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Sue on Pay: Say on Pay's Impact on Directors' Fiduciary Duties

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SUE ON PAY: SAY ON PAY'S IMPACT ON DIRECTORS' FIDUCIARY DUTIES

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This Article advances a normative case for using say on pay litigation to enhance the state courts' role in policing directors' compensation decisions. Outrage over what many perceive to be excessive executive compensation has escalated dramatically in recent years. In 2010, such outrage prompted Congress to mandate say on pay—a nonbinding shareholder vote on executive compensation. In the wake of say on pay votes, some shareholders have brought suit against directors alleging that a negative vote indicates a breach of directors' fiduciary duties. To date, the vast majority of courts have rejected these suits. This Article insists that such rejection represents a wasted opportunity, and argues that Delaware courts should use say on pay litigation to alter how they assess board duties related to pay practices for at least three reasons. First, empirical evidence suggests that we cannot rely exclusively on say on pay to alter board behavior. Second, if Delaware and other state courts fail to respond to calls for better regulation of compensation practices, those courts risk further federal intrusion in this area, which could undermine private-ordering along with value-enhancing experimentation and innovation that can only occur at the state level. Third, say on pay votes are an ideal vehicle for increasing state courts' role not only because courts should encourage boards to consider shareholder concerns but also because negative say on pay votes may be a critical signal that there is a defect in pay policies that needs to be addressed. Instead of being used as a tool to bypass fiduciary duty law, say on pay should serve as a springboard for reinvigorating such law as it pertains to executive compensation.

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INTRODUCTION

Undoubtedly, executive compensation is one of the most controversial corporate governance issues in recent years.[1] Both lawmakers and the general public have expressed considerable outrage over what they view as excessive executive compensation.[2] Such outrage not only stems from a belief that there is an insufficient link between executive pay and corporate performance but also from concern about the widening gap between executive compensation and the pay of average workers.[3]

Although American fury over executive compensation is not new,[4] it has grown considerably amidst the financial crisis. And it has been fueled by stories of executives receiving significant pay packages while their companies performed poorly or received federal bailout funds.[5] Some have even insisted that excessive executive pay played a role in fueling, or even precipitating, the financial crisis by

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1. *See* Mark J. Loewenstein, *Reflections on Executive Compensation and a Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 201 (1996) (noting that the public outcry over CEO pay has no parallel in sports or the movie business); Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. REV. 299, 302 (2009) ("No corporate governance issue captures the imagination and frustration of the American public and politicians more than executive compensation."); Michael C. Jensen et al., *Remuneration: Where We've Been, How We Got to Here, What Are the Problems, and How to Fix Them* 1 (Harvard Bus. Sch. NOM Research Paper No. 04-28; European Corporate Governance Inst. Fin. Working Paper No. 44, 2004), *available at* http://www.cgscenter.org/library/board/remuneration.pdf ("Few issues in the history of the modern corporation have attracted the international attention garnered by what the largest corporations pay their top executives.").

2. *See* Michael M. Phillips, *The AIG Controversy: 'Outrage' Overflows on Capitol Hill as Lawmakers Denounce Bonuses*, WALL ST. J., Mar. 19, 2009, at A4.

3. *See* Sheryl Gay Stolberg & Stephen Labaton, *Banker Bonuses Are 'Shameful,' Obama Declares*, N.Y. TIMES, Jan. 30, 2009, at A1; *see also infra* Part I.B.

4. *See* Charles C. Pak, *Toward Reasonable Executive Compensation: Outcry for Reform and Regulatory Response*, 1994 ANN. SURV. AM. L. 633, 633 ("Executive compensation, or more appropriately, the overcompensation of executives, is the controversial corporate governance topic of the 1990s."); Jensen et al., *supra* note 1, at 29 (noting that executive compensation became a major political issue in the 1990s); *see also* Harwell Wells, *"No Man Can be Worth $1,000,000 a Year": The Fight over Executive Compensation in 1930s America*, 44 U. RICH. L. REV. 689, 705–07 (2010).

5. *See* THE CONFERENCE BD., THE CONFERENCE BOARD TASK FORCE ON EXECUTIVE COMPENSATION 6–7 (2009) (noting that "[e]xecutive compensation has become a flashpoint for [the public's] frustration and anger" and that the economic crisis "has only intensified public anger over executive compensation"), *available at* http://www.conference-board.org/pdf_free/execcompensation2009.pdf; Kenneth R. Davis, *Taking Stock—Salary and Options Too: The Looting of Corporate America*, 69 MD. L. REV. 419, 419–21 (2010); Aaron Lucchetti & Matthew Karnitschnig, *On Street, New Reality on Pay Sets in*, WALL ST. J., Jan. 31, 2009, at B1 (noting that the five largest Wall Street firms paid a total of $26 billion in bonuses in 2008, the same year that their companies lost a combined $25.3 billion).

incentivizing executives to pursue unjustifiably risky transactions.[6] Such stories accelerated efforts to reform executive pay practices.[7]

