were under criminal investigation). Many corporations engage in “blue-washing” and “green-washing.” “Blue-washing” corporations claim the mantle of ethical leadership by affiliating with the United Nations while doing little to actualize the ideals of the Global Compact; “green-washing” is

not deterred by the plethora of reforms and high-profile investigations and prosecutions.⁹ Neither the changes in the law nor the emphasis on its enforcement were enough to stem the ubiquity of greed.¹⁰

Amidst daily revelations of corporate misdeeds, the ideas of business ethics, good corporate citizenship, and organizational accountability are being addressed with new resolve.¹¹ The “greed is good” mantra once

done by making dubious public relations claims about sustainability and eco-friendly actions. See, e.g., William S. Laufer, *Social Accountability and Corporate Greenwashing*, 12 J. BUS. ETHICS 253 (2003) (discussing companies’ social reporting and corporate compliance responsibilities). Reputation washing extends far beyond genuine public relations practice to include insidious deception. LAUFER, *supra*, at 163 (“It is trickery that not only uses publicity to explain the problem away but also portrays the ethical laggard—the [. . .]washer—as an ethical leader.”); see also Donald O. Mayer, *Kasky v. Nike and the Quarrelsome Question of Corporate Free Speech*, 17 BUS. ETHICS Q. 65-96 (2007) (analyzing the first legal challenge of reputation washing as consumer fraud and its ethical implications). Washing as it relates to social accounting is also common practice. See David Owen & Tracey Swift, *Introduction: Social Accounting: Reporting and Auditing: Beyond the Rhetoric?*, 10 BUS. ETHICS: EUROPEAN REV. 4 (2001) (noting the “specious gloss” on social reporting initiatives in the United States and Europe). For a history of corporate reputation management and the quest for social and moral legitimacy, see ROLAND MARCHLAND, *CREATING THE CORPORATE SOUL: THE RISE OF PUBLIC RELATIONS AND CORPORATE IMAGERY IN AMERICAN BIG BUSINESS* (1998).

9. See, e.g., LAUFER, *supra* note 8, at 40-41 (listing hundreds of lawsuits against numerous multi-national companies instituted by the Securities and Exchange Commission, the Corporate Fraud Task Force, and Department of Justice in the aftermath of Sarbanes-Oxley). Then President Bush established the Corporate Fraud Task Force with the goal of “cleaning up corruption in the board room and restoring investor confidence.” CORPORATE FRAUD TASK FORCE, *SECOND YEAR REPORT TO THE PRESIDENT* (2004). He declared that: “Corporate responsibility is essential to America. It is essential to shareholders. It is essential to investors.” *Id.* These efforts were undertaken to calm investor fears, revive perceptions of legitimacy in markets, and demonstrate the resolve of state and federal regulators. See Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals about Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285 (2004) (providing an overview of reforms aimed at enabling better oversight of various corporate stakeholders); see also Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457, 1502 (1993) (observing that government and not the private sector has the incentive to become informed about systemic risks).

10. LAUFER, *supra* note 8; see also Khurana & Zelleke, *supra* note 4, at B4 (“[P]ublic companies have become largely personal ATMs, machines from which to extract as much personal wealth as quickly as possible, within the boundaries of the law (usually).”); cf. Steven L. Schwarcz, *Understanding the ‘Subprime’ Mortgage Crisis*, 60 S. C. L. REV. 549 (2009) (noting the need for regulation to address the collective-action problem of systemic risk even in the absence of greed).

11. The basic concept of corporate social responsibility (CSR) is that business has responsibilities beyond shareholders or investors in the firm. One of the early classics on corporate social responsibility is HOWARD R. BOWEN, *SOCIAL RESPONSIBILITIES OF THE BUSINESSMAN* (1953). Bowen believed that the several hundred largest businesses in the United States were vital centers of power and decision making; thus, the decisions of these businesses affected the lives of citizens in many ways. He believed that businesses had the responsibility to conform to the values and aims of the society in which they were

heard on Wall Street has been replaced with an urgent cry for conscience and a restoration of confidence in corporate behavior.¹² In fact, the gravity of the current crisis has pushed reform proposals to the front of the public policy agenda in our nation's capital. As Wall Street moves to K Street, the effectiveness of existing laws, regulations, and regulatory bodies are being re-examined in a search for long-term reform.¹³

One target of the reform measures is excessive executive

embedded. At the time, 93% of businessmen surveyed agreed with him. CSR became a frequent topic of conversation among businesspeople in the 1970s, which was one reason that economist Milton Friedman came out with his often-quoted article for the *New York Times* magazine, “The Social Responsibility of Business is to Increase its Profits.” (Sept. 13, 1970). The essence of Friedman's critique, still debated to this day, is that managers have no special expertise in philanthropy or social good, and that managers who spend corporate equity to be “socially responsible” are wrongfully using shareholder money without clear benefit to the company. Despite this critique, the notion that corporations have responsibilities beyond those to its investors continues to have many adherents. See, e.g., HARVARD BUSINESS REVIEW ON CORPORATE RESPONSIBILITY (C.K. Prahalad & Michael E. Porter eds., 2003); Archie Carroll, *Corporate Social Responsibility: Evolution of a Definitional Construct*, 38 BUS. & SOC'Y 268 (1999); see also ED FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH (1984) (promoting “stakeholder theory” in contrast to seeing the corporation as solely responsible to its shareholders).

More recently, management and business ethics scholars have advanced a related notion of corporate citizenship. Simply put, corporate citizenship is “CSR plus.” The “plus” speaks to a corporation's public advocacy, including its lobbying efforts. To some observers, this goes beyond giving moral consideration to stakeholders beyond investors, and speaks to the power of corporations to influence public policy that sets the rules of the game for business activities. For the growing discussion of corporate citizenship, see DAVID VOGEL, THE MARKET FOR VIRTUE: THE POTENTIAL AND LIMITS OF CORPORATE SOCIAL RESPONSIBILITY (2005); Dirk Matten et al., *Behind the Mask: Revealing the True Face of Corporate Citizenship*, J. BUS. ETHICS 109 (2003); Andreas Georg Scherer & Guido Palazzo, *Toward a Political Conception of Corporate Responsibility: Business and Society Seen from a Habermasian Perspective*, 32 ACAD. MGT. REV. 1096 (2007). For an earlier debate over the objective of business, compare A.A. Berle Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931) with E. Merrick Dodd Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

12. See Remarks on Signing the Sarbanes-Oxley Act of 2002, 2 PUB. PAPERS 1319 (July 30, 2002), available at <http://www.gpo.gov/fdsys/pkg/PPP-2002-book2/pdf/PPP-2002-book2-doc-pg1319.pdf> (last visited July 7, 2010) (“[C]orporate corruption has struck at investor confidence, offending the conscience of our Nation.”). See also Sarah H. Duggin & Stephen M. Goldman, *Restoring Trust in Corporate Directors: The Disney Standard and the “New” Good Faith*, 56 AM. U. L. REV. 211, 261 (2006) (“Corporate governance reform became a national priority following the financial disasters that ravaged Enron, WorldCom and other corporate giants beginning in the fall of 2001.”).

13. See Michael Lewis & David Einhorn, Op-Ed, *The End of the Financial World as We Know It*, N.Y. TIMES, Jan. 4, 2009, at WK9 (criticizing the governmental focus on short-term improvements in investor confidence); see also Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 266-67 (2010) (proposing a market-liquidity-provider concept as an improvement over the current ad hoc approaches taken by the Bush and Obama administrations); *infra* notes 14, 37-38 (discussing government reforms).

compensation.¹⁴ Indeed, with skyrocketing CEO paychecks¹⁵ linked to layoffs, plant closings, and corporate downsizing,¹⁶ few issues in the

14. See, e.g., Binyamin Appelbaum, *FDIC Pushes to Rein in Executive Pay at Banks*, WASH. POST, Jan. 13, 2010, available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/01/12/AR2010011201492.html?> (last visited July 7, 2010) (discussing proposal advanced by the Federal Deposit Insurance Corporation to penalize banks for risky compensation practices); Andrea Fuller, *House Backs Limits on Pay To Executives*, N.Y. TIMES, Aug. 1, 2009, at B1 (reviewing passage of the bill introduced by Barney Frank, Chairman of the House Financial Services Committee, to limit executive pay by eliminating conflict of interests on compensation committees, requiring nonbinding shareholder vote on pay, and authorizing rulemaking to regulate pay packages at companies whose assets total more than \$1 billion). The Emergency Economic Stabilization Act of 2008 (EESA), for instance, has a number of restrictions on executive pay for the participating firms. See Ferri & Weber, *supra* note 3, at Exhibit 2 (summarizing the executive compensation provisions in the EESA); see also V.G. Narayanan et al., *Executive Pay and the Credit Crisis of 2008*, Harvard Business School Case No. 109-036 (Boston: Harvard Business School Publishing, 2008) (discussing the credit crisis, executive compensation, and their interaction). The American Recovery and Reinvestment Act, subsequently passed in February 2009 after the transition to the Obama administration, added new restrictions for highly-paid executives of financial institutions that receive TARP assistance, including prohibitions against paying bonuses, retention awards, or incentive compensation (other than payments of long-term restricted stock). H.R. REP. NO. 111-64, at 2-3 (2009). Notably, the statutory limitations on pay do not affect the past compensation of executives at those failing financial institutions whose CEOs received billions for their actions that helped bring down the investment-banking system and cause the credit crisis. *Id.*; see also Tom Randall & Jamie McGee, *Wall Street Executives Made \$3 Billion Before Crisis*, BLOOMBERG, Sept. 26, 2008, <http://www.bloomberg.com/apps/news?pid=20601109&sid=aGL516xOPEHc> (last visited Feb. 15, 2010) (“Wall Street’s five biggest firms paid more than \$3 billion in the last five years to their top executives, while they presided over the packaging and sale of loans that helped bring down the investment-banking system.”).

15. Between 1970 and 1996, median cash compensation paid to S&P 500 CEOs (including salaries, bonuses, and small amounts of other cash pay) more than doubled. Kevin J. Murphy, *Executive Compensation 1* (April 1998) (unpublished manuscript, on file with authors) [hereinafter *Executive Compensation*]. During the same timeframe, median total realized compensation (including cash pay, restricted stock, payouts from long-term pay programs, and the amounts realized from exercising stock options) nearly quadrupled. *Id.* at 76. From 1992 through 2000, “median total compensation nearly tripled from \$2.3 million in 1992 to over \$6.5 million in 2000.” Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 847 (2002) (referring specifically to chief executive officers in S&P 500 Industrials (companies excluding utilities and finance firms)). In 2006, the median total compensation of the top 150 U.S. CEOs was \$10.1 million. Edward Dash, *More pieces. Still a puzzle.*, N.Y. TIMES, Apr. 8, 2007, at sec.3; see also Jeffrey Moriarty, *How Much Compensation Can CEOs Permissibly Accept?*, 19 BUS. ETHICS Q. 235, 235 (2009) (noting CEO pay is 314 times the \$32,142 earned by the median full-time private industry worker in the U.S. in 2006).

16. See Kevin J. Murphy, *Executive Compensation and the Modern Industrial Revolution*, 15 INT’L J. INDUST. ORG. 417 (1997) (noting perception of high CEO salaries as producing harmful consequences); Kevin J. Murphy, *Politics, Economics, and Executive Compensation*, 63 U. CINN. L. REV. 713 (1995) (same); accord Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN.

history of the modern corporation have attracted as much attention.¹⁷ Commentators have noted that it “has taken center stage in the governance reform debate in the United States.”¹⁸

The suggested legislative correctives are reinforced by the ethics literature where much critical ink has been spilt regarding ethical duties in corporate governance.¹⁹ There is a developing consensus that directors have a moral obligation not to pay excessive executive compensation relative to performance, the market, or other indicators.²⁰ Some

831 (1993) (showing that downsizing increases stock prices in industries with excess capacity which would tie layoffs to an increase in value of executive stock options); *see also* James B. Wade et al., *Overpaid CEOs and Underpaid Managers: Equity and Executive Compensation*, 17 *ORGAN. SCIENCE* 527 (2006) (surveying literature showing that perceived pay inequities lead to lower productivity and product quality, decreased employee morale, and increased turnover); *cf.* David Hirshleifer, *Managerial Reputation and Corporate Investment Decisions*, 22 *FIN. MGMT.* 145, 146 (1993) (explaining that investor beliefs about manager and firm reputation influence the cost of raising capital, recruiting employees, and marketing products).

17. Murphy, *Executive Compensation*, *supra* note 15, at 1 (“Once relegated to the relative obscurity of business periodicals, executive pay has become an international issue debated in Congress and routinely featured in front-page headlines, cover stories, and television news shows.”).

18. Fabrizio Ferri & David Maber, *Say on Pay Vote and CEO Compensation: Evidence from the UK* 2 (Mar. 2009) (unpublished manuscript, on file with authors). William H. Donaldson, former Securities and Exchange Commission Chairman, explained: “One of the great, as-yet-unsolved problems in the country today is executive compensation and how it is determined.” Lori Calabro, *Regulators and Shareholders Want Compensation Committees to Explain Why CEOs Make So Much*, *CFO MAGAZINE*, Oct. 1, 2003, available at <http://www.cfo.com/article.cfm/3010475?f=related> (last visited July 7, 2010). The new constraints on executive pay proposed in the bill passed by the House on July 31, 2009 are also evidence that Congress was serious about regulating compensation packages with large bonuses that are often cited as a cause of the financial crisis. *See* Fuller, *supra* note 14 (discussing the proposed bill). The Senate was set to consider executive compensation as part of a regulatory overhaul package after its August recess. *Id.*

19. *See* STEPHEN M. GOLDMAN, *TEMPTATIONS IN THE OFFICE: ETHICAL CHOICES AND LEGAL OBLIGATIONS* (2008) (asserting that business men and women have moral duties not encompassed by legal requirements); *see also* Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 *BUS. ETHICS Q.* 235 (2002) (arguing that clarification of the criteria on which executives are evaluated will maximize value); John J. McCall, *Assessing American Executive Compensation: A Cautionary Tale for Europeans*, 13 *BUS. ETHICS: A EUROPEAN REV.* 243 (2004) (assessing executive pay from a moral perspective); Bruce Walters et al., *Top Executive Compensation: Equity or Excess? Implications for Regaining American Competitiveness*, 14 *J. BUS. ETHICS* 227 (1995) (calling for reforms to ensure compensation is not controlled solely by management); *cf.* Alexei M. Marcoux, *A Fiduciary Argument Against Stakeholder Theory*, 13 *BUS. ETHICS Q.* 1 (2003) (demonstrating the moral inadequacy of stakeholder theory). *See generally* John Hasnas, *The Normative Theories of Business Ethics: A Guide for the Perplexed*, 8 *BUS. ETHICS Q.* 19 (1998) (examining three normative theories of business ethics).

20. *See* Mel Perel, *An Ethical Perspective on CEO Compensation*, 48 *J. BUS. ETHICS* 381, 385-86 (2003) (examining the ethical considerations in CEO compensation); *see also* Jeffrey Moriarty, *Do CEOs Get Paid Too Much?*, 15 *BUS. ETHICS Q.* 257 (2005) (arguing

scholarship even suggests that the CEO has an ethical obligation not to accept such excessive compensation.²¹

The absence of ethical awareness among elite boards is amply illustrated in the actions of American International Group (AIG). The insurance giant engendered public disapproval when it paid millions of dollars in bonuses to its top employees in the wake of a 180 billion dollar government bail-out.²² As for the credit default swap business gone awry that caused the company's downfall, former CEO Greenberg explained: "They got greedy."²³ Given the Obama administration's acquiescence in the face of AIG's insistence that contract considerations have tied its hands in attempting a return of taxpayer money, AIG also apparently got away with it.²⁴

that CEOs get paid too much under any theory); discussion *infra* Part V.B.

21. Moriarty, *supra* note 20; discussion *infra* Part V.B.

22. In September 2008, the Federal Reserve authorized the first infusion of cash to AIG. Congress later supplemented these funds with the \$700 billion bailout bill (EESA), which established the Troubled Assets Relief Program (TARP). See Edmund L. Andrews et al., *Fed in an \$85 Billion Rescue of an Insurer Near Failure*, N.Y. TIMES, Sept. 17, 2008, at A1 (calling the Federal Reserve's loan the "most radical intervention in private business in the central bank's history"); Stephen Bernard, *Bailed-Out AIG Seeks Gov't Approval to Give Million-dollar Bonuses to Executives*, ASSOC. PRESS, July 10, 2009, <http://www.cnsnews.com/public/content/article.aspx?RsrcID=50854> (noting AIG's total loan package is \$182.5 billion); see also *After Rescue, Bonuses Still Flow At AIG*, CBS NEWS ONLINE, Dec. 11, 2008, <http://cbs2.com/business/aig.federal.bailout.2.884982> [hereinafter *After Rescue*] (quoting the Assistant Secretary of the U.S. Treasury calling the retention payments "excessive" for a failing institution). Prior to the bonus payments, the company executives enjoyed a desert spa retreat within days of receiving the government's infusion of cash. Peter Whoriskey, *AIG Spa Trip Fuels Fury on Hill*, WASH. POST, Oct. 8, 2008, at D1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/10/07/AR2008100702604.html?sid=ST2008100702063>.

23. *Ex-CEO Greenberg Calls for Revamped AIG Bailout*, WORKFORCE MGMT., Apr. 7, 2009, available at <http://www.workforce.com/section/00/article/26/29/87.php>. AIG sued Greenberg for illegally taking \$4.3 billion in stock the year of his departure. Mary Williams Walsh, *Ex-chief and AIG Set for Court*, N.Y. TIMES, June 15, 2009, at B1.

24. See *Obama Tries to Stop AIG Bonuses: "How Do They Justify This Outrage?"*, CNN NEWS, Mar. 16, 2009, <http://www.cnn.com/2009/POLITICS/03/16/AIG.bonuses/index.html>; Edmund L. Andrews & Peter Baker, *A.I.G. Planning Huge Bonuses After \$170 Billion Bailout*, N.Y. TIMES, Mar. 14, 2009, at A1, available at <http://www.nytimes.com/2009/03/15/business/15AIG.html?emc=eta1> (reporting that when word of bonuses reached the Obama administration, U.S. "Treasury Secretary Timothy F. Geithner told the firm they were unacceptable and demanded they be renegotiated . . . but that the bonuses w[ould] go forward because lawyers said the firm was contractually obligated to pay them."). Congress did attempt to reclaim the funds via an excise tax. See Greg Hitt, *Drive to Tax AIG Bonus Slows*, WALL ST. J., Mar. 25, 2009, at A1, available at <http://online.wsj.com/article/SB123794222776332903.html> (reporting that a bill imposing a 90% excise tax on AIG bonuses paid to individual employees passed the House); see also *The AIG Key Executives Bonus Accountability and Capture Act*, H.R. 1598, 111th Cong. (1st Sess. 2009). The House Judiciary Committee also attempted to remedy the audacity of

The AIG situation is neither new nor unique.²⁵ In this country and abroad, “fat cats” and “rewards for failure,” such as handsome retirement packages and option repricings, have incited shareholder and community outrage.²⁶ Outside the United States, calls for increased accountability to shareholders have been heard and legislation adopted.²⁷ Within the country, the debate continues as federal and state policymakers jockey for position along with the corporate clientele they serve.²⁸

AIG in the “End Greed” Bill (End Government Reimbursement of Excessive Executive Disbursements). H.R. REP. NO. 111-50, at 3-4 (2009) (authorizing the Justice Department to sue for the return of bonuses given to employees of companies that have received more than \$10 billion from the government on a fraudulent transfer theory and giving the Attorney General power to limit executive compensation to ten times the average non-management wages as a company would have to do in bankruptcy). For a discussion of the continuing bonus saga, see *infra* Part VI.B.

25. See, e.g., Louise Story & Eric Dash, *Bankers Reaped Lavish Bonuses During Bailouts*, N.Y. TIMES, July 30, 2009, at A1 (reporting that “nine of the financial firms that were among the largest recipients of federal bailout money paid about 5,000 of their traders and bankers bonuses of more than \$1 million apiece for 2008 President Obama called financial institutions ‘shameful’ for giving themselves nearly \$20 billion in bonuses as the economy was faltering and the government was spending billions to bail [them] out”).

26. Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1021 (1999) (noting that “[o]utraged investors have made their views known to corporate boards of directors using shareholder proposals, binding bylaw amendments, ‘Just Vote No’ campaigns, and other activist efforts”); Rik Kirkland, *The Real CEO Pay Problem*, FORTUNE, July 10, 2006, at 78, 80 (“[T]he outrage has grown so intense that the country’s top CEOs are now vigorously debating the problem in private.”); see also Ferri & Maber, *supra* note 18, at 1 (noting that the rapid growth of CEO pay had often made headlines in the British Press (citing Charles Arthur, *The Fat Cats Are Back*, INDEP., July 25, 2000)); BBC NEWS, *Glaxo Backs Down on CEO Pay Deal*, Nov. 26, 2002; BBC NEWS, *Vodafone Risks Fury over Boss’s Pay*, June 19, 2002; Tony Jackson, *The Fat Cats Keep Getting Fatter*, FIN. TIMES, Aug. 1, 1998.

27. See generally STEPHEN DEANE, *WHAT INTERNATIONAL MARKETS SAY ON PAY—AN INVESTOR PERSPECTIVE* (Institutional Shareholder Servs.) 2 (2007) (listing other countries that have adopted or are considering similar legislation such as Norway, Sweden, Australia, and the Netherlands); Stephen Davis, *Does ‘Say on Pay’ Work? Lessons on Making CEO Compensation Accountable* (2007) (unpublished manuscript, on file with authors), http://millstein.som.yale.edu/Davis_Say_on_Pay_Policy%20Briefing.pdf (discussing how the U.S. could benefit from the U.K.’s experience with legislation on advisory voting on executive compensation).

28. See, e.g., Posting of Ted Allen to RiskMetrics Group, Risk & Governance Blog, *A “New Opening” for Investors*, <http://blog.riskmetrics.com/gov/2008/11/a-new-opening-for-investorssubmitted-by-ted-allen-publications.html> (last visited Mar. 29, 2010) (“With the election of Barack Obama, investor activists are hopeful that his administration will open the door to advisory votes on executive pay, proxy access, broker voting reform, and greater attention to environmental and social issues.”); discussion *infra* Part II.A.

The debate extends beyond the Capitol to universities across the nation. Philosophy, law, and business scholars have been researching the problem and proposing solutions. See Murphy, *Executive Compensation*, *supra* note 15, at 1 (“There has also been an explosion in academic research on executive compensation.”). For a summary of the evolving business literature and research spanning accounting, economics, finance, industrial relations,

As legislatures fight the good fight to curb executive pay packages against the interests and designs of political lobbyists, this article suggests a role for courts in the reform process. It proposes a judge-made solution to support the regulatory reform effort to help keep corporate executive compensation abuses in check. In particular, it maintains that courts should consider applying the equitable doctrine requiring a litigant to have “clean hands”²⁹ to bar civil lawsuits by CEOs seeking damages for breach of contract against companies that refuse to pay remuneration schemes that are excessive by market and/or other standards. Consideration of the defense in this situation would encourage directors to withhold payment while simultaneously stymieing executive overreaching and the substantial corporate costs that go along with it. Significantly, the legal evaluation of unclean hands in the case of excessive executive compensation is informed

organizational behavior, strategy, and executive compensation, see Allen, *supra*. Scholarship from business academics in the last decade has also been extensive. Sherwin Rosen, *Contracts and the Market for Executives*, in *CONTRACT ECONOMICS* 181 (Lars Werin & Hans Wijkander, eds., 1992); Gerald T. Garvey & Todd T. Milbourn, *Asymmetric Benchmarking in Compensation: Executives are Rewarded for Good Luck but Not Penalized for Bad*, 82 J. FIN. ECON. 197 (2006); Henry L. Tosi et al., *How Much Does Performance Matter? A Meta-analysis of CEO Pay Studies*, 26 J. MGMT. 301 (2000); Ravi Singh, *Board Independence and the Design of Executive Compensation* (2006) (Harvard Business School Working Paper, on file with authors). For legal literature addressing excessive executive pay, see Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005); William W. Bratton, *The Academic Tournament Over Executive Compensation*, 93 CAL. L. REV. 1557 (2005); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142 (2005); Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1 (2000); James McConvill, *Executive Compensation and Corporate Governance: Rising Above the “Pay-for-Performance Principle,”* 43 AM. BUS. L.J. 413 (2006). For ethics scholarship addressing executive compensation, see *supra* notes 19-21.