Say on pay—a nonbinding shareholder vote on executive compensation—has garnered significant attention and support as a measure for curbing outsized executive compensation.[8] In 2009, the federal government mandated say on pay for corporations receiving funding under the Troubled Asset Relief Program ("TARP").[9] As a result, some 300 companies were required to provide annual say on pay votes.[10] In 2010, the Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd–Frank") extended this requirement to all public companies.[11] The push to mandate say on pay stems from a belief that it could help curtail inappropriate pay packages and practices, while holding directors more accountable for their compensation decisions.[12]

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6. *See* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 249 (2010); Jeremy Ryan Delman, *Structuring Say-on-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation*, 2010 COLUM. BUS. L. REV. 583, 584; Frederick Tung, *Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation* (Emory Pub. Law Research Paper No. 10-93, Emory Law & Econ. Research Paper No. 10-60, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1546229.

7. *See* Deborah Solomon & Laura Meckler, *Strict Executive-Pay Caps Planned—Latest Salvo from Obama Administration Aims to Rein in Firms Receiving Federal Aid*, WALL ST. J., Feb. 4, 2009, at A3; Stolberg & Labaton, *supra* note 3 (noting President Obama's reference to Wall Street pay practices as "shameful"); Press Release, U.S. Dep't of the Treasury, Treasury Announces New Restrictions on Executive Compensation (Feb. 4, 2009), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg15.aspx.

8. *See* COMPENSIA, INC., THOUGHTFUL PAY ALERT: SHAREHOLDER ADVISORY VOTES ON EXECUTIVE COMPENSATION—A "SAY ON PAY" PRIMER 1–2 (June 22, 2009) (noting emphasis on say on pay and its popular appeal), *available at* http://www.compensia.com/tp_alerts/ThoughtfulPay_SayOnPay_0609.pdf; Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 1034–36 (2010).

9. *See* 12 U.S.C. § 5221 (2012).

10. *See* Robert W. Reeder III, Sullivan & Cromwell LLP, *Compensation Disclosure and Shareholder Activism*, *in* HOT ISSUES IN EXECUTIVE COMPENSATION 2009, at 139 (2009), *available at* www.pli.edu/emktg/toolbox/CompDis_ShareAct25.DOC; Rosanna Weaver et al., *A Closer Look at Executive Compensation*, *in* RISKMETRICS GROUP POSTSEASON REPORT 2009: A NEW VOICE IN GOVERNANCE: GLOBAL POLICYMAKERS SHAPE THE ROAD TO REFORM 24, 24 (Oct. 2009), *available at* https://www.governanceexchange.com/repository/KnowledgeGateway/pubs/2009_PSR_Client_final.PDF.

11. *See* Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, sec. 951, § 14, 124 Stat. 1376, 1899–1900 (2010) [hereinafter Dodd–Frank Act] (codified at 15 U.S.C. § 78n–1 (2012)).

12. *See* LATHAM & WATKINS LLP, "SAY ON PAY" SHAREHOLDER ADVISORY VOTES ON EXECUTIVE COMPENSATION: THE NEW FRONTIER OF CORPORATE GOVERNANCE ACTIVISM 1–2 (2007), *available at* http://www.lw.com/upload/pubContent/_pdf/pub2039_1.pdf; Jeffrey N. Gordon, "*Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 337–50 (2009).

Rather than join the numerous voices engaged in the debate over the merits of say on pay,[13] this Article examines how say on pay impacts boards' fiduciary duties. Boards have been at the center of the executive pay controversy because they bear responsibility for establishing and approving executive pay.[14] Indeed, if executive pay levels are excessive, then boards have inadequately performed their obligations in this area. Some commentators even contend that changes in CEO compensation will not occur unless boards become more accountable.[15] As a result, reforms often focus on enhancing board responsibility and making directors more accountable for their compensation decisions.[16] For purposes of corporate governance, fiduciary duty law represents the primary accountability mechanism.[17] Yet most commentators believe that such law, particularly as articulated by Delaware courts, has been an inadequate constraint on director behavior.[18] In the realm of executive compensation, fiduciary duty law has played little, if any, role in policing boards. This is because courts afford considerable deference to boards' executive compensation decisions, even upholding executive compensation decisions characterized as "sloppy and perfunctory."[19] Such deference creates the concern that fiduciary duty law has

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13. *See, e.g.*, Gordon, *supra* note 12, at 352–53; Andrew C.W. Lund, *Say on Pay's Bundling Problems*, 99 KY. L.J. 119, 129–33 (2010).

14. *See infra* Part I.D.

15. *See* Barbara Hansen & Gary Strauss, *Companies Think They're Worth . . . $100,000,000*, USA TODAY, Apr. 10, 2006, at 1B (quoting Harvard Professor Lucian Bebchuk).

16. *See infra* Part II.B, Part II.C.

17. *See* Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1046 (1993) (noting that for most scholars, fiduciary duty law enforced through shareholder litigation represents the primary means of director accountability).

18. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 46 (2004) ("[A]lmost all cases since 1900 have refused to overturn compensation decisions made by the boards of publicly traded firms."); Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 81–82, 98 (1992) ("In virtually every case since the turn of the century, courts have either applied the business judgment rule and endorsed the compensation practice, or simply thrown in the towel and refused to deal with the problem."); Lawrence A. Cunningham, *A New Legal Theory to Test Executive Pay: Contractual Unconscionability*, 96 IOWA L. REV. 1177, 1198 (2011) (noting that Delaware's standard of review had taken Delaware courts and corporate law "largely out of the policing picture"); Loewenstein, *supra* note 1, at 215; Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 MINN. L. REV. 846, 855, 869 (2011). *But see* Thomas & Wells, *supra*, at 865–80 (pinpointing instances where plaintiffs have had some success in challenging executive compensation decisions, though most did not occur in Delaware and did not occur at public companies).

19. *See* Brehm v. Eisner, 746 A.2d 244, 249, 263 (Del. 2000).

done little to ensure that directors comply with their obligation to ensure that executives are paid at an appropriate level.[20]

This Article argues that say on pay can and should address this concern. In the wake of say on pay votes, shareholders have filed several lawsuits against directors in which they have relied on such votes to suggest that directors have breached their fiduciary duties.[21] Commentators and courts have insisted that Dodd–Frank prohibits shareholders from using say on pay to reshape fiduciary duty law.[22] Moreover, commentators almost universally agree that such suits are without merit and believe that say on pay does not and should not have any impact on directors' fiduciary duties.[23] Appearing to confirm this assessment, courts have almost universally chosen to dismiss suits in this area.[24]

This Article insists that courts should choose a different path. To be sure, despite efforts aimed at enhancing director accountability for executive compensation matters, the combination of executive compensation reforms likely increases the difficulty of challenging director decision-making in this area and thus of holding directors accountable through fiduciary duty rules.[25] Nevertheless, this Article takes issue with the presumption that such suits should be construed as meritless. In fact, recent Delaware jurisprudence strongly suggests that there are circumstances (admittedly, very limited) under which shareholders may be successful in fiduciary duty actions involving executive compensation.[26] Then too, Dodd–Frank itself does include a provision indicating that such law is not designed to alter state fiduciary duty law.[27] Yet this Article insists that while such a provision may be viewed as a prohibition against compelling changes to fiduciary duty law, it does not prevent courts from reassessing and reinvigorating such law.

More importantly, this Article argues that there are three reasons it may prove advantageous for Delaware courts to use say on pay litigation to alter the manner in which they assess board duties regarding pay. First, although say on pay has the potential to alter and improve pay practices, empirical studies suggest that it would be inappropriate to rely exclusively on say on pay to check director behavior. Thus, fiduciary law is still necessary to cure problematic pay practices. Second, if Delaware and other state courts fail to respond to calls for better

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20. Robert E. Scully, Jr., *Executive Compensation, the Business Judgment Rule, and the Dodd–Frank Act: Back to the Future for Private Litigation*, FED. LAW., Jan. 2011, at 36, 38.

21. *See infra* Part III.B.

22. *See, e.g.*, SARAH A. GOOD ET AL., PILLSBURY WINTHROP SHAW PITTMAN LLP, PLAINTIFFS' FIRMS GAINING STEAM IN NEW WAVE OF SAY-ON-PAY SHAREHOLDER SUITS? 3 (2012), *available at* http://www.jdsupra.com/legalnews/plaintiffs-firms-gaining-steam-in-new-w-03932/; Order Granting Defs.' Motion to Dismiss the Compl., Teamsters Local 237 v. McCarthy, No. 2011-CV-197841 (Ga. Super. Ct. Sept. 16, 2011), 2011 WL 4836230 (indicating that fiduciary duty suits were not supported by Dodd–Frank's language).

23. GOOD ET AL., *supra* note 22, at 1.

24. *See id.* at 2.

25. *See infra* Part III.B.

26. *See* Thomas & Wells, *supra* note 18, at 865.

27. *See* Dodd–Frank Act § 951(c).

regulation of compensation practices, those courts risk further federal intrusion in this area. Such intrusion could have negative implications because federal regulation too often leads to one-size-fits-all solutions while hindering corporate innovation and experimentation.[28] Third, say on pay votes are likely an ideal vehicle for increasing state courts' role not only because courts should encourage boards to consider shareholder concerns but also because negative say on pay votes may be a critical signal that there is a defect in pay policies that needs to be addressed. For these reasons, courts should take the opportunity to use say on pay as a springboard for developing a more in-depth assessment of board decision-making related to compensation matters.