29. See generally T. Leigh Anenson, *Beyond Chafee: A Process-Based Theory of Unclean Hands* 47 AM. BUS. L.J. (forthcoming 2010) [hereinafter *Process-based Theory of Unclean Hands*] (suggesting a four-phase theory of incorporation for the procedural protection of the court); T. Leigh Anenson, *Limiting Legal Remedies: An Analysis of Unclean Hands*, 99 KY. L.J. (forthcoming 2010) [hereinafter *Limiting Legal Remedies*] (analyzing and synthesizing cases accepting and rejecting unclean hands in legal cases); T. Leigh Anenson, *Treating Equity Like Law: A Post-merger Justification of Unclean Hands*, 45 AM. BUS. L.J. 455 (2008) [hereinafter *Post-merger Justification of Unclean Hands*] (proposing merger theory that allows for the incorporation of unclean hands in damages actions); see also T. Leigh Anenson, *Litigation Between Competitors with Mirror Restrictive Covenants: A Formula for Prosecution*, 10 STAN. J.L. BUS. & FIN. 1 (2005) (discussing use of equitable defenses and other strategies to preclude competitor challenge to validity of employment non-compete agreement); T. Leigh Anenson, *The Role of Equity in Employment Noncompetition Cases*, 42 AM. BUS. L.J. 1, 51-52 (2005) (outlining potential use of unclean hands and other equitable defenses in the context of employment non-compete agreements).

by the ongoing conversation among legal, business, and ethics scholars and attempts an interdisciplinary approach to the problem.³⁰

The equitable maxim of “he [or she] who comes into equity must come with clean hands” was developed to “protect the court against the odium that would follow its interference to enable a party to profit by his [or her] own wrong-doing.”³¹ Conduct need not be illegal to constitute unclean hands and warrant dismissal.³² Behavior that does not conform to “minimum ethical standards” in business satisfies the doctrine.³³

While there have been countless cases of unclean hands involving unethical or immoral conduct in commercial settings over the course of the last three centuries,³⁴ no court has considered the defense in the context of excessive compensation. But no court has refused its application either. Indeed, no board has attempted to withhold or reduce executive compensation schemes. This article contends that the doctrine could be put to good use in cases where executives have engaged in unethical conduct and still pursued contract claims without “clean hands.” It argues that courts have discretion in determining whether conduct is unclean as it relates to pay at the time of contract formation up until full execution.³⁵ Parts II through VI justify uniting and extending the legal, business, and

30. See Murphy, *Executive Compensation*, *supra* note 15, at 1 (“CEO pay research has grown even faster than CEO paychecks.”).

31. *N. Pacific Lumber Co. v. Oliver*, 596 P.2d 931, 939-40 (Or. 1979) (quoting Henry Lacey McClintock, *PRINCIPLES OF EQUITY* 63 (1948)).

32. See *Precision Instrument Mfg. Co. v. Automotive Maint. Mach. Co.*, 324 U.S. 806, 815 (1945) (holding that “misconduct need not necessarily have been of such a nature to be punishable as a crime or to justify legal proceedings of any character”); *Keystone Driller Co. v. Gen. Excavator Co.*, 290 U.S. 240, 244-45 (1933) (commenting that unclean hands may be invoked on the basis of “conscience, or good faith, or other equitable principle”); *Deweese v. Reinhard*, 165 U.S. 386, 390 (1897) (reasoning that “[a]ny and all misfeasance that smacks of injustice may constitute ‘unclean hands’”).

33. *Precision Instrument*, 324 U.S. at 816; see also *Morton Salt Co. v. G.S. Suppiger Co.*, 314 U.S. 488, 492-94 (1942) (holding that equity may rightly withhold its assistance from improper business practices); 4 *CALLMANN ON UNFAIR COMPETITION, TRADEMARK & MONOPOLY* § 23:14 (4th ed. 2001 Supp.) (stating that the doctrine of unclean hands “is of special importance in unfair competition cases, for fairness in business . . . is a common duty owed by all to all”).

34. See Zechariah Chafee, Jr., *Coming Into Equity With Clean Hands*, 47 *MICH. L. REV.* 877, 878 (1949) [hereinafter Chafee I] (detailing cases involving unethical conduct in commercial settings); Zechariah Chafee, Jr., *Coming Into Equity With Clean Hands*, 47 *MICH. L. REV.* 1065 (1949) [hereinafter Chafee II] (examining the same such cases as those outlined in Chafee I); see also *ZECARIAH CHAFEE, JR., SOME PROBLEMS OF EQUITY* 2 (1950) (exploring the rules of carrying on utilized by equity courts). For legal research on unclean hands since Chafee’s publications, see *supra* note 29.

35. See *infra* Part VI.B. (explaining the circumstances under which the defense may apply). If the CEO has been paid an excessive amount (through, for example, a bonus or severance package), the company may seek rescission on the basis of unclean hands similar to other traditional contract defenses. See *infra* Part IV.B and note 225 (discussing how several contract defenses derived from equity).

ethics literature to defend the use of the unclean hands doctrine under circumstances constituting excessive executive compensation.

Part II explains that the use of the unclean hands is consistent with the political will embodied in existing federal law like Sarbanes-Oxley and proposed reform measures that include shareholder “say on pay” legislation. Part III maintains that the invocation of unclean hands in response to executive overreaching in contract cases strengthens the primary role of states as the custodians of corporate integrity and governance. Allowing unclean hands in breach of contract cases brought by errant executives sustains the long-established fiduciary duties of directors in the corporate law of the several states. It also supports the new duty of good faith recently recognized in Delaware. The unclean hands defense prevents corporate liability for breach of contract and, at the same time, possibly avoids personal liability for directors for the lack of good faith in the exercise of their management responsibilities.

Part IV discusses how defeating excessive compensation by applying the clean hands doctrine in damages actions preserves the traditional purpose and use of the defense to curtail unethical business practices in contract cases. Judicial invocation of unclean hands also continues the modern doctrinal trend of extending the defense to damages actions. It additionally reinforces the role of equity in maintaining the integrity of the law.

Part V argues that freedom of contract interests are outweighed by fairness concerns in the form of unclean hands in considering executive overcompensation by reference to the medieval theory of “just price” and modern ideas in business ethics. It describes the ethical principles reinforcing the “clean hands” doctrine and outlines the evolution in ethics which supports the notion that both directors and CEOs have moral obligations to their companies concerning executive pay.

Part VI outlines a measure of “excessiveness” that courts can and should apply. It takes as a starting point existing ethical standards as well as compensation considerations in corporate legal settings and unites them with the economic and other determinants derived from business disciplines. It then illustrates how the defense would work by reference to the many real life examples of executive excesses. The article concludes that the application of unclean hands to check compensation abuses is a legitimate and effective role for courts in the reform process.

II. FEDERAL REGULATORY REFORM

The use of unclean hands to curb executive compensation abuses is consistent with the political will embodied in existing federal law and many proposed reform measures. In particular, these reforms seek shareholder “say on pay” as well as greater accountability in general.

A Shareholder “Say on Pay” Reform

Shareholder accountability and participation on pay packages have been part of the bailout discussions.³⁶ The controversial \$700 billion government rescue plan enacted as the Emergency Economic Stabilization Act of 2008 contains executive pay restrictions contingent on the kind of government aid received by the corporation.³⁷

Bills have also been introduced in Congress mimicking legislation in the United Kingdom and other countries.³⁸ Legislation was enacted by the

36. See, e.g., Jie Cai & Ralph J. Walkling, Shareholders’ Say on Pay: Does It Create Value? (2007) (unpublished comment, Drexel University Working Paper, on file with authors). Shareholder “say on pay” is mandatory for companies receiving federal aid under TARP and Treasury officials have stated that an advisory vote on executive pay may soon be required of all publicly traded companies. *Say on Pay: Are You Ready?*, NACD DIRECTORS DAILY, July 27, 2009, at 2. Scholars have also recommended similar non-binding shareholder votes on executive compensation issues as a matter of state statutory reform. See Loewenstein, *supra* note 28, at 28; Thomas & Martin, *supra* note 26, at 1043-48; cf. Jeffrey N. Gordon, *Executive Compensation: If There’s a Problem, What’s the Remedy? The Case for “Compensation Discussion and Analysis,”* 30 J. CORP. L. 675, 702 (2005) (arguing for a Compensation Discussion and Analysis signed by the compensation committee members and submitted to the shareholders for approval).

37. See *supra* note 14 (discussing reform measures for excessive executive compensation). Enacted in response to our current financial crisis, the EESA effectively allows the Treasury to buy mortgage-related “troubled” assets and invest in banks and insurance companies to shore up their capital. See also *A Year of the Dow Jones Industrial Average*, THE BOSTON GLOBE, Oct. 10, 2008, available at http://www.boston.com/business/articles/2008/10/10/dow_1year (demonstrating that by the close of trading on Friday, October 10, 2008, the Dow Jones had lost 39.4% of its value from a year earlier); *The Dow Jones Industrials’ Moves since Lehman Fall*, LAS VEGAS SUN, Sept. 9, 2009, available at <http://www.lasvegassun.com/news/2009/sep/09/the-dow-jones-industrials-moves-since-lehman-fall/> (reporting that the week following the emergency legislation, the Dow Jones industrial average dropped each day, for a total six-day loss of 2,031.65 points).

38. See Ferri & Maber, *supra* note 18 (noting binding shareholder say on pay legislation in Norway, Sweden, Australia, and the Netherlands). In April 2007, the House of Representatives approved a bill seeking to introduce a say on pay rule. H.R. 1257, 110th Cong. (2007). An analogous bill was introduced in the Senate by then-presidential candidate Barack Obama. S. 1181, 110th Cong. (2007); Stephen Taub, *Obama Pushes Say On Pay*, Apr. 11, 2008, available at http://www.cfo.com/article.cfm/11037327/c_11036422; Posting of L. Reed Walton to Risk & Governance Blog, *U.S. Senate Takes up “Say on Pay” Bill*, <http://blog.riskmetrics.com/gov/2007/04/us-senate-takes-up-say-on-pay-billssubmitted->

UK government in 2002 in response to investors concerned with the adoption of controversial U.S.-style compensation practices.³⁹ The law mandates an annual, advisory shareholder vote on the executive compensation report prepared by the board of directors and has been successful in increasing the dialogue between shareholders and management.⁴⁰

Additionally, some U.S. firms have voluntarily adopted “say on pay” practices and others will likely follow.⁴¹ Given the negative view of

by-l-reed-walton-staff-writer.html (Apr. 30, 2007); cf. H.R. 4291, 109th Cong. (2005) (requiring shareholder approval of compensation and golden parachute plans). For other reforms, see Martin, *infra* note 67, at 532.

39. *Have Fat Cats Had Their Day?*, THE ECONOMIST, May 24, 2003, at 63. For a comparison of U.S. and UK executive pay, see Martin J. Conyon et al., Are US CEOs Paid More Than UK CEOs? Inferences From Risk-Adjusted Pay (The University of Pennsylvania Working Paper, 2009), available at <http://ssrn.com/abstract=907469>; Martin J. Conyon & Kevin J. Murphy, *The Prince and the Pauper? CEO Pay in the United States and United Kingdom*, 110 ECON. J. 640 (2000) (finding that in 1997 CEOs in the U.S. earned 45% higher cash compensation and 190% higher total compensation than CEOs in the UK). For a comprehensive international comparison between CEOs in twelve OECD countries, see John M. Abowd & Michael L. Bognanno, *International Differences in Executive and Managerial Compensation*, in DIFFERENCES AND CHANGES IN WAGE STRUCTURES 67 (Richard B. Freeman & Lawrence F. Katz eds., 1995) (assessing data from 1984 to 1992 and finding U.S. CEO compensation exceeds that for CEOs in Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, and the United Kingdom).

40. See Ferri & Maber, *supra* note 18 (concluding that the policy objectives of the legislation are being met, at least with respect to those companies with the most egregious pay practices); see also William Hutchings & Mike Foster, *Shareholder Voting Gets Rethink in U.K.*, WALL ST. J., Aug. 10, 2009, at C5 (discussing proposed reforms to engage shareholders in the long-term fiscal health of the firms in which they invest); cf. Jeffrey N. Gordon, “Say on Pay”: *Cautionary Notes on the U.K. Experience and the Case For Shareholder Opt-In*, 46 HARV. J. LEGIS. 323 (2009) (proposing a federal legislative provision of a shareholder right to decide whether a public firm should opt in to an advisory shareholder vote regime to clarify and unify existing state and federal law instead of the proposed mandatory rule). The *Wall Street Journal* reported that Royal Dutch Shell PLC is the largest among a growing group of British companies whose shareholders have voted down compensation plans in advisory votes. Guy Chazan & Joann S. Lublin, *Shell Investors Revolt Over Executive Pay Plan*, WALL ST. J., May 20, 2009, at B1; see also Gordon, *supra* (comparing CEO compensation of Royal Dutch Shell PLC, Europe’s largest oil company, and Exxon Mobil Corp., the largest U.S. oil company, and reporting that European investors are angry over bonuses—\$1.76 versus \$17.6 million—that are relatively modest by U.S. standards).

41. For instance, only days after the election of Barack Obama on November 4, 2008, companies such as Sun Microsystems and Motorola voluntarily adopted “say on pay.” Ferri & Weber, *supra* note 3. Between 2006 and 2008, proposals for the adoption of say on pay had a high degree of support in compensation-related proposals. See Thomas & Martin, *supra* note 26, at 1025 (stating that there is an average of 40% in favor); Marilyn F. Johnson & Margaret B. Shackell, *Shareholder Proposals on Executive Compensation* (Michigan State University Working Paper, Apr. 1997) (on file with authors) (examining the success of “say on pay” proposals in the years 1992-95); see also Ferri & Weber, *supra* note 3, at 4

executive compensation post-Enron, there has been a significant increase in the frequency of pay-related proposals.⁴² Shareholder activism aimed at affecting the pay setting process like “say on pay” has had the highest voting support and implementation rate compared to other proposals concerning compensation.⁴³ These initiatives, albeit aimed at targeted firms, also influence the policy-making debate.⁴⁴

B. Sarbanes-Oxley Legislation

Moreover, five years before the reform bills targeted executive compensation, the Sarbanes-Oxley Act of 2002 (“SOX”) attempted to strengthen corporate accountability to shareholders.⁴⁵ Then-President Bush described the statute as “the most far-reaching reforms of American

(listing the 2008 shareholder proposals for say on pay). Prominent investor TIAA-CREF has voted in favor of these measures. Thomas & Martin, *supra* note 26, at 1044. Shareholder activists led by AFSCME (a union pension fund) also targeted more than 150 US firms with non-binding shareholder proposals requesting the adoption of “say on pay.” Ferri & Maber, *supra* note 18, at 2 n.2.

42. See Yonca Ertimur et al., Shareholder Activism and CEO Pay, 11, 31 (working paper, Apr. 2009) (on file with authors) (analyzing a sample of 134 vote-no campaigns and 1,198 shareholder proposals related to executive pay between 1997 and 2007).

43. *Id.* at 31. In addition to “say on pay,” process-oriented proposals include the ability to expense stock options and a requirement to receive approval for golden parachutes. *Id.* at 11. Other kinds of compensation-related proposals seek to influence the outcome (i.e., performance-based vesting conditions) or objectives (i.e., link pay to social criteria) of the pay setting process. See *id.* at 9-10 (characterizing such proposals as “pay design” and “pay philosophy”).

44. *Id.* at 15, 25-26. Studies suggest that giving shareholders a greater voice in the boardroom by an advisory vote on executive compensation further aligns owner-manager interests, at least for those companies with inefficient executive compensation and relatively poor corporate governance. Cai & Walkling, *supra* note 36, at 1 (“[S]uggest[ing] that the market views say-on-pay as value-creating for the companies with inefficient executive compensation and relatively poor corporate governance but value-destroying for other companies.”). The success of such initiatives, however, has had little effect on the reduction in CEO compensation overall. Ertimur et al., *supra* note 42, at 31. Nevertheless, studies have found that other proposals seeking to influence the pay setting procedures as well pay design have reduced CEO pay. See Fabrizio Ferri & Tatiana Sandino, *The Impact of Shareholder Activism on Financial Reporting and Compensation: The Case of Employee Stock Options Expensing*, 84 ACCT. REV. 433, 456 (2009) (reporting a \$2.3 million reduction in total CEO pay in firms after approval of proposals to expense employee stock options); Ertimur, *supra* note 42, at 30 (demonstrating a causal link between labor union sponsored proposals involving the design of executive pay like those linking pay and performance from 2002-07 and a reduction in CEO pay by \$1.5 million in firms with excess pay); see also Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1770 (2008) (finding a \$1 million CEO pay decline in firms targeted by hedge fund activists).

45. Public Company Accounting Reform and Investor Protection Act of 2002, Pub. L. No. 107-204, 116 Stat. 745-810 (codified at scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

business practices since the time of Franklin Delano Roosevelt.”⁴⁶ In signing the bill into law, he emphasized: “[T]his law says to every American: There will not be a different ethical standard for corporate America than the standard that applies to everyone else.”⁴⁷ Generally, SOX and other post-scandal reforms of the stock exchanges and the Securities and Exchange Commission (“SEC”) attempt to cure systemic failures of corporate governance caused by faulty internal financial controls and the lack of board independence.⁴⁸ It is an effort to make management more accountable, along with other gatekeepers and advisors, after persistent and repeated “corporate looting by insiders”.⁴⁹

As it relates to executive compensation, SOX prohibits loans to senior officers.⁵⁰ If the corporation is required to file an accounting restatement due to misconduct, SOX mandates that CEOs and CFOs return bonuses, incentives, equity-based compensation, and certain profits from the sales of securities.⁵¹ It also prohibits executive officers from trading in the equity

46. President George W. Bush, Remarks on Signing the Sarbanes-Oxley Act of 2002, in 38 WEEKLY COMP. PRES. DOC. 183 (July 30, 2002).

47. *Id.*

48. *See generally* Roberta S. Karmel, *Realizing the Dream of William O. Douglas: The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 86-87 (2005) (discussing the new role of the federal government in corporate governance matters); LAUFER, *supra* note 8, at 39 (summarizing SOX provisions and the reasons for them). Among other things, SOX requires the verification of financial statements by CEOs and CFOs under threat of criminal sanction. *See, e.g.*, 15 U.S.C. § 7241 (2002) (requiring that company officers verify financial statements), 15 U.S.C. § 78m (2002) (requiring that company officers verify financial statements or face criminal penalties). It further directs the SEC and other federal agencies to promulgate additional rules and regulations. *See, e.g.*, 15 U.S.C. § 7233 (2002) (directing SEC to issue regulations pertaining to audit procedures and creditor independence); 15 U.S.C. § 7245 (2002) (directing the SEC to issue rules pertaining to professional responsibility of attorneys practicing before the SEC). The internal financial controls provisions of SOX are part of a broader mandate for issuers to establish and maintain disclosure controls and procedures to ensure the quality of information in public reports. Some argue that the costs of the statute’s internal financial control provisions outweigh its benefits. Henry N. Butler & Larry E. Ribstein, *The Sarbanes-Oxley Debacle: What We’ve Learned; How to Fix It*, 38-42 (Mar. 13, 2006) (unpublished research paper prepared for the American Enterprise Institute, The Liability Project).

49. LAUFER, *supra* note 8, at 39 n.272 (citing Richard Posner, *The Economics of Business Scandals and Financial Regulation* (Oct. 2002) (unpublished manuscript)). *See generally* Donald C. Langevoort, *Managing the “Expectations Gap” in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1153-54 (2003) (discussing investor protection and corporate integrity as the central theme of reform).

50. Sarbanes-Oxley allows loans to officers made in the ordinary course of business. 15 U.S.C. § 78m(k).

51. 15 U.S.C. § 7243(a) (“If an issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws, the chief executive officer and chief financial officer of the company shall reimburse the issuer . . .”).

securities of their companies during an employee fund blackout period.⁵² Additionally, SOX grants the SEC authority to freeze corporate assets to prevent the payment of bonuses to executives involving financial fraud.⁵³ Finally, it gives the SEC authority over board composition and committee structure as well as the power to prohibit executives from serving as corporate officers through administrative proceedings.⁵⁴

SOX's panoply of prescriptions and requirement of reimbursement, however, have had (at best) limited influence in preventing officers from benefitting at the expense of their companies. The lack of enforcement of the clawback provisions that mandate a return of executive pay in the event of a restatement is particularly significant.⁵⁵ Since its enactment, there have been thousands of restatements and only twice has the SEC forced executives to return their unfair share.⁵⁶ Moreover, both cases involved participation by the officer in the misconduct and alleged fraud.⁵⁷ In a recent (third) lawsuit, however, the SEC appears to be taking a more aggressive approach to its clawback authority and has sought the forfeiture of bonuses and stock sale profits from a former CEO after false accounting by other executives caused the company to inflate earnings that led to a restatement.⁵⁸ Shareholders have also instituted private lawsuits to fulfill

52. 15 U.S.C. § 7244 (2002).

53. 15 U.S.C. § 78u-3 (2002).

54. 15 U.S.C. § 78j-1 (2002); 15 U.S.C. § 78u-3(f).

55. See Rachael E. Schwartz, *The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean*, 64 BUS. LAW. 1, 5 (2008) (advising that the largest portion of a CEO or CFO's compensation, whether incentive-based or equity-based, is potentially subject to section 304 (citing *The WSJ 350: A Survey of CEO Compensation*, WALL ST. J., Apr. 9, 2007, at R1 and *C.E.O. Pay: The New Rules*, N.Y. TIMES, Apr. 8, 2007, at BU10)).

56. Schwartz, *supra* note 55, at 2; see also *id.* at 13-14 (relaying that the SEC obtained a “clawback” under this provision of \$400 million in stock profits and incentive compensation from William McGuire, the former CEO of UnitedHealth Group Inc. in 2007 and \$190,000 in cash bonuses from Frances M. Jewels, former CFO of Sycamore Networks, Inc. in 2008). The SEC has power under the securities laws (pre-SOX) to disgorge not only profits but the base salary of the CEO. *Id.* at 32-33. Nevertheless, under this clawback power, courts require the SEC to show that the misstatement resulted in the executive obtaining money that he or she otherwise would not have received. *Id.* at 15. Executive bonuses under SOX can be clawed back without regard to causation. *Id.*

57. *Id.* at 13-14. Both cases involved stock options backdating. *Id.*

58. See Phred Dvorak, *SEC Orders Former CSK Auto Chief To Return Pay*, WALL ST. J., July 24, 2009, <http://online.wsj.com/article/SB124831208417074457.html> (describing lawsuit filed against Maynard Jenkins seeking the return of two years of performance-based compensation paid as the result of falsely inflated earnings); David Scheer et al., *SEC Demands Ex-CSK Chief Forfeit Pay in Landmark Case (Update1)*, BLOOMBERG, July 23, 2009, <http://www.bloomberg.com/apps/news?pid=20601103&sid=aqI28XZcPPHw> (predicting that the lawsuit against former CEO not involved in wrongdoing will up the ante for other companies facing potential restatements). Rachael E. Schwartz, Senior Counsel for the SEC's Enforcement Division, criticized the SEC's stringent reading of the statutory language and argued for an expansive enforcement policy requiring repayment regardless of

the statutory policy of restitution, but they have been universally rebuffed by the federal courts.⁵⁹

C. Federal Securities Law

The disclosure provisions of federal securities legislation have a similar purpose: to deter abusive practices by corporate managers such as excessive compensation.⁶⁰ The SEC has regulated the disclosure of executive pay packages since the securities laws were enacted and continues to update and increase the disclosed amount of executive compensation data.⁶¹ In addition to reorganizing the mandated

scienter, knowledge, or any participation in the wrongdoing. *See generally* Schwartz, *supra* note 55 (describing SOX obligations for executive compensation); *see also id.* at 5 (noting that section 304 explicitly authorizes the SEC to create an exemption for any circumstance in which the proposed application of section 304 might cause injustice such as when a CEO is powerless to prevent the wrong doing of low-level employees). For an alternative view, see John Patrick Kelsh, *Section 304 of the Sarbanes-Oxley Act of 2002: The Case for a Personal Culpability Requirement*, 59 BUS. LAW. 1005 (2004) (describing the potential for personal liability in executive compensation cases).

59. Neither the company nor any of its shareholders can sue to enforce section 304; only the SEC may bring an action. Schwartz, *supra* note 55, at 2; *see also id.* at 2 n.4 (citing lower district court cases rejecting a private cause of action under the clawback provision of Sarbanes-Oxley).

60. *See* Jerry W. Markham, *Regulating Excessive Executive Compensation—Why Bother?*, 2 J. BUS. & TECH. L. 277, 284 (2007) (“One of the federal securities’ laws’ principal targets of reform was excess executive compensation.”); *see also* George T. Washington, *The Corporate Executive’s Living Wage*, 54 HARV. L. REV. 733, 734-35 (1941) (depicting how corporate executives increased their salaries to compensate for the reduction in bonuses after the 1929 stock market crash while laying off thousands of workers). One of the architects of the 1933 Securities Act, Felix Frankfurter, explained its intended “in terrorem” effect:

The existence of bonuses, of excessive commissions and salaries, of preferential lists and the like, may all be open secrets among the knowing, but the knowing are few. There is a shrinking quality to such transactions; to force knowledge of them into the open is largely to restrain their happening.

Felix Frankfurter, *Securities Act—Social Consequences*, FORTUNE, Aug. 1933, at 55.

61. The SEC’s authority over executive compensation stems from Sections 3(b), 6, 7, 10, and 19(a) of the 1933 Securities Act, as amended, Sections 10(b), 12, 13, 14, 15(d) and 23(a) of the 1934 Exchange Act, as amended, and Sections 8, 20(a), 24(a), 30 and 38 of the Investment Company Act of 1940, as amended. 71 Fed. Reg. at 6598 (Feb. 8, 2006). The SEC first regulated executive pay disclosures in 1938. Exchange Act Release No. 34-1823 (Aug. 11, 1938). The 1992 Regulations included a Performance Graph and Compensation Committee Report which detailed compensation and corporate performance, as reflected in the stock price. Executive Compensation Disclosure, Exchange Act Release No. 33-6962, 57 Fed. Reg. 48126 (Oct. 21, 1992); Executive Compensation Disclosure, Securityholder Lists and Mailing Requests, Exchange Act Release No. 33-7032, 58 Fed. Reg. 63010, at sec. II (commenting that amendments were intended to make compensation disclosure clearer, more comprehensive and useful to shareholders). The 1996 Regulations are discussed *infra* notes 63-65 and accompanying text.

compensation materials, the most recent regulations require that management reveal retirement and severance packages and outstanding equity interests.⁶² The regulations also establish a minimum federal threshold of \$10,000 as a trigger for disclosing perks.⁶³ In the words of SEC Chairman Cox, its job is “to help investors keep an eye on how much of their money is being paid to top executives who work for them.”⁶⁴

Nevertheless, the SEC focuses on wage information, not wage controls (which it leaves to state corporate law).⁶⁵ While the SEC may enforce the disclosure requirements against companies for misleading compensation information, it does not set CEO compensation or provide a formula for determining it.⁶⁶

Consequently, notwithstanding the value of increased transparency, critics have challenged the SEC to undertake a more meaningful role in policing compensation decisions.⁶⁷ Given that the regulations do not

62. 71 Fed. Reg. 53,183-89 (Jan. 3, 2006) (summarizing the regulations).