Part I of this Article examines executive compensation trends before and after the financial crisis and explains how most commentators have concluded that compensation is excessive.[29] Part I ends by revealing that most commentators agree that the best way to address excessive executive compensation is to enhance accountability. Part II discusses the rise of say on pay as an ideal accountability measure, as well as the debate regarding the merits of say on pay. Part III reveals why most commentators believe fiduciary duty law is neither necessary nor appropriate as an accountability tool. Part III also explores the potential viability of the shareholder derivative actions brought in the wake of say on pay votes in the context of current Delaware law.[30] Moreover, Part III reveals how most courts have chosen to dismiss say on pay suits. Part IV demonstrates why the efforts to dismiss the importance of fiduciary duty law as an accountability check for compensation decisions may be premature and makes the affirmative case not only for altering the manner in which Delaware courts assess such suits, but also for using say on pay suits as a platform for such alteration.

I. EXECUTIVE COMPENSATION AND ACCOUNTABILITY

A. Executive Compensation Trends

Studies confirm that executive pay at large U.S. companies has sharply risen over the past few decades. Most studies define executive pay to include base salaries and bonuses or incentive-based compensation, including cash, stock, stock

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28. *See infra* Part IV.B.5.

29. Despite some debate on the topic, this Article accepts the premise that executive compensation is excessive at some corporations and needs to be curtailed. Even defenders of executive pay acknowledge that some practices can be problematic. *See, e.g.*, Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1661–62 (2005). This Article also acknowledges the difficulties of determining when compensation should be deemed excessive, which is why this Article focuses on reforms that rely on the corporation's own metrics and policies as a guide for such a determination.

30. Part III and this Article as a whole focus on Delaware due to its acknowledged prominence in corporate law. *See* Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 457 (2004). According to the Delaware Division of Corporations, Delaware is the incorporation home to more than 50% of U.S. public companies and 63% of Fortune 500 companies. *Delaware Division of Corporations*, DELAWARE.GOV, http://corp.delaware.gov/ (last visited Feb. 18, 2013).

options, or other arrangements.[31] One study revealed that the average annual CEO pay at S&P 500 companies increased from $850,000 in 1970 to more than $14 million in 2000—an increase driven largely by the practice of awarding stock options and restricted stock.[32] During the 1980s, CEO compensation grew by 212%,[33] and from 1980 to 1995, average CEO pay increased by 380%.[34] From 1993 to 2003, median CEO compensation at S&P 500 firms increased 146%.[35] During that same period, the median pay of the five most highly compensated executives at S&P 500 companies increased by 125%.[36] Median CEO pay increased by 25% in 2004,[37] and another 25% in 2005.[38] These studies confirm that executive compensation in general, and CEO compensation in particular, has grown considerably in the past few decades.

CEO compensation dipped during the financial crisis but appears to have rebounded.[39] In 2007, median CEO pay at S&P 500 companies was about $9 million.[40] In 2008, median pay fell for the first time since 2002, dropping 6.8% to approximately $8.4 million.[41] Such a drop stemmed from the fact that in 2008 median bonuses and incentive cash payments fell 27%, though base salaries rose by 3%.[42] Median CEO pay fell again in 2009 by 7.9% to $7.5 million.[43] In 2010,

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31. *See* Barris, *supra* note 18, at 63–64; Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 284 (2005); Hansen & Strauss, *supra* note 15.

32. Jensen et al., *supra* note 1, at 24–25; *see also* Barris, *supra* note 18, at 64 (revealing that stock options represent the fastest growing component of compensation packages). Studies also suggest that executive compensation increased due to an increased frequency of filling CEO vacancies externally, as opposed to locating new CEOs inside the firm. *See* Jensen et al., *supra* note 1, at 32–34.

33. Barris, *supra* note 18, at 60.

34. Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 6 (2000).

35. Bebchuk & Grinstein, *supra* note 31, at 285.

36. *Id*.

37. Hansen & Strauss, *supra* note 15.

38. *Id*.

39. *See generally* Mira Ganor, *Agency Costs in the Era of Economic Crisis: The Enhanced Connection Between CEO Compensation and Corporate Cash Holdings*, 55 ARIZ. L. REV. 105 (2013).

40. Press Release, Equilar, Inc., CEO Pay Drops 4.0% to $2.7 Million. Bonuses Fall 22.6% (Apr. 7, 2009) [hereinafter CEO Pay Drops], *available at* http://www.equilar.com/company/press-release/press-release-2009/ceo-pay-falls-6.8-in-first-drop-since-2002-bonuses-cut-by-20.6.html (noting that median CEO salaries in 2007 were $9,061,057).

41. *Id*.

42. *See* Del Jones & Barbara Hansen, *CEO Pay Packages Sink with the Economy*, USA TODAY, May 4, 2009, at 1B; *see also* CEO Pay Drops, *supra* note 40 (noting a 20.6% drop in median bonuses and a 5.7% rise in median base salary at S&P firms from 2007 to 2008). The SEC requires corporations to value stocks options as if they were exercised on the grant date, which could inflate or deflate CEO's compensation. *See* Jones & Hansen, *supra*. In 2008, it was estimated that 90% of CEO options were under water, meaning that their "current stock price [was] too low to yield a profit." *Id.* Hence, the actual value of CEO compensation, incorporating such options, was considerably lower. Of

CEO compensation returned to its 2007 levels with median CEO pay totaling about $9 million, a 27% jump from 2009.[44]

In addition to the tremendous growth in CEO compensation, the gap between CEO wages and those of the average worker[45] has grown considerably over the decades. In 1960, the average CEO made 40 times as much as the average worker.[46] In 1991, CEOs received 140 times the average worker's pay.[47] In 2001, this ratio peaked at 525 to 1.[48] In 2003, the ratio of CEO pay to average worker pay fell to 301 to 1 and then rose to 431 to 1 in 2004.[49] Currently, empirical data reflects a ratio of anywhere from 400 to 1 to about 300 to 1.[50]

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course, restricted stock and options were issued in 2009 at low strike prices. *See id.* Therefore, such grants may be considerably more valuable once stock prices rise. *See id.* Moreover, many companies either reprice or reissue options if they become valueless. *See* BEBCHUK & FRIED, *supra* note 18, at 165; Davis, *supra* note 5, at 431–32.

43. Press Release, Equilar, Inc., Bucking Trend, S&P 400 CEO Compensation Rises in Equilar Pay Study (May 5, 2010), *available at* http://www.equilar.com/company/press-release/press-release-2010/overall-ceo-compensation-falls-bonuses-surge-in-sp-500-pay-study.html.

44. Matt Krantz & Barbara Hansen, *CEO Pay Soars While Workers' Pay Stalls*, USA TODAY, Apr. 1, 2011, at 1B. *But see* Daniel Costello, *The Drought is Over (at Least for C.E.O.'s)*, N.Y. TIMES, Apr. 10, 2011, at BU1 (noting that median CEO pay rose to $9.6 million, a 12% jump from 2009). In 2010, the highest paid CEO made about $84 million. *See id.*; Joann S. Lublin, *CEO Pay in 2010 Jumped 11%*, WALL ST. J., May 9, 2011, at B1.

45. For an example of one editorial that seeks to describe "average worker," see Charles Kolb, *The Value(s) of Wall Street*, HUFFINGTON POST (July 20, 2010, 2:07 PM), http://www.huffingtonpost.com/charles-kolb/the-values-of-wall-street_b_652697.html.

46. Ron Ashkenas, *Rethinking the Assumptions Behind Executive Pay*, HARV. BUS. REV. (June 22, 2010, 11:00 AM), http://blogs.hbr.org/ashkenas/2010/06/rethinking-the-assumptions-beh.html.

47. *See* BEBCHUK & FRIED, *supra* note 18, at 130–31.

48. Jeanne Sahadi, *CEO Pay: Sky High Gets Even Higher*, CNNMONEY (Aug. 30, 2005, 12:24 PM), http://money.cnn.com/2005/08/26/news/economy/ceo_pay/.

49. *Id.*

50. *See* Delman, *supra* note 6, at 598–99 (noting that the ratio of CEO pay to the average worker's pay was more than 300 to 1 in 2008); Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2027 (2007) (noting that the ratio of a CEO's pay to the average worker's pay went from approximately 40 to 1 to more than 400 to 1 by 2007); Loewenstein, *supra* note 34, at 6 (noting that from 1980 to 1995, average CEO pay increased 380% even though workers' salaries only increased by 60%); Jennifer Hicks, *Does CEO-to-Worker Pay Ratio Matter?*, SMARTBLOG ON LEADERSHIP (June 1, 2011), http://smartblogs.com/leadership/2011/06/01/does-ceo-to-worker-pay-ratio-matter/ (noting that CEOs made 336 times the pay of an average worker in 2010); Albert R. Hunt, *Letter from Washington: As U.S. Rich-Poor Gap Grows, So Does Public Outcry*, N.Y. TIMES (Feb. 18, 2007), http://www.nytimes.com/2007/02/18/world/americas/18iht-letter.4637416.html?pagewanted=all (noting that CEO pay is 400 times that of the average worker's pay).

B. Executive Compensation as Excess

Public opinion surveys consistently report that the vast majority of Americans believe executives at publicly held corporations are overpaid.[51] At least one survey reveals that about 90% of institutional investors view executives' pay as excessive.[52] Those who characterize executive compensation as excessive generally do so for one of the three reasons discussed below.