63. *Id.*; Press Release, SEC, 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>. Along with compensation matters, the regulations also address related party transactions, director independence, and corporate governance. 71 Fed. Reg. 53,158 (Jan. 3, 2005).

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

65. *Id.* Chairman Cox explains: “It is [the shareholders’ and directors’] job, not the government’s, to determine how best to align executive compensation with corporation performance, to determine the appropriate levels of executive pay, and to decide on the metrics for determining it.” *Id.*; see also Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 418 (2003) (discussing the limits of increased disclosure in that it assumes there is an ability to use the information); Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 534 (1999) (noting that disclosure has been the central focus of the federal agency structure).

66. *Id.*; see also SEC Release, *supra* note 63 (SEC questioning the effectiveness of its regulations that require corporations to furnish compensation reports rather than file them such that Exchange Act liability for misstatements would attach). For SEC enforcement actions, see, e.g., U.S. Securities and Exchange Commission, 2005 Performance and Accountability Report, at 2, available at <http://www.sec.gov/about/secpar2005.shtml> (noting settlement with Tyson Foods and its former CEO, Donald Tyson, who collectively paid a penalty of \$2.2 million for misleading disclosures of compensation information). There are still ample reports of companies disguising executive pay packages. See, e.g., Lucian Ayre Bebchuk & Jesse M. Fried, *Stealth Compensation Via Retirement Benefits*, 1 BERKELEY BUS. L.J. 291 (2004) (advising that corporate boards have been camouflaging compensation through retirement benefits and other payments); Patrick McGeehan, *Options in the Mirror, Bigger Than They Seem*, N.Y. TIMES, Apr. 9, 2006, sec. 3, at 6 (commenting on how Lehman Brothers obscured executive compensation through stock option grants and valuation).

67. See Jennifer S. Martin, *The House of Mouse and Beyond: Assessing the SECs Efforts to Regulate Executive Compensation*, 32 DEL. J. CORP. L. 481 (2007) (urging the

provide a remedy for shareholders who object to compensation practices, commentators conclude that current SEC regulations are incapable of solving the executive pay problem.⁶⁸

In lieu of government enforcement, private lawsuits are available under the securities laws for misleading disclosures. Such lawsuits offer another means of enforcing officer accountability for financial misconduct.⁶⁹ The availability of a private right to sue “encourages investors, bolsters capital markets, and facilitates economic growth.”⁷⁰

While there is ongoing debate about the impact of private litigation upon capital markets,⁷¹ liabilities for securities fraud have become a globally accepted phenomenon.⁷² In particular, foreign securities regimes

SEC to go further than its longstanding disclosure approach to executive compensation based on the broad protections for board decisions over compensation under state corporate law); cf. Philip C. Berg, *The Limits of SEC Authority Under Section 14(a) of the Exchange Act: Where Federal Disclosure Ends and State Corporate Governance Begins*, 17 J. CORP. L. 311 (1992) (discussing ways the SEC can undertake proxy reform).

68. Markham, *supra* note 60; Martin, *supra* note 67; see also Lucien Bebchuk, *The SEC: Beyond Disclosure*, FORBES, Jan. 19, 2006, available at http://www.forbes.com/2006/01/18/sec-executive-comp-comment-cx_lb_0119bebchuk.html (asserting that requirements by the SEC that companies disclose executive compensation schemes will not fix the problem of executive compensation alone). There has been an extensive and longstanding discussion about the merits of disclosure as opposed to direct conduct controls. See Alison Grey Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L.J. 311, 325 (1974) (arguing that substantive regulation is the best means of deterring undesirable practices); John C. Coffee Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1115 (1977) (“Disinfectants are not, after all, a universal panacea; sometimes surgery is required.”); William O. Douglas, *Protecting the Investor*, 23 YALE L.J. 522, 528 (1934) (noting the effectiveness of conduct regulation). The tax laws have also been criticized as ineffective in checking executive compensation. Markham, *supra* note 60, at 287-91; see also Sarah Anderson et al., *Executive Excess 2008: How Average Taxpayers Subsidize Runaway Pay*, INST. FOR POL’Y STUD. & UNITED FOR A FAIR ECON, Aug. 25, 2008, at 5 (finding that tax subsidies related to executive pay total \$20 billion and that Congressional reforms targeting the loopholes have stalled in the face of opposition from corporate lobby groups).

69. There is a right to sue under section 10(b). 15 U.S.C. § 78j(b) (2002), 17 C.F.R. §240.10b-5(2007). See *Basic Inc. v. Levinson*, 485 U.S. 224, 230-31 (1988) (“Judicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of § 10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the 1934 Act’s requirements.”).

70. See Robert A. Prentice, *Stoneridge, Securities Fraud Litigation, and the Supreme Court*, 45 AM. BUS. L.J. 611, 681 (2008) (reporting results of an empirical study (citing FRANK B. CROSS & ROBERT A. PRENTICE, *LAW AND CORPORATE FINANCE* 182 (2007))); *id.* at 680 n.305 (showing there is extensive literature arguing that robust securities regimes facilitate capital markets and spur economic growth).

71. See *id.* at 678 (finding the “case for encouraging such suits is no less persuasive than the case for discouraging them”).

72. See Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 832-38 (2006) (showing that developed economies emulate most of the core attributes of

have been sensitive to the need for executive accountability.⁷³ This worldwide concern reflects President Roosevelt’s belief that the securities laws were for the “protection of investors [and] for the safeguarding of values.”⁷⁴

Yet recent scandals involving collateralized debt obligations and options backdating have challenged the effectiveness of securities laws.⁷⁵ Amidst urgent calls for accountability to shareholders, federal courts are struggling to fashion an analytically sound rubric of liability in civil securities fraud suits.⁷⁶ To make matters worse, a recent decision by the U.S. Supreme Court has signaled that federal courts are limiting liability exposure in the securities arena.⁷⁷ As a result, courts will not invent

U.S. securities regulation).

73. See Jennifer G. Hill, *Regulatory Responses to Global Corporate Scandals*, 23 WISC. INT’L L.J. 367, 401-02 (2005) (discussing Australia’s increase in executive accountability); Robert B. Thompson & Hillary A. Sale, *Securities Fraud As Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 876-77 (2003) (describing federal disclosure laws in the United States that impose governance duties on corporate officers).

74. 78 CONG. REC. 2264 (daily ed. Feb. 9, 1934) (Message From Pres. Roosevelt) (providing reasons for the enactment of the Exchange Act of 1934); see also Prentice, *supra* note 70, at 682 (“President Roosevelt perceived securities regulation as largely a moral question rather than an economic one.” (citing JAMES E. SARGEANT, ROOSEVELT AND THE HUNDRED DAYS: STRUGGLE FOR THE EARLY NEW DEAL 221 (1981))).

75. See, e.g., Jay R. Ritter, *Forensic Finance*, 22 J. ECON. PERSP. 127 (2008).

76. See Donald C. Langevoort, *The Reform of Joint and Several Liability Under the Private Securities Litigation Reform Act of 1995: Proportionate Liability, Contribution Rights, and Settlement Effects*, 51 BUS. LAW. 1157, 1165-66 (1996) (noting the fine line between levels of intent). Two types of securities litigation are typical: insider trading and misleading disclosures. In the latter case, a corporate officer makes a false or misleading statement about an important product line or financial matter such as quarterly earnings in the corporation’s favor that inflates the stock price. When the truth is discovered, a class of investors sues the corporation and key officers for fraud under Section 10(b) of the Securities and Exchange Act of 1934. Under either scenario, scholars are attempting to make sense of contradictory court decisions. See generally Patricia S. Abril & Ann M. Olazábal, *The Locus of Corporate Scierter*, 2006 COLUM. BUS. L. REV. 81 (suggesting that the scierter may reside other than with the officer who utters the misrepresentation); Regina F. Burch, “Unfit to Serve” *Post-Enron*, 42 VAL. U. L. REV. 1081, 1084 (2008) (arguing that non-management directors’ reckless failures to respond to red flags may amount to an intentional omission of material information in violation of Rule 10b-5); Hugh C. Beck, *The Substantive Limits of Liability for Inaccurate Predictions*, 44 AM. BUS. L.J. 161 (2007) (advocating a falsity-driven analysis of the PSLRA’s safe harbor’s “meaningful cautionary statements” requirement); Ann M. Olazábal & Patricia S. Abril, *The Ubiquity of Greed: A Contextual Model for Analysis of Scierter*, 60 FLA. L. REV. 401 (2008) (extending the stock sales model to create a rubric for consideration of adequacy of allegations of motive and opportunity in 10b-5 complaints).

77. See *Stoneridge Inv. Partners, v. Scientific-Atlantic*, 55 U.S. 148 (2008) (refusing to recognize liability for knowing participation in securities fraud by parties who make no misleading statements upon which the public could have relied under Section 10(b) and Rule 10b-5); see also Tony Mauro, *Justices Skeptical of Investor Class Actions*, LEGAL TIMES, Oct. 15, 2007 (calling it “the securities fraud case of the decade”); Nicholas

liabilities to capture fraud as they once did.⁷⁸ One commentator has concluded that the Court's decision was clear that federal courts are to sit on the sidelines despite the ever artful and creative business methods that have, and will continue, to breed new instances of fraud or other financial misconduct.⁷⁹ Congress alone must now act swiftly and with prescience to provide adequate investor protection.⁸⁰

Furthermore, the Supreme Court's stance vis-à-vis securities legislation parallels its recent refusal to recognize remedies in other commercial cases.⁸¹ The effect of this jurisprudence is to further

Rummell, *Supremes to Weigh in on Vendor Liability for Fraud*, FIN. WK., Oct. 8, 2007, available at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20071008/REG/71005025> (characterizing the case as “the *Roe v. Wade* of securities law”).

78. See Prentice, *supra* note 70, at 639-40 (reviewing prior securities fraud litigation as well as other fraud jurisprudence to show that neither the Supreme Court nor state or lower federal courts distinguished between primary and secondary liability). Robert Prentice explains: “These ‘A helps B fool C’ schemes are hardly new inventions. Until *Stoneridge*, they had always been punished rather than rationalized as typical business operations.” *Id.* at 615.

79. See *id.* at 677 (noting that a “stinting definition of fraud provides crooks with a road map for getting away with the most egregious of schemes”); accord John C. Coffee, Jr., *The Metastasis of Mail Fraud: The Continuing Story of the ‘Evolution’ of a White-Collar Crime*, 21 AM. CRIM. L. REV. 1, 3 (1983) (“If we freeze the evolution of the [mail fraud] statute, new forms of predatory behavior will appear to which the legislature cannot realistically be expected to respond quickly.”); see also Schwarcz, *supra* note 13, at 20 (explaining that the complexities of securities can make financial markets more susceptible to fraud); cf. Samuel W. Buell, *Novel Criminal Fraud*, 81 N.Y.U. L. REV. 1971, 1972 (2006) (commenting on the flexibility of legislative and common law fraud given that it “will always confront novel economic practices that have not previously been classified as fraudulent”).

80. See Prentice, *supra* note 70, at 612-13 (criticizing those praising the decision for its judicial restraint (citing Paul S. Atkins, *Stoneridge and the Rule of Law*, WALL ST. J., Jan. 25, 2008, at A14)).

81. See *Great-West Life & Annuity Insurance Co. v. Knudson*, 534 U.S. 204 (2002) (denying an insurance company equitable relief in the form of forcing another party to pay money since such a remedy would be a legal one); *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308, 324 (1999) (reversing a trial court's grant of injunctive relief on the basis that such relief exceeded the trial court's jurisdiction); see also Judith Resnik, *Constricting Remedies: The Rehnquist Judiciary, Congress, and Federal Power*, 78 IND. L.J. 223, 224, 253-55 (2003) (criticizing the court's restrictive reading of its own power in relationship to Congress and explaining that the *Grupo Mexico* and *Great-West Life* cases are part of a jurisprudential trend in other areas); accord *The Supreme Court, Term—Leading Cases*, 113 HARV. L. REV. 200, 317 (1999) (characterizing the *Grupo Mexico* decision as a “cramped understanding” of the powers of federal courts). While these two decisions involved equitable remedies and have generated commentary on the perceived power of the federal courts over equity, Stephen B. Burbank, *The Bitter with the Sweet: Tradition, History, and Limitations on Federal Judicial Power—A Case Study*, 75 NOTRE DAME L. REV. 1291 (2000) (critiquing *Grupo Mexico* and emphasizing the interdependence of law and equity in social progress), more recent decisions sanctioning dismissals on the basis of discretionary equitable defenses demonstrate that the Supreme Court's position on remedies has less to do with equity and more to do with its place within

discourage Congress from looking to federal courts as a means of enforcing a national agenda.

Given the more limited role of the federal courts in protecting investors from fraudsters (or from adequately responding in other business disputes) as well as the SEC’s narrow mandate regarding executive pay packages, state courts should continue to “step into the breach” left by federal law in their time-honored role as guardians of public policy.⁸² As discussed below in Part III, there is controversy over the effectiveness of state court litigation concerning excessive executive compensation.⁸³ Combating executive pay abuses in the context of an unclean hands defense would help fulfill the promise of state courts as the primary purveyors of public policy and assist existing and proposed federal law in reaching its goals of shareholder and stakeholder accountability. Therefore, the doctrine of “clean hands” provides a more complete response to executive compensation schemes that are potentially lethal to companies and their constituents.

III. STATE CORPORATION LAW

Dismissals for unclean hands in breach of contract cases, brought by errant executives, support the long-standing view of holding state law as the primary regulator of the corporation.⁸⁴ Corporations are not only created under state law, but their internal affairs are also governed by state

the federal political system. *Accord* Prentice, *supra* note 70, at 612-13 (concluding that the court’s decision in *Stoneridge* was “an activist opinion driven primarily by undisguised and quite debatable policy preferences”); Resnik, *supra*, at 225 (characterizing, in a similar manner, the Court’s jurisprudence as motivated by judicial policy preferences). *See generally* Robert J. Aalberts & T. Leigh Anenson, Discretionary Limits on Statutes of Limitations: A Defense of Laches (working paper, on file with authors) (analyzing Supreme Court equity cases).

82. Judith S. Kaye, *State Courts at the Dawn of the New Century: Common Law Courts Reading Statutes and Constitutions*, 70 N.Y.U. L. REV. 1, 11-13 (1995) (discussing how state courts are answering Justice Brennan’s call to “step into the breach” and interpreting their state constitutions more expansively than the federal constitution in the inaugural Brennan Lecture delivered at the New York University School of Law (quoting William J. Brennan, Jr., *State Constitutions and the Protection of Individual Rights*, 90 HARV. L. REV. 489, 503 (1977))).

83. *See infra* Part III; *cf.* LAUFER, *supra* note 8, at 40 (discussing how New York state criminal law closed the regulatory gaps of federal law in the area of excessive executive compensation during the post-Enron era).

84. *See* *Cort v. Ash*, 422 U.S. 66, 84 (1975) (“Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.”); *see also* Martin, *supra* note 67, at 537 (“Challenges to executive compensation decision making logically reside in state law . . .”).

statutory default rules.⁸⁵ Moreover, a well-developed body of state case law regulates the relationship between shareholders and management.⁸⁶ Because states have not amended corporate statutory provisions to address abusive executive pay practices, litigation challenging the strength of the owner-management connection has been the primary means of correcting executive compensation.⁸⁷ Typically, such lawsuits are brought by shareholders on behalf of the corporation and seek to hold directors personally liable for waste and breaching their fiduciary duties.⁸⁸

It is axiomatic that corporate directors have a direct fiduciary relationship with the entities they serve and an indirect fiduciary relationship with the shareholders.⁸⁹ One of the most important purposes of corporate fiduciary law is to instill trust in management behavior for the benefit of the shareholders and the public.⁹⁰ Invocation of unclean hands in

85. Suggestions for state statutory reform to curb excessive executive compensation have included shareholder approval (binding or nonbinding) of executive compensation packages or at least of contracts with such specific features, allowance for shareholder resolutions on executive pay policies that are binding on the board, and permitting greater shareholder involvement in the selection of directors. LUCIAN A. BEBCHUK & JESSE M. FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 198 (2004). There is also the possibility of establishing corporate bylaws concerning executive compensation. Thomas & Martin, *supra* note 26, at 1047-49.

86. See Duggin & Goldman, *supra* note 12 (discussing the development of fiduciary duty law).

87. In response to an earlier Delaware decision, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), Delaware and other states have amended their general corporation law to permit corporations to include a provision in their certificate of incorporation to exculpate directors from personal liability for breaching their duty of care (although not their duty of loyalty or the newly recognized duty of good faith). For example, see DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). *Van Gorkom*, and subsequent cases like *In re Walt Disney Co.*, *infra* notes 96-102, have received a high level of scholarly attention due to the implications of their holdings. See, e.g., Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 54 (2002) (discussing the role of a corporation's board from a legal and practical perspective).

88. Martin, *supra* note 67; see also John W. Murrey, III, *Excessive Compensation in Publicly Held Corporations: Is the Doctrine of Waste Still Applicable?*, 108 W. VA. L. REV. 433 (2005) (discussing the waste doctrine in the context of excessive executive compensation).

89. See Duggin & Goldman, *supra* note 12, at 257-58 ("Shareholders *entrust* control of their property to the directors who are charged with overall management of the corporation. They expect those who manage the companies they invest in to produce value, and they anticipate a share in the benefit derived from their capital." (citing Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L.J. 425, 430 (1993))).

90. Mitchell, *supra* note 89, at 430; see also Larry Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 556 (2001) ("Trust can be seen simply as a *decision* by one person to give power over his person or property to another in exchange for a return promise."). Mitchell notes that in the corporate context, "[t]he power and control that are present in all fiduciary relationships are exaggerated . . . because the indeterminate length of the enterprise and the practically infinite array of investment opportunities for the corporation make any possibility of specified limitations on directors' power or ongoing control by the

response to executive overreaching in contract cases strengthens the primary role of states as the custodian of corporate integrity and governance.⁹¹ It also represents a complementary response to the current crisis of corporate trust and supports state fiduciary duty law.⁹² Fiduciary duties are rooted in ancient equity and are often emphasized with respect to the importance of the preservation of equity in the modern commercial world.⁹³

Still, the saga of shareholder derivative litigation has not been a surefire way to cure executive excesses. During the Great Depression, the first in a series of high profile cases challenged the outrageous compensation packages paid to industry moguls as a breach of directorial duties and showed some promise in stemming excessive executive pay.⁹⁴ Such lawsuits have been ongoing ever since, especially during recessionary periods like now, when CEO paychecks outpace those of the average worker and corporate earnings.⁹⁵

stockholders unrealistic.” *Id.*

91. See Marleen A. O’Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1235 (2003) (commenting that Enron “serves as a ‘perfect storm’ metaphor that the checks and balances in the American system of corporate governance are not working . . .”). For articles discussing the pros and cons of directorial fiduciary duties, see Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1267-68 (1999); Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors’ Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 394 (2005); Charles Hansen, *The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule, A Commentary*, 41 BUS. LAW. 1237, 1245 (1986); E. Norman Veasey, *A Perspective on Liability Risks to Directors in Light of Current Events*, INSIGHTS, Feb. 2005, at 15.

92. See Duggin & Goldman, *supra* note 12, at 261 (“The shenanigans of senior executives in combination with the oversight failures of directors generated a *crisis in corporate trust*.”); Lyman P.Q. Johnson, *Reclaiming an Ethic of Corporate Responsibility*, 70 GEO. WASH. L. REV. 957, 965-66 (2002) (discussing ways through which an ethic of corporate responsibility may be reinstated); see also Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27, 72 (2004) (arguing that “a moral vocabulary has been, and should remain, central to corporate law discourse”).

93. LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 393 (3rd ed. 2005); William Gummow, *Conclusion*, in *EQUITY IN COMMERCIAL LAW* 515, 518 (James Edelman & Simone Degeling eds., 2005); Lionel Smith, *Fusion and Tradition*, in *EQUITY IN COMMERCIAL LAW*, *supra*, at 19, 30.

94. See, e.g., *Rogers v. Hill*, 289 U.S. 582, 591 (1933) (finding that executive pay could become excessive and amount to waste and constitute a breach of fiduciary duties); see also Markham, *supra* note 60, at 281-83 (detailing cases involving American Tobacco Company, Bethlehem Steel, and National City Bank).

95. See Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 571 (2001) (examining 124 cases where shareholders have brought claims of excessive compensation and concluding that shareholders are more likely to find success against smaller corporations when litigating outside of Delaware).

The effectiveness of fiduciary duty litigation over CEO compensation schemes was spotlighted recently in Delaware. In the seminal case of *In re Walt Disney Company Derivative Litigation*, the Supreme Court of Delaware affirmed the Chancery Court's recognition of a new duty of good faith in executive pay practices.⁹⁶ The Delaware Court of Chancery had declared that, in addition to the traditional duties of care and loyalty, directors must have honesty of purpose and "a true faithfulness and devotion to the interests of the corporation and its shareholders."⁹⁷

The creation of this fiduciary principle of good faith arose in the decade-long shareholder derivative litigation over the hiring and firing of Michael Ovitz by his long-time friend and Disney CEO, Michael Eisner.⁹⁸ Shareholders sought to recover against the directors after they paid Ovitz some \$130 million in compensation (including a termination payout) for his abysmal one-year performance.⁹⁹ Despite advising corporate counsel and the compensation committee to hire experts and follow best practices, the chancellor ultimately determined that no breach of duties had occurred by the Disney directors under the circumstances, and the Delaware Supreme Court affirmed that decision.¹⁰⁰

The case has sparked a firestorm of controversy over the already burning question of CEO compensation.¹⁰¹ It has been lauded for creating

96. 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006). The shareholder derivative litigation involving The Walt Disney Company produced six court opinions. *See Duggin & Goldman, supra* note 12, at 215 n.14 (recounting the decisions and their holdings).

97. *Id.* at 755, *aff'd*, 906 A.2d at 67. For a pre-*Disney* discussion of Delaware's emerging good faith duty, see Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456 (2004); *see also* E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399 (2005) (recounting developments in Delaware's corporate law, including the duty of good faith, by former Delaware Supreme Court Chief Justice Veasey during his tenure on the court).

98. *Disney*, 906 A.2d at 35-46.

99. *Id.* at 35.

100. *Id.*; *Disney*, 907 A.2d at 760 n.487 (albeit describing Disney's business practices as that of "an imperial CEO" operating with a "supine or passive board"). For instance, the compensation committee used an expert consultant, compared Ovitz's options to others it had approved for other executives, and knew the downside protection of \$150 to \$200 million Ovitz was seeking before leaving his company. *Disney*, 906 A.2d at 56-59; *see also* Martin, *supra* note 67, at 500-01 (comparing *Disney* and *Van Gorkom* and concluding that the Delaware Supreme Court was consistent in its rulings).

101. *See generally* Duggin & Goldman, *supra* note 12 (discussing the "new" duty of good faith); *see also* Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 7-8 (2005) ("The duty of good faith emerged in an environment of *sturm und drang* in corporate governance, when a series of scandals—including frauds and failures at Enron, WorldCom, Tyco, and Adelphia, celebrity insider trading, and corruption in the IPO market—drew American corporate governance into question and plunged previously settled questions into heated debate."). For a

the obligation of good faith in setting executive pay levels.¹⁰² But it has also renewed calls for all courts to increase the level of scrutiny of board decisions in an effort to encourage directors to negotiate more “defensible” packages with CEOs.¹⁰³

As a defense in a contract suit against the company, unclean hands avoids the lenient review of board decisions under existing fiduciary duty law. Moreover, whether the outcome in *Disney* denotes the diminishing utility of fiduciary duty litigation in compensation cases, the recognition of an obligation of good faith provides at least the potential for extra protection from abusive pay practices in the future.¹⁰⁴ Dismissals under the “clean hands” doctrine for excessive executive compensation support the board’s good faith duty to monitor and oversee officers by allowing them to deny payment without incurring contract liability on behalf of the company.¹⁰⁵ It would encourage directors not to negotiate absurdly fantastic compensation schemes in the first place and sustain their refusal to pay contracted-for compensation under circumstances of executive malfeasance.¹⁰⁶

Concomitantly, with the availability of the “clean hands” doctrine, the directors’ failure to invoke the defense under circumstances amounting to

description of how Delaware became the “center of the corporate universe” authored by the Chief Justice of the Supreme Court of Delaware, see E. Norman Veasey, *Musings from the Center of the Corporate Universe*, 7 DEL. L. REV. 163, 166-67 (2004).

102. See generally Martin, *supra* note 67 (discussing the positive element of the *Disney* ruling establishing the duty of good faith).