1. The Pay-for-Performance Disconnect

The most prevalent reason why shareholders and the public view executive compensation as excessive is that they believe that such compensation is not sufficiently linked to corporate performance. Hence, such groups express outrage when executives receive large pay packages while their companies' stock price or annual shareholder return is flat or deteriorating.[53]

Whatever the causes, the pay-for-performance disconnect appears to be the primary driver of discontent over executive compensation. In the context of say on pay, recent data reveals that proxy advisory firms[54]—which are entities that issue recommendations regarding how shareholders should vote—are most likely to recommend rejecting corporations' pay practices when there is a perceived pay-for-performance disconnect.[55] Similarly, the primary reason shareholders give for

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51. *See, e.g.*, Press Release, Humphrey Taylor, Chairman, Harris Interactive, Polls Find Strong Populist Mood in Europe and to a Lesser Extent in the USA 3 tbl.4 (July 25, 2007), *available at* http://www.harrisinteractive.com/vault/Harris-Interactive-Poll-Research-FT-Globalization-2007-07.pdf (revealing that 77% of Americans believe that executives are over paid); *RBJ Snap Poll: CEOs of Public Companies Are Overpaid*, ROCHESTER BUS. J. (May 27, 2011), http://www.rbj.net/print_article.asp?aID=187715 (noting that 86% respondents to an RBJ Daily Report Snap Poll said CEOs of U.S. companies are given too much money).

52. Press Release, Towers Watson, Institutional Investors Dissatisfied with U.S. Executive Pay System, Watson Wyatt Study Finds (Dec. 13, 2005), *available at* http://www.watsonwyatt.com/render.asp?catid=1&id=15518.

53. *See* THE CONFERENCE BD., *supra* note 5, at 7, 9 (noting that public anger over executive compensation relates to the overall increase in pay but also to pay arrangements that appear unrelated to performance). In their seminal book, *Pay Without Performance*, Lucian Bebchuk and Jesse Fried illustrate the widespread pay-for-performance disconnect at public companies and advance theories for its root causes, as well as potential solutions. *See* BEBCHUK & FRIED, *supra* note 18.

54. *See* LISA M. FAIRFAX, SHAREHOLDER DEMOCRACY: A PRIMER ON SHAREHOLDER ACTIVISM AND PARTICIPATION 60–61 (2011).

55. *See* COGENT COMP. PARTNERS, SAY-ON-PAY UPDATE: VOTING RESULTS AND TRENDS SO FAR 4–5 (June 1, 2011), *available at* http://www.cogentcompensation.com/images/resources/SayOnPayUpdate_June2011.pdf; MICHAEL R. LITTENBERG ET AL., SCHULTE ROTH & ZABEL LLP, THE VOTES ARE IN—DECONSTRUCTING THE 2011 SAY ON PAY VOTE 2 (2011), *available at* http://www.srz.com/files/News/dbf0ba31-2627-402c-b211-3a6cc3e83295/Presentation/NewsAttachment/643250b0-a583-444c-9011-05277889fc1e/062811_The_Votes_Are_In_Deconstructing_the_2011_Say_on_Pay_Vote.pdf (revealing that Institutional Shareholder Services ("ISS") pinpointed a pay-for-performance disconnect at 31 of the 36 companies whose pay packages were rejected by shareholders).

rejecting a company's pay package relates to pay-for-performance issues.[56] For example, shareholders rejected the pay arrangements at a company in which the CEO received a $6.7 million increase in pay while the company's one-year shareholder return was negative 10.3% and its three-year return was negative 30.6%.[57] Then too, in each of the lawsuits filed after a negative say on pay vote, shareholders claimed that there was a disconnect between executive pay and company performance.[58]

During the financial crisis, the disconnect between pay and performance drove compensation issues into the spotlight. For instance, public anger skyrocketed upon learning of the decision by American International Group ("AIG") to pay its executives bonuses totaling $165 million on the heels of receiving more than $170 billion in bailout funds from the federal government.[59] Such outrage prompted Congress to pass laws prohibiting companies, which receive financial assistance, from awarding incentive pay, applying a 90% tax to AIG and other firms that accepted large sums of federal bailout funds,[60] and ultimately imposing laws prohibiting TARP companies from paying bonuses.[61] Similar outrage followed news that the head of Lehman Brothers Holding, Inc. ("Lehman Brothers"), made some $480 million in the years preceding the bank's historic collapse in 2008.[62] The public's fury was ignited again upon learning that Merrill Lynch & Company, Inc. ("Merrill Lynch"), paid $3.6 billion in bonuses after losing about $27 billion and receiving $10 billion in TARP funding.[63] Indeed, the New York Attorney General issued a report revealing that nine banks issued $32.6 billion in bonuses in 2008 while receiving $175 billion of funding from the

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56. TED ALLEN ET AL., INSTITUTIONAL S'HOLDER SERVS., 2011 U.S. POSTSEASON REPORT 5 (Sept. 29, 2011), *available at* http://www.issgovernance.com/files/private/2011_US_PostSeason_Report_0929.pdf.

57. *Id.* at 7.

58. *See* William Alan Nelson II, *Ending the Silence: Shareholder Derivative Suits and Amending the Dodd–Frank Act so "Say on Pay" Votes May be Heard in the Boardroom*, 20 U. MIAMI BUS. L. REV. 149, 172–74 (2012); *infra* Part II.C (discussing suits).

59. *See* Edmund L. Andrews & Peter Baker, *A.I.G. Planning Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES, Mar. 15, 2009, at A1; *see also* Helene Cooper, *Obama Orders Treasury Chief to Try to Block A.I.G. Bonuses*, N.Y. TIMES (Mar. 16, 2009), http://www.nytimes.com/2009/03/17/us/politics/17obama.html?fta=y; Jonathan Weisman et al., *Political Heat Sears AIG*, WALL ST. J., Mar. 17, 2009, at A1.

60. *See* Carl Hulse & David M. Herszenhorn, *House Approves 90% Tax on Bonuses After Bailouts*, N.Y. TIMES, Mar. 20, 2009, at A1.

61. *See* 12 U.S.C. § 5221(b)(3)(D) (2012)) (requiring TARP companies to prohibit the payment of bonuses).

62. Jim Puzzanghera, *Lehman Chief Grilled on Pay, Leadership of Company*, BOS. GLOBE (Oct. 7, 2008), http://www.boston.com/business/articles/2008/10/07/lehman_chief_grilled_on_pay_leadership_of_company/.

63. *See* ANDREW CUOMO, NO RHYME OR REASON: THE 'HEADS I WIN, TAILS YOU LOSE' BANKS BONUS CULTURE 10 (July 30, 2009), *available at* http://www.ag.ny.gov/sites/default/files/press-releases/archived/Bonus%20Report%20Final%207.30.09.pdf; Michael J. de la Merced & Louise Story, *Nearly 700 at Merrill in Million-Dollar Club*, N.Y. TIMES, Feb. 12, 2009, at B1.

government.[64] The report fueled sentiments of outrage, as well as congressional reform efforts.[65]

2. Parachutes as Good as Gold

The second concern regarding executive compensation relates to executives who receive exit packages after overseeing a corporation whose performance has declined.[66] These exit packages, known as "golden parachutes," mushroomed during the takeover movements in the 1980s.[67] During that period, executives began contracting for exit packages that would compensate them in the event of being fired after a takeover or some other change of control.[68] Golden parachutes can be viewed as an anti-takeover device because their existence made it more costly to terminate incumbent executives, thereby either increasing the cost of a potential takeover or ensuring that executives would remain in the office post-takeover.[69] Since the 1980s, golden parachutes have become a fixture of executive pay packages.[70]

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64. *See* CUOMO *supra* note 63, at 5–6.

65. *See* Louise Story & Eric Dash, *Bankers Reaped Lavish Bonuses During Bailouts*, N.Y. TIMES, July 31, 2009, at A1; Karen Freifeld, *Banks Paid $32.6 Billion in Bonuses Amid U.S. Bailout (Update4)*, BLOOMBERG (July 30, 2009, 5:38 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aHURVoSUqpho.

66. *See* Miriam A. Cherry & Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 MINN. L. REV. 368, 374 (2009); Josh Fineman, *Nardelli Exit Package Called 'Outrage," May Heighten Pay Debate*, BLOOMBERG (Jan. 3, 2007, 4:59 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aI7fAyAMAi2A. Shareholders also have expressed concern about so-called "golden coffins"—benefits paid upon the death of an executive that significantly exceed life insurance or other payments typically made to employees. *See* THE CONFERENCE BD., *supra* note 5, at 22. In 2009, there was significant shareholder support for shareholder proposals seeking to curb golden coffin benefits. Subodh Mishra, *Governance Proposals: Support for Reform Grows*, *in* RISKMETRICS GROUP POSTSEASON REPORT 2009: A NEW VOICE IN GOVERNANCE: GLOBAL POLICYMAKERS SHAPE THE ROAD TO REFORM 13, 13–14 (Oct. 2009), *available at* https://www.governanceexchange.com/repository/KnowledgeGateway/pubs/2009_PSR_Client_final.PDF.

67. Richard P. Bress, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 955–58 (1987).

68. *See id.* at 955–60*; see also* Cherry & Wong, *supra* note 66, at 374.

69. *See* Robert A. Prentice, *Target Board Abuse of Defensive Tactics: Can Federal Law Be* Mobil*ized to Overcome the Business Judgment Rule?*, 8 J. CORP. L. 337, 341 (1983); Oliver Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1218 n.63 (1984). *But see* Bress, *supra* note 67, at 955–62 (noting that golden parachutes may be beneficial to companies prone to engage in takeover activity because they may reduce the risks associated with takeovers and help align executives' incentives with those of shareholders).

70. Jensen et al., *supra* note 1, at 28–29. In 2000, 70% of the largest 1,000 companies had change-in-control agreements, as opposed to 41% in 1988. *Id.* at 29. Such agreements typically incorporate golden parachutes. *See* Hansen & Strauss, *supra* note 15 (noting that golden parachute payments have become "boilerplate").