103. See Thomas & Martin, *supra* note 95, at 599-600 (discussing standards of review in executive compensation cases); see also Martin, *supra* note 67, at 537-38 (describing opportunities for stricter review in state courts); accord GRAEF CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES (1991) (proposing that courts use an intermediate level of scrutiny in reviewing compensation packages); Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 87 (1992) (discussing the standard of “reasonableness” in such cases); Detlev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 252-61 (1983) (reviewing case law on executive compensation and review); Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1897-99 (1992) (describing how a change in standards of review might influence corporate action).

104. *Contra* Markham, *supra* note 60, at 284 (claiming that courts are institutionally unable to deal with the issue of excessive compensation paid to executives).

105. See, e.g., Press Release, Watson Wyatt Worldwide, Corporate Directors Give Executive Pay Models Mixed Reviews (June 20, 2006), available at <http://www.watsonwyatt.com/news/press.asp?ID=16180> (finding in a worldwide survey that 61% of directors think that executives are overpaid).

106. See *Jones v. Harris Assoc. L.P.*, 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting) (noting the “feeble incentives of boards of directors to police compensation” (citing, e.g., Ivan E. Brick et al., *CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?*, 12 J. CORP. FIN. 403 (2006))), *cert. granted*, 129 S.Ct. 1579, 173 L.Ed.2d 675 (Mar 09, 2009) (No. 08-586).

excess pay may be a violation of their fiduciary duty. The extra threat of liability should incentivize them to act in the best interests of the company.¹⁰⁷ Shareholder activism and even public indignation, also proving an effective deterrent against executive excesses in the pay setting process, should additionally motivate directorial diligence in seeking refuge from contract overreaching with unclean hands.¹⁰⁸

Used in this way, the doctrine of “clean hands” provides an extra line of defense against avaricious executives and incentivizes directors to do the right thing regarding the negotiation and execution of officer pay packages. While neither the market nor the law alone has been effective in keeping directors faithful to their fiduciary responsibilities,¹⁰⁹ the defense of unclean hands provides an additional weapon in the corporate arsenal to combat executive greed and its toxic consequences to company stakeholders.

IV. EVOLUTION OF EQUITY

Along with advancing the common goal of management accountability found in state corporation law and federal legislation, defeating excessive compensation by applying the “clean hands” doctrine preserves the traditional purpose and use of the defense. Court utilization of unclean hands also curtails unethical business practices in contract cases and continues the modern doctrinal trend in extending the defense to damages actions. It additionally reinforces the time-honored role of equity in maintaining the integrity of the law.

107. A strengthening of existing fiduciary law (through higher level scrutiny or otherwise) would be beneficial to encourage directors with respect to contract compensation decisions. See, e.g., Michael Abramowicz & M. Todd Henderson, *Prediction Markets for Corporate Governance*, 82 NOTRE DAME L. REV. 1343, 1382 (2007) (advocating court use of prediction markets in fiduciary duty litigation to assess board decisions over how much to pay the CEO).

108. See Ertimur et al., *supra* note 42, at 27-30 (explaining how shareholder activism can act as a catalyst for change by inspiring other investors, the press, and even independent directors who have been targeted in vote-no campaigns); discussion *supra* notes 43-45 and accompanying text (discussing rates of implementation of shareholder proposals and reduction in CEO pay); see also John E. Core et al., *The Power of the Pen and Executive Compensation*, 88 J. FIN. ECON. 1, 1-25 (2008) (studying the determinants and effect of negative compensation-related press coverage). For additional evidence of board responsiveness to shareholder activism, see *infra* Part VI.B.

109. See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1747-53 (2001) (suggesting trust is a more important factor in business decisions than fear of legal or market sanctions).

A. *Role of Ancient Equity in Commercial Cases*

It must be emphasized that it was through courts not legislatures that society originally received protection from scandalous commercial practices. For example, when the common law courts failed to stop defendants from being made to pay twice on the collection of a note under seal, equity was there.¹¹⁰ When the common law judges turned a blind eye to mistakes in the formation of contracts or in the unfairness of their execution, equity again intervened.¹¹¹ Over time, these equitable principles became so well-regarded that the common law courts adopted them as their own.¹¹² To be sure, the absorption of equity has been extensive enough that lawyers and lay persons alike consider “equity” to be a synonym for

110. See 1 JOHN NORTON POMEROY, EQUITY JURISPRUDENCE §§ 20, 27 n.16 (5th ed. 1941) (describing how the debtor would be required to pay multiple times on the same debt due to the absence of the defense of accord and satisfaction under the rigid common law); RALPH A. NEWMAN, EQUITY AND LAW: A COMPARATIVE STUDY 26 (1961) (“If one paid a debt expressed in a sealed instrument without obtaining an acquittance, he could be made to pay again.”).

111. The following areas were also in need of equitable protection from the strict common law:

A person who injured another in self-defense must pay damages for the battery; he was also guilty of a crime. Killing by accident was a crime. Misrepresentation was not protected against by existing forms of action. A wife’s property belonged to her husband during coverture. . . . Only contracts in the form of covenants under seal were enforced, and even in such cases the common law courts gave relief only if the breach involved an affirmative act. The theory of dependent promises was as yet undreamed of, and recovery for unjust enrichment was four centuries away.

T. Leigh Anenson, *The Triumph of Equity: Equitable Estoppel in Modern Litigation*, 27 REV. LITIG. 377, 380 n.5 (2008) (quoting NEWMAN, *supra* note 110, at 25–26); see also ROBERT MEGARRY & P.V. BAKER, SNELL’S PRINCIPLES OF EQUITY 12 (27th ed. 1973) (“A plaintiff who had obtained a judgment in his favour in a court of law might be prevented from enforcing it by a ‘common injunction’ granted by the Court of Chancery, because in the opinion of the latter court he had obtained the judgment unfairly.”); Oliver Wendell Holmes, *Early English Equity*, 1 L.Q. REV. 162, 162–63 (1885) (discussing substantive doctrines developed in chancery).

112. Evidence of these equitable principles can be seen in *Spect v. Spect*:

The distinction between strict law and equity is never in any country a permanent distinction. Law and equity are in continual progression, and the former is constantly gaining ground upon the latter. A great part of what is now strict law was formerly considered as equity, and the equitable decisions of this age will unavoidably be ranked under the strict law of the next (internal citation omitted).

26 P. 203, 205 (Cal. 1891) (quoting Lord Redesdale explaining the equitable penetration of the common law); Robert S. Stevens, *A Plea for the Extension of Equitable Principles and Remedies*, 41 CORNELL L.Q. 351, 354 (1956) (discussing the law’s adoption of equitable principles); see also discussion *infra* notes 125–31 and accompanying text (discussing common law absorption of many equitable defenses in contract law).

fairness.¹¹³ Simply put, “[i]t is a question of ethics.”¹¹⁴

It is true that since the rise of the regulatory state during the early twentieth century, protection from fraud and other nefarious commercial practices has fallen within the domain of legislation. But public protection from unethical conduct did not begin with the financial fraud and dubious ethical practices that ushered in the Great Depression and inspired the Securities Acts of 1933 and 1934.¹¹⁵ Nor did it originate in the previous century with the enactment of the anti-trust laws to bust the powerful

113. See, e.g., *Rauscher v. City of Lincoln*, 691 N.W.2d 844, 852 (Neb. 2005) (“Equity is determined on a case-by-case basis when justice and fairness so require.”); *Clark v. Teeven Holding Co.*, 625 A.2d 869, 878 (Del. Ch. 1992) (“The use of the term ‘equitable principles’ . . . is merely equivalent to the words ‘principles of fairness or justice.’”); *Ohio St. Bd. of Pharmacy v. Frantz*, 555 N.E.2d 630, 633 (Ohio 1990) (indicating that justice is the objective of equity); see also MEGARRY & BAKER, *supra* note 111, at 6 (noting that, in modern English statutes, provisions relating to what is “equitable” are usually construed to mean what is “fair”); Donald Nichols & Chandra Subramaniam, *Executive Compensation: Excessive or Equitable?*, 29 J. BUS. ETHICS 339, 340 (2001) (equating equity with fairness in the context of CEO compensation); Roger Young & Stephen Spitz, *SUEM—Spitz’s Ultimate Equitable Maxim: In Equity, Good Guys Should Win and Bad Guys Should Lose*, 55 S.C. L. REV. 175, 178 (2003) (commenting that the basic orthodoxy of equity is that “[the] good guys should win and [the] bad guys should lose”). Indeed, it was the perception that parallel court systems were applying similar substantive rules under different procedural processes that led to the idea of integration. See William Searle Holdsworth, *Blackstone’s Treatment of Equity*, 43 HARV. L. REV. 1, 7 (1930) (reviewing the discussion between Lord Mansfield and Blackstone about the procedural and substantive differences in law and equity); Thomas O. Main, *Traditional Equity and Contemporary Procedure*, 78 WASH. L. REV. 429, 464 (2003) (discussing the merger of the law and equity regimes and the importance of maintaining equitable principles).

114. *Dezell v. Odell*, 3 Hill 215, 225 (N.Y. Sup. Ct. 1842); see also Zechariah Chafee, Jr., *Foreword to SELECTED ESSAYS ON EQUITY* 59 (Edward D. Re ed., 1955) (commenting that equity courts “mainly clothed moral values with legal sanctions”). Every chancellor from 1380 to 1488 was a church official. Thomas Edward Scrutton, *Roman Law Influence in Chancery, Church Courts, Admiralty, and Law Merchant*, in *SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY* 208, 214–15 (Ass’n of Am. Law Schs. ed., 1907); see also Henry Arthur Hollond, *Some Early Chancellors*, 9 CAMBRIDGE L.J. 17, 23 (1945) (indicating that the position was held by laymen for only about twelve years during the fourteenth century). As an ecclesiastic, the official was trained in Canon and moral law. Garrard Glenn & Kenneth Redden, *Equity: A Visit to the Founding Fathers*, 31 VA. L. REV. 779, 780 (1945) (discussing the long line of bishops and archbishops serving as chancellors). Non-clerical chancellors were drawn from the ranks of the common lawyers beginning in the sixteenth century. MEGARRY & BAKER, *supra* note 111, at 9; see also Glenn & Redden, *supra*, at 779 (advising that Sir Thomas Moore was the first lawyer to be Lord Chancellor in 1529).

115. Securities Exchange Act of 1933, 15 U.S.C. § 77a (2002); Securities Exchange Act of 1934, 15 U.S.C. § 78a (2002). See Herman & MacLean v. Huddleston, 459 U.S. 375, 388-89 (1983) (explaining that the purpose of the securities laws was “to rectify perceived deficiencies in the available common law protections by establishing higher standards of conduct in the securities industry”); Prentice, *supra* note 70, at 619, 623 (noting that the securities laws were meant to strengthen the common law and citing additional lower federal court cases).

railroad trusts.¹¹⁶

Rather, protection from unethical conduct began in England during the Middle Ages when chancellors and, eventually, equity courts applied moral principles to achieve justice during a time when the “‘might makes right’ mentality was once the conscience of kings and nobles.”¹¹⁷ Since the rise of the modern corporation, corporate directors have become the new aristocracy and have crowned CEOs king.¹¹⁸ It does not take too much imagination to recognize how medieval history bears an eerie resemblance to the present day events. Moreover, given that the public power vacuum left by foreign governments is being filled by private multinational

116. See George F. Canfield, *Is a Large Corporation an Illegal Combination or Monopoly under the Sherman Anti-Trust Act?*, 9 COLUM. L. REV. 95, 108 (1909) (discussing the treatment of railroad companies under the anti-trust laws); Thomas S. Ulen, *Cartels and Regulation: Late Nineteenth Century Railroad Collusion and the Creation of the Interstate Commerce Commission*, 40 J. ECON. HIST. 179 (1980) (same); see also FRIEDMAN, *supra* note 93, at 390 (citing the technological advances of the nineteenth century as first providing corporations—initially the railroads—a commanding position in the economy). President Theodore Roosevelt pressed for greater corporate accountability and an even more expanded role for the federal government in the oversight of big business. *President Roosevelt Speaks on Trusts*, N.Y. TIMES, Apr. 4, 1903, at 1; see, e.g., *Standard Oil Co. of New Jersey v. United States*, 221 U.S. 1 (1911) (finding that the defendant’s practices constituted a restraint of trade); *United States v. American Tobacco Company*, 221 U.S. 106 (1911) (same).

117. Anenson, *supra* note 111, at 386 (quoting WILLIAM F. WALSH, A TREATISE ON EQUITY 99–100 (1930)); see also WILLIAM SHAKESPEARE, RICHARD III act 5, sc. 2 (“Every man’s conscience is a thousand men.”). Legal and the ethical principles were not separate concepts during the formative stages of the common law legal system. See George Burton Adams, *The Origin of English Equity*, 16 COLUM. L. REV. 87, 91 (1916), reprinted in SELECTED ESSAYS ON EQUITY 1, 5 (Edward D. Re ed., 1955) (“Common Law and Equity originated together as one undifferentiated system in the effort of the king to carry out his duty of furnishing security and justice . . .”); William F. Walsh, *Equity Prior to the Chancellor’s Court*, 17 GEO. L.J. 97, 100–06 (1929) (finding the roots of equity administration beginning with nobility); see also H. D. Hazeltine, *The Early History of English Equity*, in ESSAYS IN LEGAL HISTORY: READ BEFORE THE INTERNATIONAL CONGRESS OF HISTORICAL STUDIES HELD IN LONDON IN 1913, at 261–85 (Paul Vinogradoff ed., 1913) (providing examples of equity-like ethical principles in the common law). The High Court of Chancery emerged as a separate forum for the administration of equity around the fourteenth century. NEWMAN, *supra* note 110, at 22–23; see also 1 JOHN LORD CAMPBELL, LIVES OF THE LORD CHANCELLORS 206 (1878) (noting that the court began as a marble table and chair at the upper end of Westminster Hall on the right hand side of the entryway, opposite to the King’s Bench on the left). For details on the separation of law and equity court systems, see Anenson, *supra* note 111, at 378 n.4. Countries of the civil law never developed distinct concepts of law and equity. See Jerome Frank, *Civil Law Influences on the Common Law—Some Reflections on Comparative and Contrastive Law*, 104 U. PA. L. REV. 887, 895 (1956) (comparing the English and German systems of equity).

118. See, e.g., Herbert Hevenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1593, 1641 (1988) (noting how directors, in contrast to shareholders, are the entities allowed to assert constitutional claims involving the corporation).

companies,¹¹⁹ there are even more reasons to consider an equitable response to unethical behavior. As business entities have grown in size and sophistication, along with their insatiable interests and unethical stratagems, so too has equity.¹²⁰ Indeed, it was the flexibility and

119. See generally SARAH ANDERSON ET AL., FIELD GUIDE TO THE GLOBAL ECONOMY (2005) (placing Wal-Mart and General Motors in the top twenty-five overall in a 2002 comparison of countries' national gross domestic products with the sales of major corporations); SPECIAL REPORT: THE FORBES GLOBAL 2000 (2005), available at <http://www.forbes.com/2005/03/30/05f2000land.html> (noting the influx of international companies into non-domestic markets); WORLD BANK DEVELOPMENT REPORT 2007: DEVELOPMENT AND THE NEXT GENERATION 294 (Table 4, Economic Activity), available at http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2006/09/13/000112742_20060913111024/Rendered/PDF/359990WDR0complete.pdf (last visited Feb. 11, 2010) (showing the economic activity of countries around the world); cf. DANIEL A. YERGIN & JOSEPH STANISLAW, THE COMMANDING HEIGHTS: THE BATTLE FOR THE WORLD ECONOMY (1998) (describing the imbalance of power between government and the growing private sector to the point that nation-states have lost the ability to influence the market, to deliver social goods, and to protect the environment); DAN BRIODY, THE HALLIBURTON AGENDA: THE POLITICS OF OIL AND MONEY (2004) (commenting on the influence of private military companies and their parents on foreign policy direction in some nation-states); RAYMOND BAKER, CAPITALISM'S ACHILLES HEEL: DIRTY MONEY AND HOW TO RENEW THE FREE MARKET SYSTEM (2005) (arguing that MNCs profit maximization objective has exploited tax laws of different nation-states and deprived them of adequate public resources to regulate the market or provide essential public goods); JURGEN HABERMAS, THE POSTNATIONAL CONSTELLATION: POLITICAL ESSAYS (2001) (discussing national governments' deregulation agendas leading to obscene profits and drastic income disparities due to the fear of capital flight).

120. See Burbank, *supra* note 81, at 1296 (commenting that our legal culture is accustomed to claims for the "triumph of equity" and to thinking about equity as an engine of legal development"); Sidney Post Simpson, *Fifty Years of American Equity*, 50 HARV. L. REV. 171, 179-81 (1937) (predicting that the future of equity is good and certain because it is a flexible tradition for allowing growth in the law). For the popularity of the doctrine of "clean hands" in particular, see CHAFEE, SOME PROBLEMS OF EQUITY, *supra* note 34, at 12 (noting the "astonishing number" of cases decided under the doctrine of unclean hands); Anenson, *Post-Merger Justification of Unclean Hands*, *supra* note 29, at 459 ("Despite its containment to mainly actions in equity, cases considering the doctrine during the present century already tally in the thousands.").

Over the last decade, more than one-half of Americans owned stock in corporations, in comparison with only one percent owning stock in 1900 and thirteen percent owning stock in 1980. See THEODORE CAPLOW ET AL., THE FIRST MEASURED CENTURY: AN ILLUSTRATED GUIDE TO TRENDS IN AMERICA, 1900-2000 Ch. 14 (2001), available at <http://www.pbs.org/fmc/book/14business6.htm> (discussing the amount of stock-holders based on the percentage of the population); U.S. CENSUS BUREAU, U.S. DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 2006 455 (125th ed. 2005), available at <http://www.census.gov/prod/2005pubs/06statab/income.pdf> (providing 1998 data indicating that approximately fifty-two percent of Americans own stock in corporations through individual investment, mutual funds, and pension plans). Large corporations also employ tens of millions of workers. See U.S. CENSUS BUREAU, *supra*, at 382 (follow "Table Number 655" link) (detailing the composition of individuals' savings). See generally Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business*

discretionary nature of equity that allowed courts to incorporate ethical standards of business into the law in a way that reflected prevailing social norms.¹²¹

B. Integration of Equity in Modern Contract Law

The success of the early equity courts and their principles should not to be forgotten.¹²² Today, many (if not most) of the theories of modern contract law are derived from ancient equity.¹²³ Defenses like fraud, duress, illegality, unconscionability, and accommodation originated in equity.¹²⁴ Other equitable defenses like estoppel,¹²⁵ waiver,¹²⁶ rescission,¹²⁷

Organizers in the Nineteenth Century, 51 U.C.L.A. L. REV. 387, 390-92 (2003) (explaining how the corporate structure provided an ideal legal framework for amassing the vast sums necessary to develop capital and to facilitate business and financial objectives).

121. See NEWMAN, *supra* note 110, at 12-22; *id.* at 255 (“The evolution of law is to a large extent the history of its absorption of equity.”); see also Mike Macnair, *Equity and Conscience*, 27 OXFORD J. LEGAL STUD. 659, 664 (2007) (noting the prevailing view of the Chancery as providing a regime to deal with the defects of the late medieval common law, which failed to adapt to new developments in society and the economy).

122. See, e.g., Keith Mason, *Fusion: Fallacy, Future or Finished?*, in EQUITY IN COMMERCIAL LAW, *supra* note 93, at 74 (commenting that “the Court of Chancery flowered ‘to soften and mollify the Extremity of the Law.’” (quoting Lord Ellesmere in his claim for equity’s supremacy over Lord Coke’s common law before James I)); Douglas Laycock, *The Triumph of Equity*, 56 LAW & CONTEMP. PROBS. 53, 67-68 (1993) (explaining that common law without equity would have been a functioning system, but in many applications it would have been “barbarous, unjust, absurd” (quoting 1 FREDERICK W. MAITLAND, EQUITY 1, 19 (2d ed. 1936))).

123. See generally LARRY A. DIMATTEO, EQUITABLE LAW OF CONTRACTS: STANDARDS AND PRINCIPLES 30 (2001) (explaining that the foundational principles of equity (fair play, protection of weaker parties, equality of consideration) influenced the development of contract law in the eighteenth century). It has also been argued that equitable principles have been incorporated again into contract law during the twentieth century. See W. DAVID SLAWSON, BINDING PROMISES: THE LATE-20TH CENTURY EQUITABLE REFORMATION OF CONTRACT LAW (1996) (asserting that beginning in the 1960s courts ended the remains of unfettered freedom of contract and replaced it with the reasonable expectations approach and fairness rationales in contract enforcement); see also Larry A. DiMatteo, *Equity’s Modification of Contract: An Analysis of the Twentieth Century’s Equitable Reformation of Contract Law*, 33 NEW ENG. L. REV. 265 (1999) (maintaining that equitable consideration of fair exchange has increasingly been used as a counterweight to freedom of contract).

124. See James B. Ames, *Specialty Contracts and Equitable Defenses*, 9 HARV. L. REV. 49 (1896) (discussing how the former equitable defenses of fraud, illegality, failure of consideration, payment, accommodation, and duress were subsequently recognized at law in specialty contracts). For a discussion of the contribution of equity to the law of fraud, see 3 JOHN N. POMEROY, A TREATISE ON EQUITY JURISPRUDENCE: AS ADMINISTERED IN THE UNITED STATES OF AMERICA §§ 872-974a (Spencer W. Symons ed., 5th ed. 1941) and DOUGLAS LAYCOCK, MODERN AMERICAN REMEDIES 907 (1985) (citing fraud as another example of equitable affirmative relief to a legal claim). For unconscionability, see *Leasing Service Corp. v. Justice*, 673 F.2d 70, 71 (2d Cir. 1982) (“Originating in Equity as a form of relief against the harshness of penal bonds, [unconscionability] has been employed by courts

ratification,¹²⁸ and acquiescence¹²⁹ share a similar evolution. Unclean hands also originated as a defense in contract cases.¹³⁰ But due to its different procedural posture, it remained relegated to cases seeking equitable relief for most of its two hundred year history.¹³¹ Since the

to deny enforcement to harsh and unreasonable contract terms.”). Unconscionability has also been made available at law or in equity as demonstrated by U.C.C. § 2-302 (1990) and RESTATEMENT (SECOND) OF CONTRACTS § 208.

125. *See, e.g.*, *Kirk v. Hamilton*, 102 U.S. 68 (1880) (adopting equitable estoppel into the common law); *see also* William F. Walsh, *Is Equity Decadent?*, 22 MINN. L. REV. 479, 485 (1938) (explaining that equitable estoppel was “fully adopted” in courts of law by 1938). Equitable estoppel is comprised of three elements that courts must consider in accepting or denying the use of the doctrine in a particular case. T. Leigh Anenson, *From Theory to Practice: Analyzing Equitable Estoppel Under a Pluralistic Model of Law*, 11 LEWIS & CLARK L. REV. 633, 640 (2007). There are also various kinds of estoppel defenses besides equitable estoppel. For judicial estoppel, *see* Walter S. Beck, *Estoppel Against Inconsistent Position In Judicial Proceedings*, 9 BROOK. L. REV. 245, 250-55 (1940). For collateral estoppel, *see* Jay Carlisle, *Getting a Full Bite of the Apple: When Should the Doctrine of Issue Preclusion Make An Administrative or Arbitral Determination Binding in a Court of Law?*, 55 FORDHAM L. REV. 63, 84-88 (1986). For quasi-estoppel, *see* *Simmons v. Burlington, Cedar Raids & Northern Railway*, 159 U.S. 278, 291 (1895).

126. *See, e.g.*, *USH Ventures v. Global Telesystems Group, Inc.*, 796 A.2d 7, 19 (Del. Super. Ct. 2000) (“Waiver has been, for some time, used at law as a valid defense to contract suits.”); *cf.* LAYCOCK, *supra* note 125, at 907 (“I have never been able to find out whether waiver originated at law or equity, but it no longer matters.”).

127. 12A C.J.S. *Cancellation of Instruments* § 4 (1980); *see also* *USH Ventures*, 796 A.2d at 18 (noting that rescission is both a cause of action and a defense).

128. *USH Ventures*, 796 A.2d at 18-20; *Colish v. Brandywine Raceway Ass’n*, 119 A.2d 887, 892 (Del. Super. Ct. 1955). For a discussion on the ratification defense, *see* 1 JOHN N. POMEROY, *A TREATISE ON EQUITY JURISPRUDENCE: AS ADMINISTERED IN THE UNITED STATES OF AMERICA* § 69 (Spencer W. Symons ed., 5th ed. 1941).

129. *See* DAN B. DOBBS, *LAW OF REMEDIES* 44 (Hornbook Series, 2d ed. 1993) (discussing the invocation of acquiescence in purely legal cases).

130. Chafee I, *supra* note 34, at 878. The clean hands doctrine was first recognized as a legal precedent in England in 1787. *Dering v. Earl of Winchelsea*, 1 Cox Eq. 318, 29 Eng. Rep. 1185 (1787); *see also* Chafee I, *supra* note 34, at 881-82 (tracing the clean hands doctrine’s origins in various treatises). The United States Supreme Court followed in 1795. *Talbot v. Jansen*, 3 U.S. 133 (1795); *see also* *Cathcart v. Robinson*, 30 U.S. 264 (1831) (recognizing that the defense was “well settled”); CHAFEE, *supra* note 34, at 5 (“[Unclean hands] is exactly as old as the United States Constitution.”). The first state to recognize unclean hands was New Jersey in 1793. *Mason v. Evans*, 1793 WL 453, at *4 (N.J. 1793). *But see* Chafee I, *supra* note 34, at 884 (“The earliest judicial use of the phrase ‘clean hands’ on this side of the Atlantic, as far as I know, was in Ohio in 1826.” (citing *Mattox v. Mattox*, 2 Ohio 233, 233-34 (1826))). The idea of clean hands has been recognized for nearly two thousand years in the civil law. NEWMAN, *supra* note 110, at 250 n.19 (explaining the clean hands doctrine’s application in Chinese customary law in the tenth and eleventh centuries); Anenson, *Post-Merger Justification of Unclean Hands*, *supra* note 29, at 478 (noting the doctrine’s persistence in civil legal systems stemming from its use in ancient Rome in the second century).

131. Anenson, *Post-Merger Justification of Unclean Hands*, *supra* note 29, at 465-66; *see also* Anenson, *Process-Based Theory of Unclean Hands*, *supra* note 29 (“Perhaps due to its newness relative to the other doctrines, the defense remained exclusively a defense

merger of law and equity courts and their procedures,¹³² however, courts have begun to fuse unclean hands into cases where legal relief, like damages, is sought.¹³³

against equitable (not legal) actions at the time of the merger.”). When courts administered law and equity in separate judicial systems before the merger, litigants pled unclean hands exclusively as a defense to an action for equitable affirmative relief in the court of chancery. DOBBS, *supra* note 130, §2.4(1) at 66-67; Anenson, *Process-Based Theory of Unclean Hands*, *supra* note 29. It was an equitable defense to equitable claims but not a defense to legal claims. See Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd., 970 F.2d 273, 281 (7th Cir. 1992) (“Unclean hands is a traditional defense to an action for equitable relief.”); see also E.W. Hinton, *Equitable Defenses under Modern Codes*, 18 MICH. L. REV. 717, 719 (1920) (“[T]here were equitable defenses to equitable claims, where there were no similar defense to corresponding legal claims.”); cf. John L. Garvey, *Some Aspects of the Merger of Law and Equity*, 10 CATH. U. L. REV. 59, 66-67 (1961) (noting that laches shared the same procedural posture as unclean hands); Aalberts & Anenson, *supra* note 81 (discussing the use of the equitable defense of laches).

For a discussion on the general operation of the two systems, see FREDERICK WILLIAM MAITLAND, *EQUITY AND THE FORMS OF ACTION* 17 (Chayton ed. 1909); Willard Barbour, *Some Aspects of Fifteenth Century Chancery*, 31 HARV. L. REV. 834, 834 (1918); William Searle Holdsworth, *The Relation of the Equity Administered by the Common Law Judges to the Equity Administered by the Chancellor*, 26 YALE L. REV. 1, 15 (1916).

132. While some early American courts were modeled upon the dual English system with separate law and equity courts, WILLIAM F. WALSH, *OUTLINES OF THE HISTORY OF ENGLISH AND AMERICAN LAW* 69-70 (1923), some state courts as well as the federal court system administered law and equity in the same court with different procedures. Charles T. McCormick, *The Fusion of Law and Equity*, 6 N.C. L. REV. 283, 284 (1928); Robert von Moschzisker, *Equity Jurisdiction in the Federal Courts*, 75 U. PA. L. REV. 287 (1927).

In the state court system, separate law and equity procedures began to be unified with the 1848 Field Code in New York. Mildred Coe & Lewis Morse, *Chronology of the Development of the David Dudley Field Code*, 27 CORNELL L.Q. 238 (1942); Stephen N. Subrin, *David Dudley Field and the Field Code: An Historical Analysis of an Earlier Procedural Vision*, 6 LAW & HIST. REV. 311 (1988); see also CHARLES E. CLARK, *HANDBOOK OF THE LAW OF CODE PLEADING* 19-20 (1928) (noting the Field Code’s influence on the procedural reform in other states and territories). In the federal court system, the unification occurred in 1938 when the Federal Rules of Civil Procedure went into effect. See Stephen N. Subrin, *How Equity Conquered the Common Law: The Federal Rules of Civil Procedure in Historical Perspective*, 135 U. PA. L. REV. 909, 929-39 (1987) (discussing the historical use and development of equity in the federal court system); see also NEWMAN, *supra* note 110, at 51 (explaining that the federal reform resulted in “essentially the same reforms” as the states); cf. Lord Chancellor & Mr. Justice Lurton, *The Operation of the Reformed Equity Procedure in England*, 26 HARV. L. REV. 99, 100-01 (1912) (discussing the simultaneous reform effort underway in England culminating in the abolishment of the Court of Chancery and the enactment of the English Judicature Acts of 1873 and 1875); Gunther A. Weiss, *The Enchantment of Codification in the Common-Law World*, 25 YALE J. INT’L L. 435, 486-88 (2000) (discussing an 1828 speech by Lord Brougham as the catalyst for procedural change). A handful of states, including Delaware, have retained separate court systems and/or procedures. See Anenson, *Post-Merger Justification of Unclean Hands*, *supra* note 29, at 457 n.5 (listing states that have maintained separate systems).

133. While the legal status of unclean hands remains an open question in most jurisdictions, there are hundreds of cases now applying the defense against legal remedies.

The issue of the fusion of law and equity has stimulated a world-wide discussion.¹³⁴ In the United States, a series of articles has attempted to clarify the conflict and confusion in the cases and justify the incorporation of unclean hands into the law on doctrinal and normative grounds.¹³⁵ This research explained that the law-equity merger in federal and state civil procedure allows courts to adopt the defense in lawsuits seeking legal remedies on a case-by-case basis.¹³⁶ The research further directs courts to be sensitive to whether the application of the defense is consistent with its purposes and does not otherwise defeat the purposes of the asserted claim.¹³⁷ Therefore, the evolution of equity in general, and unclean hands

Anenson, *Limiting Legal Remedies*, *supra* note 29 (detailing cases demonstrating the application of the defense against legal remedies). The Supreme Court of Michigan and lower courts in California, Maryland, New York, Connecticut, and Rhode Island have begun the process of adopting the equitable defense of unclean hands. *Id.* Federal courts from the Fourth, Fifth, Sixth, Seventh, Ninth, and Eleventh Circuits have also recognized the doctrine's availability under federal law in actions seeking legal relief. *Id.*; *see also* Anenson, *Post-Merger Justification of Unclean Hands*, *supra* note 29 (summarizing such cases). *But see* Anenson, *Process-based Theory of Unclean Hands*, *supra* note 29, at 7 n.21 (noting five state supreme courts and lower courts that have rejected the defense of unclean hands in damages actions).

134. *See* BEVERLEY MCLACHLIN, INTRODUCTION TO EQUITY IN COMMERCIAL LAW, *supra* note 93, at vii (Chief Justice, Canadian Supreme Court) (“[D]espite the passage of time, the fusion of law and equity remains a live issue today, subject to debate by academics, practitioners, and judges alike.”); Tion Min Yeo, *Choice of Law for Equity*, in EQUITY IN COMMERCIAL LAW, *supra* note 93, at 147, 150 (“The extent of the fusion of the substantive rules of common law and equity remains a matter of great controversy today, and different legal systems in the common law tradition have adopted different approaches to this question.”); *see also* MCLACHLIN, *supra* (calling the law-equity debate the “fusion wars”).

135. *See, e.g.*, Anenson, *Post-Merger Justification of Unclean Hands*, *supra* note 29, at 477-508 (arguing that the division of law and equity for the defense of unclean hands answers the wrong question, lacks a rational basis, produces anomalous results, and invites other irregularities in the administration of justice); *accord* Douglas Laycock, THE DEATH OF THE IRREPARABLE INJURY RULE (1991) (making this point persuasively in other aspects of equity jurisprudence, like remedies); Douglas Laycock, *The Death of the Irreparable Injury Rule*, 103 HARV. L. REV. 687 (1990) (same); *see also* sources cited *supra* note 29; *cf.* Walter Wheeler Cook, *Equitable Defenses*, 32 YALE L.J. 645, 657 (1923) (reviewing case confusion concerning the pleading of equitable defenses after merger, and concluding that clear legal analysis is “absolutely essential if we are ever to blend common law and equity law into a single, harmonious, and self-consistent system”).

136. *See* Anenson, *Post-Merger Justification of Unclean Hands*, *supra* note 29, at 474-76; *accord* Anthony Mason, *Fusion*, in EQUITY IN COMMERCIAL LAW, *supra* note 93, at 12 (discussing merger in England and Australia, and noting: “it is also clear that the [Judicature] Acts did not require the courts to treat the rules of common law and equity as if they must forever remain unchanged in frozen isolation”); Mason, *Fusion: Fallacy, Future or Finished?*, in EQUITY IN COMMERCIAL LAW, *supra* note 93, at 56 (“[I]t [is] equally clear that the *Judicature Act* did not forbid the continuing development of law and equity, including development in the direction of integration of principles, if the single Court otherwise considered this an appropriate application of earlier precedents.”).

137. *See, e.g.*, Anenson, *Limiting Legal Remedies*, *supra* note 29 (“Rather than continuing to deny the defense in legal actions in reliance on its historical pedigree, the

in particular, provide a foundation for an equitable resolution to the issue of excessive executive compensation.

V. PUBLIC POLICY

Policy-based analysis supports the consideration of unclean hands where a CEO's excessive compensation is at issue. Specifically, fairness to the parties and to the public outweigh freedom of contract concerns. The emphasis on ethics and fair play in business relations, furthermore, is equivalent to the definition of the defense.¹³⁸ Modern ethics scholarship imposes moral duties on both directors and the CEO and supports the consideration of a CEO's “clean hands.” Lastly, the use of the clean hands defense is unlikely to raise pay and, even so, will cure compensation that is excessively inflated in individual cases.

A. *Just Price and the Public Interest*

As an initial matter, concerns for freedom of contract have always been subject to equitable correction.¹³⁹ In medieval times, “just price”

trend of absorbing the equitable defense of unclean hands into the law is likely to continue on the basis of policy.”). Zechariah Chafee, Jr., a practitioner and professor at Harvard Law School, was the first scholar to thoroughly analyze unclean hands in the United States. The Thomas M. Cooley Lectures that he delivered at the University of Michigan Law School in 1949 and his subsequent publications in the *Michigan Law Review* continue to be the primary source of the American experience with the equitable defense. Chafee I, *supra* note 34; Chafee II, *supra* note 34; Anenson, *Post-Merger Justification of Unclean Hands*, *supra* note 29. Chafee examined a total of eighteen different groups of cases considering unclean hands and concluded that each case should be decided within the orbit of the transaction and the surrounding facts. *See* Chafee I, *supra* note 34, at 887 (“[D]ecisions have been shaped by the special requirements and the subjects and not merely ethics.”); *id.* at 892 (advising of the great advantage of inducing a more critical exam of the various policies, ethical or otherwise, which ought to govern the case).

138. *See* *Keystone Driller Co. v. Gen. Excavator Co.*, 290 U.S. 240, 244-45 (1933) (“[T]hat whenever a party who, as actor, seeks to set the judicial machinery in motion and obtain some remedy, has violated conscience, or good faith, or other equitable principle, in his prior conduct, then the doors of the court will be shut against him *in limine*; the court will refuse to interfere on his behalf, to acknowledge his right, or to award him any remedy.”); CHAFEE, *supra* note 34, at 1 (declaring that the maxim of unclean hands “derives from the unwillingness of a court of equity, as a court of conscience, to lend the aid of its extraordinary powers to a plaintiff who himself is guilty of reprehensible conduct in the controversy and thereby to endorse such behavior”); *see, e.g., supra* notes 33-36 and accompanying text.

139. Judge Cardozo's now classic opinion in *Jacob & Youngs, Inc. v. Kent*, 129 N.E. 889, 891 (N.Y. 1921) stated that “equity and fairness” outweighed “consistency and certainty.” WILSON HUHNS, *THE FIVE TYPES OF LEGAL ARGUMENT* 166 (2002) (reviewing the case); *see also* Larry A. DiMatteo, *The Norms of Contract: The Fairness Inquiry and the “Law of Satisfaction”—A Nonunified Theory*, 24 HOFSTRA L. REV. 349, 443 (1995) (citing the case as an example of the ongoing tug of war in contract law between the norms of

theory moderated the certainty of contract relationships concerning principles of fairness and morality.¹⁴⁰ The modern moral equivalent is the doctrine of unconscionability where excessive price is one determinant of the defense.¹⁴¹ With employment agreements in particular, equitable considerations have given rise to a social contract theory where courts look to norms outside the four corners of the agreement.¹⁴²

certainty and predictability and the norms of fairness and justice).

140. DiMATTEO, *supra* note 123, at 3-28 (depicting how Thomas Aquinas resurrected the Aristotelian theory of justice as a philosophical foundation for the medieval doctrine of just price). A sale in excess of the just price was considered immoral and subject to judicial scrutiny. *Id.* at 3. It was a multifaceted concept that acted as “a legal device, a moral imperative, and an economic doctrine.” John W. Baldwin, *The Medieval Theories of Just Price: Romanists, Canonists, and Theologians in the Twelfth and Thirteenth Centuries*, in 49 TRANSACTIONS AM. PHIL. SOC’Y 8 (1959); *see also* DiMATTEO, *supra* note 123, at 11 (placing just price theory within the broader context of the ecclesiastical origins of equity whose purpose was to protect those with a lower economic status and to enforce relations of trust and confidence) (citations omitted).

141. *See* DiMATTEO, *supra* note 123, at 13 (“Much of the Aristotelian logic embedded in the notion of corrective justice that supported just price theory also underpins modern day contract doctrine.”); *id.* at 5 (“[R]emnants of just price theory still reverberate in the substantive fairness doctrines of the twentieth century.”). For cases discussing the origins of unconscionability, *see supra* note 116 and accompanying text. Another contemporary contract defense that looks to the equality of the bargain is economic duress. *See* DiMATTEO, *supra* note 123, at 13. Grave failures in the equivalence of value in the exchange between the parties may also vitiate the basic assumption of the contract. *See* ALCOA v. Essex Group, Inc., 499 F. Supp. 53, 91 (W.D. Pa. 1980) (applying concepts of equivalence and basic assumption to the doctrines of impracticability, frustration of purpose, and mistake); *see also* W.F. Young, *Half Measures*, 81 COLUM. L. REV. 19, 31 (1981) (analyzing half measure remedies for mistakes to determine how courts cure false basic assumptions about the contract); *cf.* Larry A. DiMatteo & Bruce Rich, *A Consent Theory of Unconscionability: An Empirical Study of Law in Action*, 33 FL. ST. U. L. REV. 1067 (2006) (arguing that despite the unconscionability doctrine’s grounding in substantive unfairness, consent-based factors are more predictive of a court’s decision to use the doctrine).

142. *See* T. Leigh Anenson & Karen Eilers Lahey, *The Crisis in Corporate America: Private Pension Liability and Proposals for Reform*, 9 U. PA. J. LAB. & EMP. L. 495 (2007) (describing the companion concepts of relational contract and psychological contract theory). Relational contract doctrine arose as a tool for understanding commercial contracts. *See, e.g.*, David Campbell, *Ian Macneil and the Relational Theory of Contract*, in IAN MACNEIL, *THE RELATIONAL THEORY OF CONTRACT: SELECTED WORKS OF IAN MACNEIL* 3 (David Campbell ed., 2001) (describing historical development of relational contract theory). Psychological contract theory began in the management literature as a method for managing business relations. *See* Katherine V.W. Stone, *The New Psychological Contract: Implications of the Changing Workplace for Labor and Employment Law*, 48 UCLA L. REV. 519, 549-53 (2001) (noting the expansion in application for psychological contract theory from management employees to lower level employees, in addition to other areas of employment law). Scholars have been pushing for recognition of these broader norms in all areas of employment law. *See* Robert C. Bird, *Employment as a Relational Contract*, 8 U. PA. J. LAB. & EMP. L. 149, 166 (2005) (explaining the history and development of psychological contract theory and its growing popularity among employment law scholars); *cf.* THOMAS DONALDSON & THOMAS W. DUNFEE, *TIES THAT BIND: A SOCIAL CONTRACTS APPROACH TO BUSINESS ETHICS* (Boston: Harvard Business School Press, 1999) (allowing

Recall too that contract law conceived the doctrine of unclean hands.¹⁴³ Importantly, courts (including the U.S. Supreme Court) have justified its application in business cases that are of great public interest.¹⁴⁴ In the context of executive compensation, the use of unclean hands furthers the broad public interest of reposing confidence in the pay process as well as the judgment of the board.¹⁴⁵ It also prevents the corresponding consequences of such pay abuses to the company and its many stakeholders.¹⁴⁶ Hence, it is private law that supports public policy.

B. *Ethics and Excessive Compensation*

In addition, the foundation of the “clean hands” doctrine is ethical behavior.¹⁴⁷ Since the astronomical rise in CEO paychecks and its

values, practices, policies to emerge locally, creating thick micro-social norms that have community support as emanations of deliberative democracy on a local scale).

143. See discussion *supra* note 131 and accompanying text.

144. See *Morton Salt Co. v. G.S. Suppiger Co.*, 314 U.S. 488, 492 (1942) (a court of equity “may appropriately withhold their aid where the plaintiff is using the right asserted contrary to the public interest”); *Precision Instrument Mfg. Co. v. Automotive Maint. Mach. Co.*, 324 U.S. 806, 815 (1945) (invoking unclean hands in part due to the public interest); *accord* *Cayuga Indian Nation of New York v. Pataki*, 413 F.3d 266, 273 (2d. Cir. 2005) (extending equitable defense of *laches* to legal cases based on protection of third parties); *cf.* Roscoe Pound, *The End of Law as Developed in Legal Rules and Doctrine*, 27 HARV. L. REV. 195, 226–27 (1914) (placing law in its historical context and comparing equity stage that prevented the individualistic, unconscientious exercise of rights to early twentieth-century socialization of law stage that prevented anti-social exercise of rights).

145. See Vagts, *supra* note 103, at 276 (“If the courts act, even occasionally, to trim compensation it will, in turn, be easier for compensation committees to tell executives that they simply cannot gratify their pocket-books and egos as much as the executives demand.”); *cf.* *SEC v. Cavanagh*, 445 F.3d 105, 117 (2d Cir. 2006) (explaining that the primary purpose of the disgorgement remedy against executives under the federal securities laws is to “prevent wrongdoers from unjustly enriching themselves through violations, which has the effect of deterring subsequent fraud The emphasis on public protection, as opposed to simple compensatory relief, illustrates the equitable nature of the remedy”); Schwartz, *supra* note 55, at 22-25 (discussing the “responsible corporate officer” doctrine that imposes strict civil and criminal liability on CEOs whose companies violated statutes dealing with public health, safety, and welfare, in situations where members of the public cannot easily protect themselves).

146. See Martin, *supra* note 67, at 538 (noting that mere warnings from judges will not “encourage directors to undertake serious, arms-length negotiations with CEOs and to reject excessive packages”); see also *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir.) (internal quotation marks omitted), *cert. denied*, 404 U.S. 1105 (1971) (“[A] corporate enterprise may well suffer harm when officers and directors abuse their position to obtain personal profits since the effect may be to cast a cloud on the corporation’s name, injure stockholder relations and undermine public regard for the corporation’s securities.”); see also discussions in *supra* notes 5, 15.

147. See Chafee I, *supra* note 34, at 886 (reviewing cases where the defense was raised in suits for specific performance of contracts where the applicant has engaged in fraud, sharp practice, or other unethical conduct); see also *supra* notes 32-33 and accompanying

repercussions,¹⁴⁸ scholars in applied philosophy and business have been weighing in on the relationship between ethics and excessive compensation.¹⁴⁹ All agree that executives and board members have ethical duties to the company with respect to hiring and compensation.

A leading strain of criticism for excessive compensation is the frequent disutility of CEO overcompensation, both to the corporation's long-term prospects and the short-term effects on shareholders.¹⁵⁰ Various scholars of philosophy and management have emphasized that excessive compensation packages detract from other functions of the corporation (such as research and development),¹⁵¹ from the morale of mid-level managers,¹⁵² and, most significantly, from shareholder earnings.¹⁵³ Moreover, regardless of utility, critics of extraordinarily large compensation for CEOs believe that such compensation violates a basic sense of fairness or justice, or what ethicists call distributive justice.¹⁵⁴

Furthermore, virtue ethics supports an ethical duty of the CEO and the board not to negotiate, accept, and/or award unreasonable compensation. In writing about executive compensation, virtue ethicists remind readers that reducing human motives to strictly economic ones may very well miss the heart of why people are called to a particular life in business.¹⁵⁵

text.

148. See discussion *supra* note 15.

149. See, e.g., Francis T Hannafey, *Economic and Moral Criteria of Executive Compensation*, 108 BUS. & SOC'Y REV. 405, 406 (2003) (proposing moral and economic criteria in a preliminary effort to provide a framework for compensation decision-making); see also *supra* notes 21-23.

150. See, e.g., Moriarty, *supra* note 15; see also Nichols & Subramanian, *supra* note 113, at 339 (noting that the utility of very large compensation packages is highly debatable).

151. Paul Wilhelm, *Application of Distributive Justice Theory to the CEO Pay Problem: Recommendations for Reform*, 12 J. BUS. ETHICS 469, 477 (1993).

152. *Id.*

153. Lucian A. Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, OXFORD REV. ECON. POL'Y 283, 284 (Summer 2005); see also Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 325-28 (1976) (concluding that perquisite consumption like automobiles, use of corporate jets, and country club memberships is a diversion of company resources that results in reduction of firm value); cf. Eugene F. Fama, *Agency Problems and The Theory of the Firm*, 88 J. POL. ECON. 288, 296 (1980) (taking the position that CEO use of company perks are a cost to the company only if they are not offset by smaller paychecks).

154. Jared Harris, *What's Wrong with Executive Compensation?*, 85 J. BUS. ETHICS 147, 150 (2008).

155. See generally John Dobson, *Ethics in Finance II*, 53 FIN. ANALYSTS J. 15, 16 (Jan/Feb 1997):

Thus, the "virtuous agent" is involved in a continual quest to find balance in decision making. Such an agent does not apply any specific rules in making decisions but rather attempts to make decisions that are consistent with the pursuit of a particular kind of excellence that, in turn, entails exercising sound moral judgment guided by such virtues as courage, wisdom, temperance,

Business as a calling to “professionalism” calls forth far more humility and public responsibility than we have seen in the recent culture of extraordinary compensation.¹⁵⁶ All of these ethical perspectives are consistent with the viewpoint, most recently expressed by Rakesh Khurana at the Harvard Business School, that business leaders must be “professionals” and move beyond a view that economic self-interest will suffice for either self, corporation, or the social good.¹⁵⁷

In light of the foregoing, ethicists espouse moral obligations of the board to ensure that pay packages effectively align pay and performance and are the result of a transparent, non-exclusive process.¹⁵⁸ In terms of the process of hiring and compensation decisions, most commentators agree that lack of independence (in its extreme forms, cronyism) is a breach of the board’s fiduciary duties that can best be avoided with non-exclusivity

fairness, integrity, and consistency.

Id. at 16; *see also* MAX DEPREE, LEADERSHIP IS AN ART (1989). DePree has written one of the best short books on ethics and leadership. When Max DePree was CEO of Herman Miller, Inc., he wrote about leadership and ethics in this way:

Try to think about a leader, in the words of the gospel writer Luke, as “one who serves.” Leadership is a concept of owing certain things to the institution. It is a way of thinking about institutional heirs, a way of thinking about stewardship as contrasted with ownership. Robert Greenleaf has written an excellent book about this idea, *Servant Leadership*.

The art of leadership requires us to think about the leader-as-steward in terms of relationships: of assets and legacy, of momentum and effectiveness, of civility and values.

Dobson, *supra*, at 12.

156. The U.S. culture of compensation likely derives from the philosophical primacy of finance and economics over an older set of aims (pre-World War II) in business education: social responsibility and professionalism. Rakesh Khurana et al., *Is Business Management a Profession?*, HARVARD BUS. SCH. WORKING KNOWLEDGE, Feb. 21, 2005, <http://hbswk.hbs.edu/item/4650.html>. This could explain the premium that U.S. executives receive in comparison with the rest of the world. *See* Wilhelm, *supra* note 152, at 469 (stating extraordinarily large compensation packages are more common in the United States than in other industrialized democracies); *see also supra* notes 40-41 (showing U.S. CEO compensation well above other countries).

157. Khurana et al., *supra* note 156; *see also* RAKESH KHURANA, FROM HIGHER AIMS TO HIRED HANDS: THE SOCIAL TRANSFORMATION OF AMERICAN BUSINESS SCHOOLS AND THE UNFULFILLED PROMISE OF MANAGEMENT AS A PROFESSION (2007).

158. Harris, *supra* note 154, at 152. In business ethics parlance, these duties are essentially a utilitarian demand that is part and parcel of executing the Board’s moral and fiduciary duty of utmost care. While the ethics literature sometimes talks in terms of “fiduciary duties,” this legal precept is also infused with ethical dimensions such as due diligence, accountability, integrity, transparency, independence, and public responsibility. Diligence, transparency, and independence are particularly important concerns for many commentators with respect to a board’s responsibilities. *See* Perel, *supra* note 20, at 381; *see also* discussion *supra* Part III.

and transparency.¹⁵⁹ A number of studies attempt to recommend how boards can best align pay and performance for the good of the company.¹⁶⁰ Others focus on how board members will only accomplish alignment by being independent, using due diligence in crafting compensation packages, and being transparent in how they go about hiring and compensating top management.¹⁶¹ Still others stress not only transparency, but also accountability, integrity, and public responsibility.¹⁶²

Correspondingly, ethicists have recently focused on the executive being hired. The literature expressly imposes a moral duty regarding compensation. Professor Moriarty contends that the CEO has a fiduciary duty to accept the minimum effective compensation—the minimum amount necessary to attract, retain, and motivate the CEO to maximize firm value.¹⁶³ Likewise, Professor Bragues asserts that a virtuous executive, one with strong character values, would not accept the highest possible amount if it might conceivably harm others within the firm.¹⁶⁴ Professor Sayles also reminds us that even a generous but fair compensation package meant to align performance and pay can be manipulated by CEOs to achieve the desired personal benefits.¹⁶⁵ Thus, back-dating options, managing earnings through the accounting process, and presenting a false face to the public is extremely self-interested and hardly consistent with CEOs' fiduciary and ethical duties.¹⁶⁶

In short, not only directors but also CEOs have moral duties regarding appropriate compensation. These ethical obligations arise both at the hiring and initial compensation stage and thereafter. Where the executive has

159. Harris, *supra* note 154, at 152; Perel, *supra* note 20, at 381.

160. Walters et al., *supra* note 19, at 227. Exercising due diligence as part of their fiduciary duties also requires sensitivity to the corporate culture; hiring a poor fit, or a good fit at a rate of compensation that unnerves or disables *esprit de corps* within managerial ranks can be a failure of fiduciary duty as well. Wilhelm, *supra* note 151, at 477.

161. Ella Mae Matsumura & Jae Yong Shin, *Corporate Governance Reform and CEO Compensation: Intended and Unintended Consequences*, 62 J. BUS. ETHICS 101, 104 (Dec. 2005).

162. Avshalom M. Adam & Mark S. Schwartz, *Corporate Governance, Ethics, and the Backdating of Stock Options*, 85 J. BUS. ETHICS 225, 226 (2009).

163. Moriarty, *supra* note 15, at 235; *see also supra* note 163 (advising that what justice requires as an ethical matter with respect to executive compensation will require a complete theory of justice in wages).

164. George Bragues, *The Ancients Against the Moderns: Focusing on the Character of Corporate Leaders*, 78 J. BUS. ETHICS 373, 380 (2008).

165. Leonard R. Sayles, *The Tipping Point: How Good Executives Go Bad*, 11 CORP. FIN. REV. 18, 20-21 (2006).

166. *Id.*; *see also* Story & Dash, *supra* note 25 (“There are some real ethical questions [concerning paying bonuses] given the bailouts and the precariousness of so many of these financial institutions[.]” (quoting Jesse M. Brill, chairman of the California-based research firm, CompensationStandards.com)). For specific examples of CEO misconduct, *see infra* Part VI.B.

accepted a position within the company that awards extraordinary compensation or engages in questionable practices concerning her pay package in a way that risks the company's future for present personal gain, she has engaged in unethical conduct that could well amount to unclean hands.¹⁶⁷

C. *Sanctity of Contract and the Risk of Raising Pay*

While promise-keeping, particularly honoring contractual obligations, also has an ethical foundation,¹⁶⁸ a CEO's ethical duties to the company should outweigh the sanctity of contract in cases of excessive pay. This is especially true where the executive knowingly compromises the long-term viability of the firm or manages earnings to enhance personal profits rather than focusing on the financial health of the company.¹⁶⁹ Certainly,

167. See Ertimur et al., *supra* note 42 (noting that executive pay has become a key corporate governance theme due to the alleged role of high-powered incentives in the corporate scandals of 2000-2002); see also Randall A. Heron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?*, 83 J. FIN. ECON. 271, (2007) (discussing the option backdating scandal); David Yermack, *Golden Handshakes: Separation Pay for Retired and Dismissed CEOs*, 41 J. ACCT. ECON. 237, 240 (2006) (explaining large severance payments made to departing CEOs are a type payoff to rid the company of the bad leadership); David Yermack, *Flights of Fancy: Corporate Jets, CEO Perquisites, and Inferior Shareholder Returns*, 80 J. FIN. ECON. 211, 230 (2006) (stating that once corporate leaders get perquisites, corporate performance often falls).

168. See CHARLES FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION* (1982) (discussing the promise or moral-based nature of contracts); see also DiMATTEO, *supra* note 123, at 24 (noting the need to honor one's contract was deemed a solemn moral duty); *id.* at 5, 10 (providing examples of Christian and Jewish responses to the failure to keep contractual promises (citing STEPHEN M. PASSAMANECH, *THE TRADITIONAL JEWISH LAW OF SALE 205* (1983) (explaining the formal condemnation before the rabbinical court of someone who did not keep a contractual promise))); RICHARD H. HELMHOLZ, *CANON LAW AND THE LAW OF ENGLAND* 263, 287-88 (London: Hambledon Press, 1987) (discussing how the failure to fulfill a contractual promise made under oath posed the risk of excommunication).

169. Prime examples are the three bank executives who were called to testify before Congress in March 2008 about their rich pay at the time that their firms were losing billions in the housing and credit crisis they helped engineer. Elizabeth MacDonald, *Final Thoughts on the Fat Cat CEO Pay Hearing*, FOXBUSINESS, Mar. 9, 2008, <http://emac.blogs.foxbusiness.com/2008/03/07/highlights-from-the-fat-cat-hearing-today> (discussing testimony of Angelo Mozilo, head of Countrywide Financial, the nation's biggest mortgage lender, E. Stanley O'Neal, former CEO of Merrill Lynch, and Charles Prince, former CEO of Citigroup, who were collectively paid \$460 million over five years while their companies lost more than \$20 billion in last two quarters of 2007). O'Neal was allowed to retire and received \$161.5 million in exit pay when Merrill Lynch reported \$18 billion in write-downs related to risky mortgages and its stock price had fallen to nearly half its value. *Id.* Prince was allowed to resign and received roughly \$30 million, including a cash bonus of more than \$10 million, millions of dollars in unvested restricted stock and stock options, and perquisites worth \$1.5 million annually. *Id.* Prince even got a performance bonus in 2007 when Citigroup (like Merrill Lynch) took more than \$18 billion

allowing companies to escape contract liability raises the possibility that it may deter executives from serving at the helm.¹⁷⁰ But studies from the business academies and elsewhere suggest that companies may not want those kinds of leaders in the first place.¹⁷¹ Excessive pay packages continue to be justified as the “free market” finding of the competitive price of top managerial talent. However, many observers point out that the market is somewhat skewed by a number of factors.¹⁷² Directors are also often mistaken in their estimation of the efficacy of incentivizing CEOs and other top management.¹⁷³

Additionally, along with narrowing the pool of potential executives, there is the possibility that the availability of unclean hands could result in higher CEO pay. Financial economists might claim that by decreasing pay predictability, the CEO would seek a risk premium to compensate for it. Even assuming an executive could accomplish that aim, the idea of acoustic separation suggests that the application of unclean hands in an

in write-downs related to the subprime and credit crisis and its stock dropped by almost half. *Id.* For a discussion of Mozilo, see *infra* notes 231-35 and accompanying text.

170. Edward M. Liddy, the government-appointed chairman of AIG (now 80% government-owned), attempted to justify the multi-million dollar bonuses to company executives and managers in the unit that caused the financial collapse of the company and the broader U.S. economy as necessary to keep the most skilled executives, and argued they should not be subject to arbitrary adjustment by the U.S. Treasury. Andrews & Baker, *supra* note 24.

171. See, e.g., Lucian Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 785 (2002) (“It is important to emphasize that the cost to the shareholders resulting from the extraction of rents [by the CEO] might well be higher than the amount of the rents themselves. To the extent that rent extraction involves efficiency costs—due, in particular, to the adoption of inefficient compensation arrangements—the shareholders’ losses will be larger than the rents extracted by managers.”); see also Murphy, *Executive Compensation*, *supra* note 15, at 54 (noting the plethora of evidence on CEOs responding predictably to dysfunctional compensation arrangements). Scholars studying executive compensation agreements agree that optimal contracting concerns do not explain the level and structure of CEO pay, but differ on the reasons for it. Compare Bebchuk et al., *supra* (relying on features of stock option plans to argue that managerial power and captured boards design pay plans to transfer rents to CEOs in ways that mitigate public outrage) with Murphy, *Executive Compensation*, *supra* note 15 (relying on the same evidence for the alternative hypothesis that companies and their managers erroneously perceive the cost of granting options to be far below their economic cost).

172. See generally Wilhelm, *supra* note 151, at 469. For example, executive searches are often “exclusive” and do not include women and minorities, compensation consultants have a strong upward influence on the range of compensation, tax advantages are factored into the packages (thus making use of public resources rather than strictly free market mechanisms), and the process is not always open and competitive. *Id.* Board members, even though they do have fiduciary duties, are essentially using “other people’s money,” which invariably raises the “market” price. *Id.*

173. See Harris, *supra* note 154, at 147 (discussing the structuring of managerial incentives); see also Murphy, *Executive Compensation*, *supra* note 15 at 59 (discussing incentivizing in the context of the relationship between compensation and performance).

effort to reduce excessive compensation would not yield a contradictory outcome.

A condition of “acoustic separation”¹⁷⁴ assumes that a rule of conduct—like contracts are binding as embodied in the common law concept of *pancta sunt servanda*—and a standard of decision—like the equitable doctrine of “clean hands”—can operate in tandem and fulfill the policy functions of both precepts.¹⁷⁵ The dual system, however, is dependent on the public being at least partially unaware that the rigid rule is actually more lenient in application.¹⁷⁶ This hidden exception to rule-based decision-making provides selective transmission.¹⁷⁷ As a result, there is a partial separation between the rule of conduct and the rule of decision such that the law can successfully pursue both ends.¹⁷⁸

Scholars have studied the theory of acoustic separation in equity and agree that equitable defenses operate under partial acoustic separation.¹⁷⁹ Professor Emily Sherwin advanced the concept of acoustic separation in justifying equitable defenses in contract law.¹⁸⁰ She concluded that public

174. See generally Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 HARV. L. REV. 625 (1984) (using “acoustic separation” to describe a situation where the general public and the rule-making officials are separated into acoustically sealed chambers).

175. *Id.* at 630-34 (distinguishing conduct rules and decision rules of acoustic separation).

176. *Id.* (discussing the conflict between the normative message of acoustic separation and the actuality of its implementation). Partial acoustic separation can occur any time certain normative messages are more likely to be understood by officials than by the public. *Id.* at 633-34 (elaborating on normative messages).

177. *Id.* at 635 (explaining how the law attempts to segregate messages to the public from messages to officials).

178. Professor Sherwin explains the benefits of acoustic separation:

Acoustic separation suggests a way for the authority to escape this dilemma, by deceiving citizens about the force of the rule in official decisions. In other words, the authority might hold out to private parties a determinate rule, with implicit or explicit instructions that the rule will be enforced by courts. At the same time, it might provide courts with a less determinate standard that calls for direct application of the underlying norm to particular cases. If this standard can be obscured from public view, it will not affect the weight of the rule in the citizens' calculations. The authority can capture the value of rules at the level of public conduct, but leave judicial decisions open to a broader range of justifications.

Emily L. Sherwin, *Law and Equity in Contract Enforcement*, 50 MD. L. REV. 253, 306 (1991).

179. *Id.* at 306 (“Remedies are remote from lay understandings of law. Equitable remedies, and the various secondary limitations on damages that make specific performance important, are remoter still.”); Gail L. Heriot, *A Study in the Choice of Form: Statutes of Limitations and the Doctrine of Laches*, 1992 B.Y.U. L. REV. 917, 949 (“In general, the common law is considerably more familiar to both lay persons and their attorneys than is equity.”).

180. Sherwin, *supra* note 178, at 307 (“The legal model of enforcement is conduct-

ignorance of the equitable defense of fairness allowed courts to use it to achieve fairness and justice without sacrificing the pursuit of stability in contract law.¹⁸¹ Simply put, “[t]he legal model of enforcement tells the public that contracts will be enforced, while the equitable model gives relief from hardship in particular cases.”¹⁸²

If these assumptions are correct, the obscurity of the equitable doctrine of “clean hands” similarly permits fairness-based adjudication without sacrificing conduct values. In the context of CEO compensation, the implication of acoustic separation means that executives will have only limited cognizance of the defense and, consequently, will fail to negotiate in anticipation of it.¹⁸³ However, while the obscurity of equitable defenses may be accurate in other contexts, the existing economic upheaval has pushed CEO compensation to the forefront of public consciousness.¹⁸⁴ As such, court action in curtailing excessive executive compensation with the doctrine of “clean hands” would likely not go unnoticed. Yet the heightened public and political scrutiny (as well as forthcoming reforms) of bold executives who have used the name of business to “gild their crimes” would also make it more difficult for CEOs to negotiate higher compensation.¹⁸⁵ If they do succeed, and their employment agreement

oriented and rule-based. The equitable model is better suited to remedial goals and particularistic [sic] decisionmaking.”).

181. *Id.* at 308 (maintaining that the lack of public awareness of the equitable fairness defense is because the public does not know remedies and because lawyers will not research remedies after the breach or at the transaction stage). Professor Gail Heriot makes a similar argument with respect to the equitable defense of *laches*. Heriot, *supra* note 179, at 949-51; see also Anenson, *Post-Merger Justification of Unclean Hands*, *supra* note 29, at 463 (noting *laches* and unclean hands share a similar procedural posture).

182. Sherwin, *supra* note 178, at 308.

183. The extension of unclean hands to legal actions indicates that litigants and their attorneys will become aware of it. See Ralph A. Newman, *The Place and Function of Pure Equity in the Structure of Law*, 16 HASTINGS L.J. 401, 426-27 (1965) (discussing the effects of available defenses on remedies granted); Andrew J. Wistrich, *Procrastination, Deadlines, and Statutes of Limitation*, 50 WM. & MARY L. REV. 607, 656 (2008) (explaining that damages are the “most common and desired remedy”). Nevertheless, while executives may become aware of the defense, they still will not know when and if it will apply due to the uncertainty of its application under the circumstances. See Sherwin, *supra* note 178, at 302 n.222 (noting parallel in Bentham’s design (as interpreted by Postema) to Dan-Cohen’s model of acoustic separation in that the rules of law would not be determinative in adjudication, which would have no precedential value, and therefore would not alter the conduct rules (citing GERALD POSTEMA, BENTHAM AND THE COMMON LAW TRADITION 403-08 (1986))). This is probably why law and equity have been seen as the perfect rule-standard pair for centuries. *Infra* note 193. The board of directors, however, should be aware of the defense in order to encourage them to withhold payment under appropriate circumstances and risk a breach of contract action.

184. See *supra* notes 14, 17-18 and accompanying text.

185. RALPH WALDO EMERSON, ESSAYS (FIRST AND SECOND SERIES) 44 (1990) (Self-Reliance).

permits exorbitant pay under the circumstances, unclean hands would be available to ensure that they do not receive or keep the excessive amount.

In any event, the goal of the defense is not to decrease pay overall or even to best align pay with performance. Rather, the purpose of unclean hands is to provide justice in individual cases.¹⁸⁶ In the context of CEO pay, application of the defense means that business leaders who are morally and legally accountable to shareholders will not get away with excessively-lined pockets caused by their own ethical lapses and reckless choices.¹⁸⁷ To the extent that executives have dirtied their otherwise “clean hands,” courts will not allow them to profit from their actions and thereby preserve the integrity of the judicial system in the process.¹⁸⁸

VI. USING “CLEAN HANDS” IN CEO COMPENSATION CASES

Finally, notwithstanding recent scholarship to the contrary, the judicial system can and should discern overcompensation through the doctrine of “clean hands.”¹⁸⁹ As a practical matter, courts are competent to measure

186. Clawbacks and nonbinding shareholder “say on pay” votes operate in a similarly discreet fashion. *Supra* Part II.A. & B; *see also infra* Part VI.B. (outlining circumstances for a court to consider in applying unclean hands). The doctrine of “clean hands” protects the parties and the court. *E.g.*, *Gaudiosi v. Mellon*, 269 F.2d 873, 881 (3d Cir. 1959); *Maldonado v. Ford Motor Co.*, 719 N.W.2d 809, 818 (Mich. 2006); *Kendall-Jackson Winery Ltd. v. Superior Court*, 90 Cal. Rptr.2d 743, 749 (Cal. Ct. App. 1999).

187. *See, e.g.*, *Precision Instrument Mfg. Co. v. Auto. Maintenance Mach. Co.*, 324 U.S. 806, 815 (1945) (explaining that the doctrine prevents “a wrongdoer from enjoying the fruits of his [or her] transgression”); *Keystone Driller Co. v. Gen. Excavator Co.*, 290 U.S. 240, 245 (1933) (emphasizing that a complainant can only have standing if he comes into court with clean hands); *Fairway Developers, Inc. v. Marcum*, 832 N.E.2d 581, 585 (Ind. Ct. App. 2005) (“The purpose of the unclean hands doctrine is to prevent a party from reaping benefits from his misconduct.”); *Kendall-Jackson Winery Ltd. v. Superior Court*, 90 Cal.Rptr.2d 743, 749 (Cal. Ct. App. 1999) (opining that unclean hands doctrine makes the wrongdoer litigant “answer for his [or her] own misconduct in the action”).

188. *See, e.g.*, *Chafee II*, *supra* note 34, at 1091 (concluding that unclean hands is not peculiar to equity given that it considers the plaintiff’s fault but is “a general principle running through damage actions as well as suits for specific relief”). The Supreme Court explained the rationale of unclean hands: “Th[e] doctrine is rooted in the historical concept of court of equity as a vehicle for affirmatively enforcing the requirements of conscience and good faith. This presupposes a refusal on its part to be the abettor of iniquity.” *Precision Instrument Mfg. Co. v. Auto. Maint. Mach. Co.*, 324 U.S. 806, 814 (1945) (internal quotation and citation omitted).

189. *See Markham*, *supra* note 60 (reviewing fiduciary duty law and questioning the competence of courts to establish a metric of excessive executive compensation). While we agree with Professor Markham that existing laws have not yet solved the problem of executive compensation, we disagree with his underlying thesis (as we understand it) that because law has not yet cured the excessive executive pay problem, we should quit trying to use it. *Id.* (arguing that it should be left to the market to control executive pay excesses). The power and prestige of the ancient chancellors did not derive from the fact that they were able to definitively resolve the perennial problems of life through law, but rather because

excessive pay that amounts to unclean hands in order to check CEO compensation. They have used a similar metric of unreasonableness of pay in other corporate contexts. Assessing when “excessive” equals “unclean” can also be made by reference to quantitative and qualitative determinants used in the growing accounting, finance, economics, and management literature on the subject. Ethical considerations and prevailing public morality should also play a role.¹⁹⁰

A. *Institutional Competence*

With any discretionary decision, there is a risk of arbitrariness and error in the adjudication process.¹⁹¹ The possibility of uncertain and inconsistent outcomes is not unique to equity or unclean hands,¹⁹² but

they understood and became a part of the mystery. See Philip Bobbitt, *Constitutional Fate*, 58 TEXAS L. REV. 695, 775 n.323 (1980) (discussing the challenges of legal interpretation and the goal of achieving justice: “Like the grub that builds its chamber for the winged thing it has never seen but is to be” (quoting a speech by Oliver Wendell Holmes *reprinted in LAW AND THE COURT, THE OCCASIONAL SPEECHES OF JUSTICE OLIVER WENDELL HOLMES* 168, 174 (M. Howe ed. 1962))). The inexhaustible circumstances of life are a constant stimulus for creativity and reform. Equity is particularly well-suited to be an engine of change. Anenson, *supra* note 111; accord DiMATTEO, *supra* note 123, at 7.

190. See discussion *supra* Part V.B.

191. See, e.g., Steve Hedley, *Rival Taxonomies Within Obligations: Is There a Problem?*, in EQUITY IN COMMERCIAL LAW, *supra* note 93, at 77, 87 (advocating the continued use of equity but noting that there will be legitimate concerns over the degree of flexibility that should be allowed (citing articles on debate about “discretionary remedialism”)); Smith, *supra* note 93, at 38 (noting that uncertainty and inconsistency are two different vices of discretion); Honorable Henry J. Friendly, *Indiscretion About Discretion*, 31 EMORY L.J. 747, 758 (1982) (discussing the importance of “broad judicial review” in preserving various principles of jurisprudence); Doug Rendleman, *The Trial Judge’s Equitable Discretion Following Ebay v. MercExchange*, 27 REV. LITIG. 63, 64 (2007) (citing articles devoted to discretion in substance, procedure, and jurisprudence); see also NEWMAN, *supra* note 110, at 19-20 (citing “equality” as one of the necessary virtues of justice (quoting FREDERICK POLLOCK, JURISPRUDENCE 37 (5th ed. 1923))); Main, *supra* note 113, at 444 (“[T]here is no more fundamental social interest than that law should be uniform and impartial.”).

192. Chafee II, *supra* note 34, at 1079 (listing examples of unclean hands decisions where the judicial preoccupation with morality led to an increase in immorality); see also Harold Greville Hanbury, *The Field of Modern Equity*, in ESSAYS IN EQUITY 32 (1934) (describing the “golden age” of equity as beginning during the time of Lord Nottingham who began the transformation of equity “from a heterogeneous medley of isolated, empirical beliefs into a stable and increasingly rigid system of rules” until the first years of the nineteenth century); JOHN SELDON, TABLE TALK 49 (Books for Libraries Press, 1927) (1855) (quoting Seldon’s famous words that equity varied with the length of the chancellor’s foot); Patrick S. Atiyah, *From Principles to Pragmatism: Changes in the Function of the Judicial Process and the Law*, 65 IOWA L. REV. 1249, 1251-59 (1980) (describing how English equity and the common law lost flexibility in the nineteenth century followed by a resurgence of discretion after the merger of law and equity in the twentieth century). Readers may also remember that it was Charles Dickens, in BLEAK HOUSE, who portrayed

pervades all aspects of laws that are measured by standards rather than rules.¹⁹³ Nonetheless, a benefit of discretion is the courts' ability to capture the wide range of misbehaviors associated with the defense.¹⁹⁴ What is “unclean,” like what is fraud, necessitates some ambiguity to promote deterrence.¹⁹⁵

It is not hope alone, but the wisdom of the ages that supports equitable intervention into executive employment contracts.¹⁹⁶ Too often, in our industrial and now information age, we attempt to create theories that objectify law in order to solve moral and political problems in the way that businesses use technology to solve physical problems.¹⁹⁷ Supreme Court jurisprudence shows that legal interpretation has not been immune from this cultural influence. But law (especially equity), like ethics, is a form of

the arrogance and delay of the English chancery courts through the metaphor of the fog that never lifts. See CHARLES DICKENS, *BLEAK HOUSE* 14 (Nicola Bradbury ed., Penguin Classics 2003) (1853) (“Never can there come fog too thick . . . which this High Court of Chancery, most pestilent of hoary sinners, holds, this day . . .”).

193. The rules-standards debate has been a popular academic discussion. The key question is how much uncertainty is tolerable in the area of law that the defense is applied. See *MindGames, Inc. v. W. Publ'g Co.*, 218 F.3d 652, 656-57 (7th Cir. 2000) (“No sensible person supposes that rules are always superior to standards, or vice versa . . .”).

194. See *Precision Instrument Mfg. Co. v. Automotive Maint. Mach. Co.*, 324 U.S. 806, 815 (1945) (“[Unclean hands] necessarily gives wide range to the equity court's use of discretion in refusing to aid the unclean litigant.”); MEGARRY & BAKER, *supra* note 111, at 105-06 (discussing how details of a trust in a property law case may not necessarily be produced in writing but rather through extrinsic evidence); NEWMAN, *supra* note 110, at 28 (“Relief in the court of the Chancellor was granted according to criteria which were not confined by rules of strict logic or by analogy to prior decisions.”); see also Smith, *supra* note 93, at 38 (discussing the relationship between equity and law and noting that discretion is not necessarily an injustice); Kent Greenawalt, *Discretion and Judicial Decision: The Elusive Quest for the Fetters that Bind Judges*, 75 COLUM. L. REV. 359, 380 (1975) (discussing the obvious inappropriateness of denying discretion when a decision-maker must choose among an almost infinite number of alternatives on bases that are complex and yield uncertain conclusions); Maurice Rosenberg, *Judicial Discretion of the Trial Judge, Viewed from Above*, 22 SYRACUSE L. REV. 635, 662 (1971) (“Many questions that arise in litigation are not amenable to regulation by rule because they involve multifarious, fleeting, special, narrow facts that utterly resist generalization . . .”). For the historical origin and evolution of equitable discretion generally, see Anenson, *supra* note 111, at 384-87.

195. See discussion *supra* note 79 and accompanying text.

196. The “power of discretion” has been considered the “great contribution of equity” to the administration of justice. HENRY L. MCCLINTOCK, *HANDBOOK OF THE PRINCIPLES OF EQUITY* 2 (West Pub. Co. 1948) (1936).

197. PHILIP BOBBITT, *CONSTITUTIONAL INTERPRETATION* 185 (1991) (emphasizing the necessity of moral decision in adjudication); cf. Arnie Cooper, *Computing the Cost*, 399 THE SUN 4, 11 (Mar. 2009) (noting a conversation with Nicholas Carr, which discusses technology and the fear that “a definition of intelligence that discredits the individual mind in favor of some automated collective mind will feed powerful systems: governments, corporations, and other large institutions. And it will emphasize efficiency of thought over depth of thought”).

practical wisdom.¹⁹⁸ It is perception, not simply precepts. It is not only about learning rules, but also about mastering bodies of practice.¹⁹⁹ It is Cardozo's intuition and Llewellyn's "situation sense."²⁰⁰ In fact, it is the very humanness of adjudication that gives our legal system the chance of justice.²⁰¹

Besides, legal theorists tell us that the experiential process of precedent moves legal precepts from the abstract to the particular and *placed*.²⁰² Doctrinal analysis over time produces clearly discernable decisional patterns.²⁰³ Prior articles have traced the pattern of equitable

198. *E.g.*, JOHN FINNIS, *NATURAL LAW AND NATURAL RIGHTS* (1980) (discussing natural law theory and practical wisdom); *cf.* V.N. Awasthi, *Managerial Decision-Making on Moral Issues and the Effects of Teaching Ethics*, 78 J. BUS. ETHICS 207 (2008) (finding ethics courses influence management judgment).

199. *E.g.*, HUHNS, *supra* note 139, at 13; Anenson, *supra* note 125, at 638.

200. BENJAMIN N. CARDOZO, *THE NATURE OF THE JUDICIAL PROCESS* 19, 25 (1922) (mentioning that decisions must be felt or that judges must feel their way); KARL N. LLEWELLYN, *THE COMMON LAW TRADITION* (1960) (describing the common law process of creating law through the groupings of transaction-types or situation-sense).

201. BOBBITT, *CONSTITUTIONAL INTERPRETATION*, *supra* note 197, at 147, 168-69 (explaining that justice is created out of the process of deciding because there is no meta-rule or hierarchy among the incommensurable modalities of legal interpretation); *id.* at 177 ("The space for moral reflection on our ideologies is created by the conflict among modalities, just as garden walls create space for a garden."). Resort to the heritage of equity also has a normative quality all its own. Reliance on ancient equitable tradition demonstrates that institutions are as faithful as they are fair. Smith, *supra* note 93, at 19, 30; *see also* Bobbitt, *Constitutional Fate*, *supra* note 189, at 765 (commenting that use of historical argument acknowledges the limits of our wisdom and the modesty of our perspective).

202. Professor Wilson Huhn's insight was that standards evolve into rules through the use of formalistic analogies that identify the factual similarities in the cases that apply the standard. Wilson R. Huhn, *The Stages Of Legal Reasoning: Formalism, Analogy and Realism*, 48 VILL. L. REV. 305, 378-79 (2003). Rules evolve into standards through the use of realistic analogies that identify the interests justifying exceptions to the rule. *Id.* at 307 (proposing that precedent bridges the transition between formalism and realism and vice versa); *see also* Anenson, *supra* note 125, at 643-51 (illustrating the phenomena in cases considering the equitable defense of estoppel). *See generally* NEIL DUXBURY, *THE NATURE AND AUTHORITY OF PRECEDENT* (2008) (providing a historical and philosophical analysis of how precedent operates in the common-law system).

203. *See* Huhn, *The Stages Of Legal Reasoning*, *supra* note 202, at 308-10 (labeling three discrete forms of legalisms as formalism, analogy and realism); *cf.* Amy Coney Barrett, *Stare Decisis and Due Process*, U. COLO. L. REV. 1011, 1072 (Summer 2003) ("Allowing an issue to be hashed out multiple times compensates for the imperfections—the very humanness—in the process of decisionmaking. It allows the courts to see a more complete picture before rushing to judgment."). *See generally* Emily Sherwin, *A Defense of Analogical Reasoning in Law*, 66 U. CHI. L. REV. 1179 (1999) (explaining the benefits of judge-made law as providing numerous data for decision-making, representing the collaborative efforts of judges over time, correcting the biases that might lead judges to discount the force of precedent, and exerting a conservative force in the law to change at a gradual pace).

integration of unclean hands in legal cases.²⁰⁴

Courts have also evaluated the reasonableness of corporate decisions concerning executive compensation in tax cases to determine the deductibility of pay in close corporations.²⁰⁵ Excessiveness is also subject to a merit-based review of reasonableness in situations of corporate takeovers.²⁰⁶ Likewise, legal scholars have suggested similar standards of “reasonableness” in testing excessive executive pay packages in the fiduciary duty context.²⁰⁷ Additionally, checking compensation levels for reasonableness at different times during the contractual relationship is not anathema to contract law. Liquidated damages, for instance, require that stipulated damages be reasonable at the time of contracting and at the time of breach.²⁰⁸ Executive compensation can be similarly seen from two perspectives of reasonableness: anticipated reasonableness—time of entering the contract—and actual reasonableness—time of the payment of bonuses or stock options or at severance. Thus, courts could consider a CEO’s conduct ex-ante to contract formation as well as ex-post, such as when the executive has engaged in reckless risk-taking. The sheer size of the pay package alone may also be grounds for the dismissal.

204. See generally Anenson, *Post-Merger Justification of Unclean Hands*, *supra* note 29. Cf. Anenson, *supra* note 125 (discussing equitable estoppel).

205. See Martin, *supra* note 67, at 538 (citing cases). In *Elliotts, Inc. v. C.I.R.*, the Ninth Circuit Court of Appeals articulated a five-factor inquiry for the reasonableness of compensation: (1) the employee’s role in the company; (2) a comparison of the employee’s salary with those paid by similar companies for similar services; (3) the character and condition of the company; (4) potential conflicts of interest; and (5) evidence of an internal inconsistency in a company’s treatment of payments to employees. 716 F.2d 1241, 1245-47 (9th Cir. 1983). The court additionally advised that when conducting the reasonableness inquiry, “it is helpful to consider the matter from the perspective of a hypothetical independent investor. A relevant inquiry is whether an inactive, independent investor would be willing to compensate the employee as he was compensated.” *Id.* at 1245.

206. See Martin, *supra* note 67, at 538 (citing cases).

207. See, e.g., Barris, *supra* note 103, at 59 (arguing for testing of the reasonableness of compensation by comparing compensation levels with those of similar firms); Vagts, *supra* note 103, at 252-61 (same); Yablon, *supra* note 103, at 1897-99 (reviewing GRAEF CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES (1991) (arguing for an intermediate level of scrutiny in reviewing compensation packages)); see also Thomas & Martin, *supra* note 95, at 599-605 (discussing the arguments on both sides).

208. Larry A. DiMatteo & T. Leigh Anenson, *Teaching Law and Theory Through Context: Contract Clauses in Legal Studies Education*, 24 J. LEG. STUD. EDUC. 19, 41-42 (2007); see also Larry A. DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633 (2001) (critiquing the law of liquidated damages and suggesting that the separate rules for reviewing the liquidated damages clause be eliminated in favor of the doctrine of unconscionability).

B. *Measuring Excessive Pay*

Along with existing ethical principles and common law considerations of reasonableness, a workable framework for determining when excessive is unclean can be derived from business practice. There is much to be learned from business scholars who have been testing the causes and implications of excessive executive pay. By way of background, CEO contracts are typically for a period of five years and specify a base salary, annual bonus payments, stock options, and long-term incentive plans.²⁰⁹

A starting point of determining unclean conduct in seeking contracted for compensation that is excessive under the circumstances could be an economic one.²¹⁰ Excessive could be measured as pay relative to the market, industry, or firm performance.²¹¹ Since there is widespread use of the controversial practice of competitive benchmarking,²¹² the amount and

209. Murphy, *Executive Compensation*, *supra* note 15, at 3, 5. While base salary comprises a declining percentage of overall compensation, *see* Brian J. Hall & Jeffrey B. Leibman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653 (1998) (noting that stock options became the largest component of executive pay for all industries except utilities in the 1990s), it is still important given that most parts of the compensation package, such as target bonuses and option grants, are measured relative to the base salary level. Murphy, *Executive Compensation*, *supra* note 15, at 10 (noting that each dollar increase in base salary has positive impact on the other compensation components). Defined pension benefits and severance arrangements also depend on salary levels. *Id.*

210. *See, e.g.*, Ertimur et al., *supra* note 42, at 17 (providing economic measure of excessive); *id.* at 23 (explaining that the increase in compensation related shareholder proposals may be because investors have easier access to measures of excessive or abusive CEO pay in the post-Enron period through governance rating agencies (e.g., The Corporate Library)).

211. BEBCHUK & FRIED, *supra* note 85. For instance, contracts typically award CEOs large blocks of stock options to align their interests with company shareholders. Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31, 37-38 (2000). However, contract terms usually do not restrict executives from engaging in derivative transactions with their options based on factors other than firm performance. Stewart J. Schwab & Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 WASH. & LEE L. REV. 231, 264 (2006) (explaining that out of a data set of 271 executive contracts with stock option compensation, only five restricted their sale, only three restricted or prohibited hedging, and none restricted or prohibited pledging); *cf.* David M. Schizer, *Executives and Hedging: The Fragile Legal Foundations of Incentive Compatibility*, 100 COLUM. L. REV. 440, 460 (2000) (claiming that stock option restrictions and insider trading policies constrain executive hedging or pledging of stock options).

212. Scholars claim that benchmarking in the form of industry median compensation statistics raises pay independent of CEO or firm performance. *See, e.g.*, Paul Oyer, *Why Do Firms Use Incentives That Have No Incentive Effects?*, 59 J. FIN. 1619 (2004). An alternative view is that benchmarking represents an efficient way to determine the reservation wage of the CEO. *See* Bengt Holmstrom & Steven N. Kaplan, *The State of US Corporate Governance: What's Right and What's Wrong*, 15 J. APPLIED CORP. FIN. 8, 19 (2003) ("The main problem with executive pay levels is not the overall level, but the extreme skew in the awards To deal with this problem, we need more effective

kind of pay package relative to industry peer groups should be analyzed while scrutinizing how the proposed peer group was constituted.²¹³

The quantitative metric would be assessed along with other qualitative indicators.²¹⁴ Such factors may include the managerial skill requirements, job complexity, and span of control.²¹⁵ Additional criteria for earnings levels would include age, experience, education, and performance.²¹⁶ The need for retention in a tight labor market and any other indicia of CEO quality or job skills other than firm performance could also be considered.²¹⁷

In addition to a substantive review, the decision-making process of

benchmarking[,] not less of it.”).

213. Use of competitive benchmarking based on industry salary surveys is nearly universal in CEO contracts. See John M. Bizjak et al., *Does the Use of Peer Groups Contribute to Higher Pay and Less Efficient Compensation?*, 90 J. FIN. ECON. 152, 153 (2008) (finding 96 of 100 randomly selected firms from the Standard & Poor’s 500 Index in 1997 used competitive benchmarking); Murphy, *Executive Compensation*, *supra* note 15, at 9. The practice has generated considerable controversy. Some fear that setting pay by peer groups would institutionalize those components of pay that are not directly linked to performance measures. Bizjak et al., *supra*, at 213. CEOs themselves and directors have expressed concerns about its “ratchet” effect on salaries irrespective of performance and the predilections of the board to place its CEO in the top half of the peer group so the company looks strong. *Id.* (quoting Walter Wriston, former chairman and CEO of Citicorp, and member of the compensation committee at General Electric Co. in the *Wall Street Journal* in 1991 and Edgar Woolard Jr., former CEO of Dupont and director at IBM, Apple, and Citigroup in the *Harvard Business Review* in 2003); see also Brian Hall, *Six Challenges to Designing Equity-Based Pay*, 15 J. APPLIED CORP. FIN. 21 (2003) (noting rise in pay per salary surveys is consistent with the views of executives and salary consultants themselves).

214. See W. VON LEYDEN, *ARISTOTLE ON EQUALITY AND JUSTICE* 12 (New York: St. Martin’s Press, 1985) (explaining that Aristotle’s concept of just price was subjective, while Thomas Aquinas objectified the economic exchange); DiMatteo, *supra* note 123, at 17 (noting that “there was not one, but many conceptions of just price” in early contract law).

215. See Murphy, *Executive Compensation*, *supra* note 15, at 9 (discussing metrics used to determine CEO base salaries).

216. *Id.*; see also Kevin J. Murphy, *Incentives, Learning and Compensation: A Theoretical and Empirical Investigation of Managerial Labor Contracts*, 17 RAND J. ECON. 59 (1986) (arguing that boards learn about CEOs over time and reward those with great ability).

217. See Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We’ve Been, How We Got to Here, What Are the Problems, and How to Fix Them*, 34 (European Corporate Governance Institute, Working Paper No. 44, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=561305 (noting that “the managerial labor market has become relatively more important for top executives in the US”). For instance, labor market considerations play a significant role in firms’ decisions to re-price employee stock options. Mary Ellen Carter & Luann J. Lynch, *An Examination of Executive Stock Option Repricing*, 61 J. FIN. ECON. 207 (2001); N.K. Chidambaram & Nagpurnanand R. Prabhala, *Executive Stock Option Repricing, Internal Governance Mechanisms, and Management Turnover*, 69 J. FIN. ECON. 153 (2003); see also Bizjak et al., *supra* note 213, at 164 (concluding that benchmarking pay with peer groups to gauge the market wage is an efficient way to determine pay for retention purposes).

setting compensation levels should be evaluated in light of the so-called “crony capitalism” that can constitute corporate management.²¹⁸ Courts are certainly aware of the possibility of management capture as well as industry best practices like the use of compensation consultants relative to pay setting procedures.²¹⁹ Additional considerations in evaluating executive pay decisions may include board leadership style, ethical values, strategies, as well as conflict management.²²⁰ Corresponding motives of the CEO could also be considered.²²¹ In conjunction with fiduciary duty law,²²² unclean hands may at least be better than after-the-fact emergency legislation to “inspire a true sense of ethical obligation.”²²³

218. LAUFER, *supra* note 8, at 196-97. *See, e.g.*, Garvey & Milbourn, *supra* note 28 (finding that CEOs are paid more for good luck than they are punished for bad luck that is indicative of the CEO’s ability to act opportunistically in setting pay). For a discussion of the negotiation and contract terms for Countrywide CEO, Angelo Mozilo, see *infra* notes 231-35.

219. *See In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 55-58 (Del. 2006) (listing procedures such as use of compensation expert); *cf.* Martin, *supra* note 67, at 519 (noting compliance may obviate shareholder litigation but not prevent excessive compensation packages since best practices contemplate procedural safeguards, not substantive ones); accord Brian Cadman et al., *The Role and Effect of Compensation Consultants on CEO Pay* (2007) (Wharton School Working Paper, on file with authors) (suggesting that executive pay schemes reflect more efficient contracting when consultants are involved in the compensation process).

The use of compensation consultants in designing executive pay packages has risen over the past few years. *Id.* (citing Alexandra Higgins, *The Effect of Compensation Consultants: A Study of Market Share and Compensation Policy Advice*, THE CORPORATE LIBRARY (2007)) (concluding that stronger governance rules have caused boards to rely on the advice of independent consultants); Francesco Guerrera, *US companies warned about pay advisers*, FIN. TIMES, Nov. 2, 2006, at 13. Critics allege that consultants help disguise and justify excessive executive pay that helps executives extract wealth from the firm at the shareholders’ expense. Lucian Ayre Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 20 ACAD. MGMT. PERSPECTIVES 5 (2006); Graef S. Crystal, *Why CEO Compensation Is So High*, 34 CALIF. MGT. REV. 9 (Fall 1991); Gretchen Morgenson, *Gilded Paychecks: Troubling Conflicts*, N.Y. TIMES, Apr. 10, 2006.

220. *See* Jeffrey Sonnenfield, *Good Governance and the Misleading Myths of Bad Metrics*, 18 ACAD. MGMT. EXECUTIVE 108, 112 (2004) (“At least as important are the human dynamics of boards as social systems where leadership character, individual values, decision-making processes, conflict management, and strategic thinking will truly differentiate a firm’s governance.”).

221. Moriarty, *supra* note 15 (defining the ethical duty of the CEO regarding her compensation subjectively); *see also* DiMATTEO, *supra* note 123, at 14 (noting controversy in the calculation of just price: “Is it the market price, that being the price that the market will bear? Or is it the amount the particular purchaser is willing to pay?”). Evaluating motive and conduct under all the circumstances is also the mainstay of the interference tort. *See* T. Leigh Anenson, *Creating Conflicts of Interest: Litigation as Interference with the Attorney-Client Relationship*, 43 AM. BUS. L.J. 173 (2006) (analyzing the tort of interference).

222. As discussed *supra* Part III, the usefulness of the “clean hands” doctrine depends in part on board’s willingness to withhold pay under appropriate circumstances.

223. William H. Donaldson, *Corporate Governance: What Has Happened and Where*

Indeed, if the defense of unclean hands had been taken into account earlier, it may have deterred the kind of “me-first maneuverings around executive pay in corporate America” that have, once again, “generated untold millions for aggressive managers and monster losses for unwitting taxpayers.”²²⁴ At the very least, it could have remedied excessive pay where warranted. It bears repeating that seeking the rescission of salary or incentive-based excessive pay or defending a breach of contract action for withholding it on the basis of unclean hands may succeed where other lawsuits fail and/or where regulatory efforts are lax.²²⁵

Recognition of the defense in breach of contract actions may have prevented the litigation costs borne by New York taxpayers in the lawsuit filed on their behalf against former New York Stock Exchange CEO Richard Grasso.²²⁶ Grasso’s rich \$186 million retirement package—one of Wall Street’s biggest paychecks—was alleged to be excessive and the

We Need to Go, 38 BUS. ECON. 4 (2003); Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 27 n.129 (2003) (noting history of reactionary regulation after markets drop); Martin, *supra* note 67, at 533 (commenting that legislative reform punishes wrongdoers and restores investor confidence, but it does not replenish lost retirement savings or pensions); Clyde Weiss, *Pension Power*, AFSCME WORKS MAGAZINE, Mar./Apr. 2003, <http://www.afscme.org/publications/5346.cfm> (last visited Mar. 17, 2010) (explaining that the Enron bankruptcy in 2001 caused losses of \$1.5 billion in retirement assets of AFSCME union members); *see also* Anenson & Lahey, *supra* note 142, at 496, 505-07 (discussing the fiscal distress of the Pension Benefit Guaranty Corporation that insures corporate pensions in the event of termination). Professor DiMatteo explains Aristotle’s conception of equity and contract: “The use of equitable principles in contracting should function as a praxis for habit-formation in the development of the traits of law-abidance and ‘just application of the principles of equality.’” DIMATTEO, *supra* note 123, at 13 (quoting W. VON LEYDEN, *ARISTOTLE ON EQUALITY AND JUSTICE* 81 (New York: St. Martin’s Press, 1985)). Most recently, there are serious questions being raised as to whether the House Bill’s attempt to reign in executive pay, if passed, will have the desired effect. *See* Gretchen Morgenson, *Fair Game: Imperfect Politics of Pay*, N.Y. TIMES, Aug. 09, 2009, <http://www.nytimes.com/2009/08/09/business/09gret.html?emc=eta1>.

224. *See* Morgenson, *supra* note 219.

225. *See* discussion *supra* Parts II & III; *see also* Markham, *supra* note 60, at 318-19 (noting difficulty of breach of contract actions against executives for their misconduct and citing cases of former CEOs Robert J. O’Connell at Massachusetts Mutual Life Insurance and Ron Zebeck at Metris). Although principles of equity support the use of unclean hands offensively, there have been no cases to date where litigants have advocated unclean hands as a basis for rescission. *See* 17 B.C.J.S. *Contracts* § 459 (2009) (discussing grounds for partial rescission); *see also* Tracy A. Thomas, *Bailouts, Bonuses and the Return of Unjust Gains*, 87 WASH. U. L. REV. 437, 444 (2009) (citing precedent showing partial rescission of a contract is available under extreme circumstances and when the provision to be rescinded is severable from the rest of the contract).

226. Aaron Lucchetti & Paul Davies, *Grasso Braces for Long Battle over Pay Ruling*, WALL ST. J., Oct. 21, 2006, at B1 (reporting that attorney fees were estimated to be \$100 million before trial); Markham, *supra* note 60, at 318 (“[T]he fight over Grasso’s pay is becoming a poster child for reasons not to challenge executive pay in court.”).

product of manipulation.²²⁷ Even Michael Ovitz, a former Disney executive, may have had a more difficult time collecting and keeping his \$140 million severance had the Board raised unclean hands after he badly bungled the company during his short tenure.²²⁸ During the (last) Great Depression, the “clean hands” doctrine may have even been effective to help stop the bleeding of companies by CEOs and their outsized pay where shareholder litigation on behalf of the company produced only spotty results.²²⁹

Currently, there is plenty for “clean hands” to cure. CEO self-indulgence has shown that “public companies have become largely personal ATMs.”²³⁰ The conduct of former Countrywide CEO, Angelo Mozilo, provides a ready example.²³¹ His bad behavior exemplifies all the

227. Aaron Lucchetti & Joann S. Lublin, *Grasso Is Ordered to Repay Millions in Compensation*, WALL ST. J., Oct. 20, 2006, at A1; Landon Thomas, Jr., *Grasso Wins Some Rulings in Pay Case*, N.Y. TIMES, May 9, 2007, at C1; Kate Kelly & Susanne Craig, *Spitzer Files Suit Seeking Millions of Grasso Money; Action Targets Ex-Chief of NYSE and Exchange Over \$200 Million Package*, WALL ST. J., May 25, 2004, at A1 (discussing lawsuit filed by New York Attorney General against the New York Stock Exchange, its former Chairman, Dick Grasso, and the former Chairman of the Compensation Committee of the Board of Directors and seeking recovery of over \$100,000,000 paid to Mr. Grasso as compensation which was unreasonable, uninformed, and the product of intimidation); *see also* Markham, *supra* note 60, at 316 (criticizing Spitzer’s allegations that Grasso was overpaid as the chairman of a not-for-profit institution and deceived the Board as to his retirement package).

228. *See* discussion *supra* Part III; *see also* JERRY W. MARKHAM, A FINANCIAL HISTORY OF U.S. CORPORATE SCANDALS FROM ENRON TO REFORM 32 (2006) (noting other cases of excessive executive compensation at Walt Disney that included Jeffrey Katzenberg, who was paid \$280 million by Disney to settle his compensation claims, and CEO Michael Eisner, who was paid over \$750 million “while he was making some colossal management blunders as head of the company”).

229. Most of these lawsuits stem from the sheer size of the pay as opposed to any after-contract conduct regarding pay that harmed the company. *See* Washington, *supra* note 60 (discussing executive pay case concerning executive Charles M. Schwab and Charles Mitchell); *see also supra* note 94 and accompanying text.

230. Khurana & Zelleke, *supra* note 4; *accord After Rescue*, *supra* note 22 (“‘It’s very unfortunate, but a culture of entitlement has emerged among Wall Street executives,’ said Peter Morici, a University of Maryland economist. ‘They’re paid far too much money and they’re trying to find ways around the rules.’”).

231. The SEC’s lawsuit against Mozilo is the highest profile government legal action against a CEO in the current financial crisis. Peter Barnes & Joanna Ossinger, *Countrywide Ex-CEO Angelo Mozilo Charged With Fraud*, FOXBUSINESS ONLINE, June 04, 2009 available at <http://www.foxbusiness.com/story/markets/countrywide-ceo-mozilo-charged-fraud/>. These charges stem from Mozilo misleading the market as to Countrywide’s loose lending practices and his \$140 million sale of Countrywide shares at the time that Countrywide was on the brink of a mortgage meltdown. *Id.* According to an independent compensation consultant hired by Countrywide, during the same time period, Mozilo negotiated an inflated pay package with easy bonus targets based on a flawed peer group. Elizabeth MacDonald, *Highlights from CEO Pay Hearing Today*, FOXBUSINESS ONLINE, available at <http://emac.blogs.foxbusiness.com/2008/03/07/highlights-from-the-fat-cat->

possible repercussions of unclean hands on the part of corporate executives. During the negotiation of his compensation package, he fired two independent compensation consultants who had concluded that his pay package was excessive before he found a consultant to approve it.²³² Notably, Mozilo’s bonus targets under the contract were set at approximately half the company’s current revenue.²³³ After Mozilo’s strong-arm tactics secured his unreasonable compensation, he then engaged in and potentially covered up the reckless risk-taking that brought down the company.²³⁴ Whether or not the SEC is able to secure a judgment against him for fraud and insider trading, unclean hands should allow the company to reclaim some of the money he pocketed at its expense.²³⁵

Of course, the devil is in the details of any litigation. A court would still need to find and weigh the relevant facts and circumstances outlined earlier before it would invoke unclean hands.²³⁶ Moreover, for the defense to work, directors must be willing to withhold payment—and defend the lawsuit on behalf of the company on the basis of unclean hands—and/or seek rescission if payment has already been made.²³⁷

It is well known that director indulgence of CEO salaries and other incentives has contributed to overcompensation.²³⁸ Directors have also participated in various forms of wrongdoing. Nevertheless, board tolerance (or feigned ignorance) has not occurred in every situation. To be sure,

hearing-today/.

232. See MacDonald, *supra* note 170; see also Bizjak et al., *supra* note 213 (discussing the perils of compensation consultants).

233. See MacDonald, *supra* note 232.

234. For instance, Mozilo threatened to quit (triggering a severance package that included liquidating 12 million shares in the bank) if the company refused to pay the income taxes on his wife’s use of the company jet. MacDonald *supra* note 170. He also sought to collect \$3 million in benefits that he was eligible to receive only when he retired. *Id.*

235. See Robert Khuzami, “Statement from an SEC Director on Mozilo Charges,” June 4, 2009, available at <http://www.sec.gov/news/speech/2009/spch060409rk.htm> (discussing the filing of fraud charges against Countrywide executives); see also Barnes & Ossinger, *supra* note 231. Mozilo’s salary was nearly \$2 million when Countrywide’s stock plunged 80% from its five year peak. MacDonald, *supra* note 170. He also received \$20 million in stock awards as part of his performance measure (and sold another \$121 million in stock) despite Countrywide’s reporting of \$1.6 billion in losses. *Id.* Mozilo stood to gain upwards of \$100 million in severance when Countrywide was purchased by Bank of America. Barnes & Ossinger, *supra* note 231.

236. See, e.g., Markham, *supra* note 60, at 316 (listing Grasso’s accomplishments while in charge of the New York Stock Exchange).

237. The potential viability of the “clean hands” doctrine in excessive pay cases may also provide bargaining leverage to a company so that executives reconsider asserting their right to extreme compensation. The fact that directors will litigate the contract case on behalf of the company should minimize the possibility that the CEO could successfully claim unclean hands or *in pari delicto*. Anenson, *Process-Based Theory of Unclean Hands*, *supra* note 29 (distinguishing the two defenses).

238. See the discussion in *supra* note 107.

countless cases of CEO shenanigans concerning compensation have caused harm to their companies without the knowledge or involvement of the board. The many instances of stock option backdating are one example.²³⁹ Executive acceptance of underpriced initial public offerings is another example.²⁴⁰ Significantly, in both situations, evidence from business research suggests that the number of executives exposed by such ethical failings is but the tip of the iceberg.²⁴¹ Therefore, not only is it possible that directors will raise the doctrine of “clean hands,” but the defense can potentially capture conduct that the SEC and other enforcement agencies cannot (or have not).

239. While the board of directors is typically not involved in these schemes—for example, Apple Computer—other executives besides the CEO can be party to them—for example, Converse Technologies. A recent incident forced CEO Bruce Karatz at KB Homes to resign. He is facing criminal charges with the potential of life in prison. He is alleged to have defrauded investors by backdating millions of stock options over six years for a personal profit of \$7 million and then lying about it. *See* Spotlight On Stock Options Backdating, available at <http://www.sec.gov/spotlight/optionsbackdating.htm> (describing SEC enforcement actions against stock options backdating).

Stock options allow the recipients to buy shares at the price for which a stock is trading on a certain date. Backdating can make options more valuable by allowing the recipient to pay the price at which a stock was trading on an earlier date, when the stock was selling for less. Backdating is not illegal *per se*, but companies are required to disclose and account for any back-dating. Ritter, *supra* note 75, at 133. The issuance of additional shares dilutes the ownership interests of the existing stockholders. *Id.* at 132. It is estimated that the revelation of backdating results in a stock price drop for the average firm of approximately 7%, roughly \$400 million in market value, while the average gain from backdating to the executives is only about \$500,000 per firm annually. *See* M.P. Narayanan et al., *The Economic Impact of Backdating Stock Options*, 105 MICH. L. REV. 1597 (2007) (discussing the impact of backdating stock options); *see also* Ritter, *supra* note 75, at 137 (concluding that the disproportionate effect of private gains to executives through stock option backdating are small in comparison to the costs imposed on shareholders).

240. Executives who have been “spun” (bribed) by investment banks are less likely to switch investment bankers on subsequent deals. Xiaoding Lui & Jay R. Ritter, *Corporate Executive Bribery: An Empirical Analysis* (2007 Working Paper), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=968712; *see also* Ritter, *supra* note 75, at 138 (noting that when Bernie Ebbers was receiving underpriced IPO allocations from Citigroup and its predecessors during 1996-2001, Worldcom paid over \$100 million in investment banking fees on various deals, nearly all going to Citigroup companies). Underpricing of IPOs raises less money for the issuing firm and reduces the returns of their pre-issue shareholders. Ritter, *supra* note 75, at 139.

241. *See* Ritter, *supra* note 75, at 131-41. Professors Heron and Lie estimate that 29% of publicly traded U.S. firms manipulated grants to top executives at some point between 1996 and 2005, with the frequency higher for tech firms, small firms, and firms with high stock price volatility. Randall A. Heron & Erik Lie, *What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?* (2008 Working Paper), available at <http://www.biz.uiowa.edu/faculty/elielie/Grants-11-01-2006.pdf>. Professors Lui and Ritter identified 134 officers and directors of 56 companies that went public in 1996-2000 for which one or more of the corporate executives were recipients of hot initial public offering allocations from its bookrunner. Lui & Ritter, *supra* note 240.

Furthermore, even providing for the penchant of directors to defer to the CEO, the changing legal landscape and public furor over executive pay should cause directors to reconsider their alliances. Shareholder advocates, especially institutional investors, are rallying against runaway executive pay and boards are responding.²⁴² Board member positions are now at stake.²⁴³ Increasing public and investor oversight should encourage directors to resort to equity and withhold or rescind payment when warranted.²⁴⁴ Warren Buffet’s warning to companies is undeniable: “[I]n judging whether corporate America is serious about reforming itself, CEO pay remains the acid test.”²⁴⁵

Potential political safeguards, such as requiring an independent compensation committee not paid by management, should also help curb compensation excesses at the outset or facilitate the later assertion of contractual defenses such as unclean hands.²⁴⁶ Impending reforms will not

242. For anecdotal evidence of board responsiveness to shareholder activism, see Lui & Ritter, *supra* note 240, at 2 n.3 (noting the high-profile cases of Pfizer and Home Depot where the vote-no campaign contributed to the ouster of the CEO); L. Reed Walton, Preliminary U.S. Postseason Report, RiskMetrics Group, Risk & Governance Blog, available at http://blog.riskmetrics.com/2008/07/preliminary_us_postseason_repo.html (last visited May 22, 2009) (describing how Washington Mutual reversed its bonus decision, replaced the chair of the human resources committee and made a number of other significant governance changes after nine directors received at least 26% opposition, including more than 40% opposition for the chair of the human resources committee, at the company’s annual shareholder meeting). To defuse public anger, several companies have recently revamped the compensation structure of executive and other employee pay. See Francesco Guerrera & Julie MacIntosh, *JPMorgan to Lift Pay and Cut Bonuses*, FIN. TIMES, July 25, 2009 (reporting that JPMorgan’s compensation decision mirrors decisions by Morgan Stanley, Citigroup and UBS). For additional discussion of say on pay reform, see *supra* Part II.A.

243. Vote no campaigns that target particular board members have proven effective in reducing CEO pay. See Ertimur et al., *supra* note 42, at 27-31 (showing \$3.1 million reduction in total compensation across firms and a \$5.5 million reduction in firms with abnormal pay); see also J.A. Grundfest, *Just Vote-No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857 (1993) (explaining vote no campaigns). If directors are ousted, an excessive pay package that was negotiated by “captured” directors may later be reconsidered by new directors who may be more willing to halt bonuses and other incentive-driven compensation schemes, especially when outsized pay is coupled with reckless risk-taking that causes harm to the firm.

244. CEOs, in particular, have achieved celebrity status with attendant public appetite for information. See Patricia S. Abril & Ann M. Olazábal, *The Celebrity CEO: Corporate Disclosure at the Intersection of Privacy and Securities Laws*, 46 HOUSTON L. REV. 1545 (2010); see also Ertimur et al., *supra* note 42, at 23 (noting increased public access to company financial information after Enron).

245. Warren Buffet, *Berkshire Hathaway Inc. 2003 Annual Report* (2003).

246. See *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting) (“Compensation consulting firms, which provide cover for generous compensation packages voted by boards of directors, have a conflict of interest because they are paid not only for their compensation advice but for other services to the firm—services for which they are hired by the officers whose compensation they advised on.” (citing, for

completely eliminate all factors that contribute to contract terms overly favorable to top executives.²⁴⁷ But even so, aggressive tactics by executives to take undue advantage of those terms clearly leaves a role for the “clean hands” doctrine.²⁴⁸

The defense’s most opportune function, however, is perhaps its most important. Unclean hands could be utilized to correct ongoing problems with the payment of bonuses at AIG and the nine other financial firms that received billions of dollars in federal funds.²⁴⁹ At AIG, the political and

example, BEBCHUK & FRIED, *supra* note 85, at 37-39)), *cert. granted*, 129 S.Ct. 1579, 173 L.Ed.2d 675 (Mar 09, 2009). For a discussion of federal and state reform proposals, see *supra* Parts II & III.

247. See, e.g., Stephen M. Salley, Note, “Fixing” Executive Compensation: Will Congress, Shareholder Activism, or the New SEC Disclosure Rules Change the Way Business Is Done in American Boardrooms?, 70 OHIO ST. L.J. 757 (2009) (discussing the efforts and likely effectiveness of Congress, activist shareholders, and the SEC’s new executive compensation disclosure rules); Frank Rich, *Wall Street Gets Rich at Main Street’s Expense*, SYDNEY MORNING HERALD, Oct. 20, 2009, at 6-7 (expressing pessimism that there will be comprehensive financial reform). For discussion of peer group abuse and its effects, see Jensen et al., *supra* note 217, at 56 (“We believe that the misuse of survey information provided by compensation consultants has led to systematic increases in executive pay levels.”); see also Markham, *supra* note 60, at 286 (discussing abuses of peer groups). The peer group that is used to analyze CEO compensation is seldom reported and often differs from the group used on the performance graph on the firm’s proxy statement. See John W. Byrd et al., *Discretion in Financial Reporting: The Voluntary Disclosure of Compensation Peer Groups in Proxy Statement Performance Graphs*, 15 CONT. ACCT’G RES. 25 (1998) (analyzing selection of firms on the performance graph in the proxy); Michael Faulkender & Jun Yang, *Inside the Black Box: The Role and Composition of Compensation Peer Groups* (2008) (working paper, on file with authors) (examining choice of peer groups in sample of 395 of the S&P 500 firms and 262 of the S&P Mid-Cap 400 firms that provided explicit lists of compensation peer companies in their first fiscal year ending after December 15, 2006).

248. A recent study of changes made in pay practices by 191 of the nation’s largest companies in the first half of 2009 shows that, despite the deleterious consequences of short-term profiteering to the U.S. economy, short-term incentives are an even bigger component of compensation. Gretchen Morgenson, *Fair Game: The Quick Buck Just Got Quicker*, N.Y. TIMES, Aug. 15, 2009, available at http://www.nytimes.com/2009/08/16/business/16gret.html?_r=1. A prior survey disclosed that 74% of corporate executives believed that bending the rules was acceptable to achieve performance goals. John F. Veiga et al., *Why Managers Bend Company Rules*, 18 ACAD. MGT. PERSP. 84 (2004). Banks have also resurrected the practice of giving guaranteed bonuses that provide million-dollar payouts regardless of performance. See Eric Dash, *Effort to Reign in Pay on Wall Street Hits New Hurdle*, N.Y. TIMES, Oct. 10, 2009, at A1, A3 (reporting guaranteed bonuses made by Goldman Sachs, JPMorgan Chase, and Morgan Stanley and AIG’s pending \$281 million bonus payouts to retain employees).

249. Accord Thomas, *supra* note 225, at 441-43, 445-46 (suggesting other equitable theories like unjust enrichment and constructive trust to remedy the AIG bonus problem); cf. Lawrence A. Cunningham, *A.I.G.’s Bonus Blackmail*, *OpEd*, N.Y. TIMES, Mar. 17, 2009, http://www.nytimes.com/2009/03/18/opinion/18cunningham.html?_r=1 (suggesting the analysis of traditional contract defenses and other legal remedies to rescind the March 2009 bonus payments at AIG). The initial bonuses were paid in March 2009. Bernard, *supra*

public pressure to withhold payment to executives and other employees responsible for the downfall of these companies has delayed the latest round of these purportedly contractually-mandated payments.²⁵⁰ It must be emphasized that the defense’s application in these situations has the potential to save the public millions of dollars.²⁵¹ Add to that amount the millions in bonuses planned by government-controlled mortgage finance giants Fannie Mae and Freddie Mac under existing contracts, and it is worth the effort to analyze whether these employees still retain their “clean hands” that would allow continuing compensation.²⁵²

note 22. The second round was scheduled for July 2009. *Id.* For news of bonuses at the banks, see Story & Dash, *supra* note 25.

250. Lavonne Kuykendall, *AIG Holds Off On Some Bonus Payments*, WALL ST. J., July 24, 2009 (reporting that AIG held off on the July payments and is negotiating with its executives to reduce the bonus payments due to employees of the company’s financial products unit). All bonuses were contracted for in 2008 before the government bailout. *Id.* For 2009 contracts, the Obama Administration has power to reject executive pay plans for companies that are part of the \$700 billion bank bailout. *Id.* Kenneth Feinberg of the Treasury Department was reviewing proposals for executive compensation packages submitted by seven bank and industrial companies on August 13, 2009. Deborah Solomon, *U.S. Pay Czar to Rework Contracts Deemed High*, WALL ST. J., July 27, 2009 (listing companies as Citigroup Inc., Bank of America Corp., American International Group Inc., General Motors Co., Chrysler Corp., Chrysler Financial and GMAC Financial Services Inc.). Treasury will reduce the salaries of the top twenty-five earners at companies receiving government aid; certain executives have been given immunity like AIG’s new CEO, Robert Benmosche. Leslie Scism, et al., *AIG Chief: Loud Voice and Listener’s Ear*, WALL ST. J., Aug. 10, 2009, at C1, C5 (reporting Benmosche’s government-approved pay package is worth \$7 to \$10 million).

251. The AIG payments include \$235 million for employees of the financial unit responsible for the company’s downfall as well as the subsequent installments of \$9 million in bonuses for top executives. Bernard, *supra* note 22. The March 2009 bonus payments to employees in the financial products unit totaled \$165 million. Cunningham, *supra* note 249; *see also* Jeremy Pelofsky & Lilla Zuill, *AIG Reveals \$455 Million in 2008 Performance Bonuses*, Reuters, May 5, 2009, <http://www.reuters.com/article/newsOne/idUSTRE5446VC20090505> (reporting that these additional payments would supplement performance bonuses of \$454 million paid to employees and executives in 2008). Extending the doctrine of “clean hands” to employees (as well as CEOs and other executives) is warranted in this situation because their reckless risk-taking caused the company’s collapse. Courts should exercise caution in invoking unclean hands regarding pay without such morally reprehensible conduct against lower-level employees who do not have fiduciary duties to the company.

252. President Obama advised the Treasury Department to “pursue every single legal avenue” to withhold or recover the AIG bonuses. Cunningham, *supra* note 249; *see also* Brian Sullivan, *Fannie, Freddie Bonuses Hit \$210 Million*, Apr. 3, 2009, available at <http://briansullivan.blogs.foxbusiness.com/2009/04/03/fannie-freddie-bonuses-hit-210-million> (reporting that the companies paid nearly \$51 million in 2008, and are scheduled to make \$146 million in payments in 2009, and \$13 million in 2010). Fannie and Freddie are not recipients of TARP funds and, as a result, are not subject to nonbinding shareholder “say on pay.” *Id.* (reporting that the companies are planning to pay more than \$210 million in bonuses through 2010); *see also* Eric Dash, *Fannie Mae to Restate Results by \$6.3 Billion Because of Accounting*, N.Y. TIMES, Dec. 7, 2006, at C1 (reporting that the Office of

In summary, rather than being ill-suited for the complexity of ascertaining “clean hands” in the case of CEO overcompensation, judges and even juries are probably the perfect forum for weighing complicated facts, motives, conduct, and community values.²⁵³ It should be emphasized that unclean hands is not being offered as an ending to the intractable issue of executive compensation, but as a new beginning of perspective and exploration. Accordingly, like its ancient use in contract cases, the legal sanction of dismissal may be capable of reining in rogue business executives and the directors who serve them. Early equity tradition reflects the prevailing belief that corporate management has ethical responsibilities that the common law—and equity—can help discharge. As a result, the “clean hands” doctrine should be considered as an antidote to excessive executive compensation.

VII. CONCLUSION

Lord Mansfield was once labeled a heretic for introducing ethics-based equity principles into common law decision-making in commercial cases.²⁵⁴ History proved him a hero.²⁵⁵ Now that “[m]anaging has given

Housing and Enterprise Oversight, which regulates Fannie Mae, announced that it was suing its former executives to recover compensation paid to them when Fannie Mae was overstating earnings by \$6.3 billion). Prior to the EESA, Congress passed the Housing and Economic Recovery Act in July 2008 which imposed restrictions on compensation for executives of federal home loan banks, Fannie Mae, Freddie Mac, and limited golden parachute payments to executives. H.R. Rep. No. 111-50, (2009).

253. *Accord* Richard W. Wright, *Substantive Corrective Justice*, 77 IOWA L. REV. 625, 689 (1992) (asserting that the reasonable person provides guidance in choosing the “intermediate, or mean between excess and deficiency in relations with others that involve claims to goods” (citing ARISTOTLE, V.I NICOMACHEAN ETHICS 1129b2-11 & v.2 at 1130a32-b5 (W.D. Ross & J.O. Urmson, trans., Grinnell: Peripatetic Press, 1984))); *see also* Anenson, *supra* note 111, at 412-16 (analyzing the split among state courts whether an equitable defense to a legal claim requires a constitutional right to trial by jury); *id.* (explaining that federal constitutional law mandates trial by jury of legal claims when the claim and defense have common issues of fact). Because unclean hands results in judicial inaction, a calculation of an exact amount is not required, but rather only a determination that the amount withheld was more than the CEO’s fair share.

254. *See* Mason, *Fusion*, in EQUITY IN COMMERCIAL LAW, *supra* note 93, at 12; *see also* Anenson, *supra* note 111, at 384 (discussing how Lord Mansfield in *Montefiori v. Montefiori*, 96 Eng. Rep. 203 (K.B. 1762), decided the first reported legal case invoking equitable estoppel (citing Walter S. Beck, *Estoppel Against Inconsistent Position In Judicial Proceedings*, 9 BROOKLYN L. REV. 245, 245 (1940))).

255. *Id.*; *see also* NEWMAN, *supra* note 110, at 12-20 (discussing how the ethical content of the common law became greatly enriched with the awakening of social consciousness at the time of Lord Mansfield); Henry Ingersoll, *Confusion of Law and Equity*, 21 YALE L.J. 59 (1912) (commenting on how Lord Mansfield “opened the common law courts to equity”). Lord Mansfield was overheard commenting that he never liked law so much as when it resembled equity. *See* Harold Greville Hanbury, *The Field of Modern Equity*, in ESSAYS IN EQUITY 28 (1934) (citing *Lord Dursley v. Lord Fitzhardinge*, 6 Ves. 251, 260 (1827) (per

‘way to manipulation’ and integrity has lost ‘out to illusion,’” Americans have a compelling interest in considering an equitable solution to the problem of excessive executive compensation.²⁵⁶

The use of unclean hands in this situation is explained and supported by ethics and business literature. It is aligned with law enforcement and regulatory priorities, maintains the moral and ethical values of state corporate law, and is synonymous with the tradition and meaning of equity itself. Resort to equitable principles like unclean hands stops CEOs from gaining more than their fair share and allows management to reclaim the moral high ground. With state and federal governments revisiting reforms, an additional corrective of equity will help curtail the current climate of graft and greed.

We are not the first generation to watch our most powerful firms and financial icons fall from grace.²⁵⁷ With the temptations engendered by massive amounts of wealth that continue to accumulate in economic entities, we will likely not be the last. Critics of the current corporate environment have called for “nothing less than a cultural change.”²⁵⁸ Law has the ability to influence social progress.²⁵⁹ The legal process both reflects and determines the values of society.²⁶⁰ The experience of equity is evidence of this dynamic and reflective process. Over hundreds of years, equity has made inroads in the law and resulted in its modification and amenability to notions of fairness and justice.²⁶¹ History teaches that courts

Lord Eldon)); *see also* Mason, *Fusion, in* EQUITY IN COMMERCIAL LAW, *supra* note 93, at 17 (explaining that Mansfield was a member of the equity bar prior to becoming a judge).

256. Arthur Levitt, The “Numbers Game” (address at the New York University Center for Law and Business, New York, NY, September 25, 1998), *available at* <http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt>.

257. LAUFER, *supra* note 8, at 42. *See generally* Markham, *supra* note 60 (recounting tales of outrageous and abusive executive pay practices over the centuries).

258. Levitt, *supra* note 256; *cf.* Eleanor W. Myers, “Simple Truths” *about Moral Education*, 45 AM. U. L. REV. 823 (1996) (explaining the widespread concern for declining values in the legal profession and the appreciation that the commercial pressures of workplaces unsympathetic to ethical practice have had the greatest impact on shaping professional behavior).

259. BOBBITT, CONSTITUTIONAL INTERPRETATION, *supra* note 197, at 752-53 (declaring that our institutions and processes do determine what kind of people we are (rejecting Grant Gilmore’s proposition that “[l]aw reflects, but in no sense determines the moral worth of a society” (citing GRANT GILMORE, THE AGES OF AMERICAN LAW 110-11 (1977) (Storrs Lectures, Yale Law School))); *see also* Norman D. Bishara, *Legislating Business Ethics: Corporate Governance, Stakeholders, and Encouraging Ethical Action* (2009) (Michigan Business School Working Paper, on file with authors) (exploring whether legislation can influence the ethical values of corporate leaders).

260. *See* BOBBITT, CONSTITUTIONAL INTERPRETATION, *supra* note 197 at 752-53.

261. *See generally* Glenn & Redden, *supra* note 114, at 753 (reviewing history of equity to demonstrate that the traditional theory of the equitable process can help solve modern problems); Wesley Newcomb Hohfeld, *The Relations Between Equity and Law*, 11 MICH. L. REV. 537, 567 n.23 (1913) (explaining that equity resulted in “a liberalizing and

can utilize unclean hands to stop present pay abuses and simultaneously affect future social change.

It is time for the judiciary to join the political branches in a comprehensive response to executives bent on exploiting institutional weaknesses. Legislation and regulatory policy evolve in a complex political and social environment. It is well known that businesses “seek not only to comply with regulators and regulations but also to influence them.”²⁶² Admittedly, a case-based solution to the problem of excessive executive compensation is but one of many methods of addressing an issue inherent in corporate America.²⁶³ But given the failure and insufficiency of the current law and enforcement efforts, it could be an important part of the overall solution.²⁶⁴ As such, courts should consider unclean hands an additional safeguard against the social costs and corresponding moral outrage caused by wayward corporate stewards who unabashedly accept

modernizing of the law” (quoting Pound)). Professor Stephen Burbank describes the importance of equitable principles in the progress of the law:

We have been fortunate that our system has included, most of the time and in most American jurisdictions, both law and equity, each of which requires the other and both of which, in combination, have helped us over more than two hundred years to make social and economic progress. That progress has often not come easily, and there is much of it still to be done.

Burbank, *supra* note 81, at 1346.

262. LAUFER, *supra* note 8, at 30; *see also* Frank Partnoy, *INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS* 5 (New York: Time Books, 2003) (outlining the ability of businesses to shape regulatory policy and reform); Michael J. Cooper et al., *Corporate Political Contributions and Stock Returns*, J. FIN. (forthcoming 2009) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=940790 (tracking 25 years of firm political contributions and finding a positive effect on future stock returns). For recent examples of the apparent regulatory capture of the SEC, *see generally* Ritter, *supra* note 75 (recounting the failure to sufficiently investigate the Ponzi scheme of Bernie Madoff and CEO stock option backdating). For the influence of big business on the SEC’s attempts to regulate executive compensation in particular, *see* Martin, *supra* note 67, at 531 (relaying how the SEC abandoned its effort to increase shareholder involvement in the nomination of directors after the business community opposed it).

263. *See* Khurana & Zelleke, *supra* note 4, at B4 (“We need to rethink how American business ought to be run, including changes to fiduciary duties, legal liability, takeover rules and business education, among many other areas.”).

264. *See generally* Nim Razook, *Common Law Obedience in a Regulatory State*, 47 AM. BUS. L.J. 75 (2010) (championing the role of judge-made law in supplementing the shortfalls of regulatory policy related to business). Earlier calls for corporate reform continue to describe the perils of the existing system:

[S]hareholder democracy, and the state chartering of corporations that are, in some ways far larger than their host states, have as much chance of keeping our giant corporations virtuous as wigs on judges have of making them wise, and the wrist slaps called criminal law have deterred corporate crimes as effectively as a fishing net slows an elephant.

Ralph Nader & Mark Green, *Corporate Democracy*, N.Y. TIMES, Dec. 28, 1979, at F17. *See generally* LAUFER, *supra* note 8 (discussing the failure of corporate criminal law).

golden parachutes as their companies go down in flames.²⁶⁵

265. See Andrews & Baker, *supra* note 24 (predicting a popular backlash against the government’s efforts to underwrite Wall Street due to AIG’s \$450 million bonus payment plan, explaining that “[o]f all the financial institutions that have been propped up by taxpayer dollars, none has received more money than A.I.G. and none has infuriated lawmakers more with practices that policy makers have called reckless”); Ferri & Weber, *supra* note 3, at 2 (“In the eyes of the public, the government intervention was a bailout for those Wall Street executives who had been profiting from the very actions causing the credit crisis.”); Mark Maremont et al., *Before the Bust, These CEOs Took Money Off the Table*, WALL ST. J., Nov. 2008, at A1 (featuring CEOs of Countrywide Financial Corporation, Lehman Brothers and Bear Stearns, among others in a list of fifteen CEOs of large home-building and financial-services firms who each reaped “more than \$100 million in cash compensation and proceeds from stock sales during the past five years”). For similar conduct by U.S. CEOs throughout history, see Markham, *supra* note 60, at 292-93 (discussing golden parachutes for William Agee at Bendix, John Kanas at North Fork Bancorp, James Kilts at Gillette, Wallace Barr at Caesars Entertainment, Steve Ross at Warner Brothers, Henry McKinnell at Pfizer, and Richard Grasso at the New York Stock Exchange, among others).