One of the most notable cases involved the CEO of The Walt Disney Company ("Disney"), who received a $140 million severance package after working at the company just over 14 months.[71] The pay package ignited shareholder outrage, spurring several lawsuits, as well as several shareholder campaigns aimed at gaining more influence over directors and their pay decisions.[72] Golden parachute arrangements also have drawn shareholders' ire during the financial crisis. Shareholders fumed when Home Depot's CEO received a $210 million severance package after overseeing a company whose stock price had fallen by 12% during his five-year tenure while the stock price at the company's biggest competitor had increased by 173%.[73] Shareholders also expressed outrage when Merrill Lynch's CEO received some $161 million as exit pay a week after the company reported a $7.9 billion write-down from subprime mortgage losses—the largest loss in the corporation's history.[74] Similarly, the CEO of Citigroup, Inc. ("Citigroup"), received about $68 million upon his departure, including a car and driver "for the lesser of five years or until he commences full time employment with another employer" after presiding over a company whose losses resulted in $7.2 billion dollars of write-downs.[75] Similar to executive compensation, shareholders express concern about golden parachutes primarily when there appears to be no link between them and corporate performance.[76]

3. Pay Inequity

Some shareholders insist that executive pay should be more closely aligned with the pay of average workers. Additionally, some investors share the

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71. *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 350 (Del. Ch. 1998).

72. *See* Brehm v. Eisner, 746 A.2d 244 (Del. 2000); *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003); *In re Walt Disney Co.*, 731 A.2d at 353. Shareholder outrage led to a "withhold the vote" campaign against Disney's CEO and board chair, resulting in 45% of the shareholder votes being withheld—at the time, one of the largest withholdings in history. Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 OHIO ST. L.J. 53, 62 (2008).

73. Fineman, *supra* note 66; Joe Nocera, *The Board Wore Chicken Suits*, N.Y. TIMES, May 27, 2006, at C1.

74. Tomoeh Murakami Tse, *Merrill CEO Steps Down, Leaves Firm in Crisis*, WASH. POST, Oct. 31, 2007, at D01. Interestingly, the board did not give the CEO severance pay. *Id.* Instead, his exit package primarily included unexercised stock options and stock awards. *Id.* The lack of severance pay prompted some to mute their criticism of the pay package. *Id.*

75. *See In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 114, 138 (Del. Ch. 2009). Such pay led to a shareholder lawsuit. *Id.* Shareholders also brought suit alleging that that directors should be held liable for failing to monitor the risk the company faced resulting from investment in subprime mortgages, as well as for failing to properly disclose the company's exposure to such risk. *Id.* at 126, 131–32.

76. *See* Del Jones & Edward Iwata, *Top Executives' Pay Takes a Hit*, USA TODAY, Sept. 29, 2008, at 4B (discussing exit pay by some firms during the crisis and noting that golden parachutes have long been a "sore point" with investors). In the U.K., shareholders view generous golden parachutes as particularly egregious because they are deemed to be "rewards for failure." *See* Fabrizio Ferri & David A. Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK*, 17 REV. FIN. 527, 527 (2013).

sentiment that CEO pay should be no more than 100 times that of the average worker.[77] From this perspective, the increasing gap between executive pay and that of the average worker makes executive compensation excessive.[78] During the crisis, this gap was amplified when CEO salaries increased while the unemployment rate steadily rose and average worker pay increased only slightly.[79]

C. Debating the Excess

There are some commentators who insist that most executive pay should not be characterized as excessive.[80] First, even though headlines are replete with stories about executives receiving lavish pay packages despite their companies' lackluster performance, these headlines may distort the actual compensation picture. For example, some CEOs agreed to forego salaries and bonuses during the height of the crisis.[81] Also, some studies indicate that CEO pay fell as profits fell during the crisis and that CEO pay has recently recovered as profits and stock prices have begun their recovery.[82] This suggests that executive pay, in some cases, is in sync with corporate performance.

Second, it is arguable that so long as the market dictates pay practices, it is inappropriate to characterize compensation as excessive.[83] The board's primary responsibility is to hire a top-performing CEO.[84] Because executives are in short

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77. Hicks, *supra* note 50, at 2 (discussing a survey where approximately 51% of respondents indicated that CEO salaries should be no more than 100 times that of the average worker).

78. *See* Delman, *supra* note 6, at 599 (noting that some shareholders and Americans view this disparity as a social injustice).

79. *See* Costello, *supra* note 44; Krantz & Hansen, *supra* note 44 (noting that CEO pay increased 27% in 2010 while average worker pay only increased by 2.1%).

80. Loewenstein, *supra* note 34, at 3–4.

81. Jones & Hansen, *supra* note 42. Seventy-nine CEOs received no bonuses and six CEOs either took no salary or a $1 salary in 2008. *Id.*

82. *See* Kantz & Hansen, *supra* note 44; EQUILAR, INC., 2009 PROXY SEASON TRENDS 6–7 (Apr. 23, 2009) (demonstrating that CEO pay decreased at poorly performing firms and that bonus payments fell by 65.2% at the worst performing firms), *available at* http://www.naspp.com/ChapterEventFiles/e2902_Equilar_Proxy_Season_Trends_for_MN_NASPP_on_04_23_2009.pdf.

83. *See* Michael B. Dorff, *Does One Hand Wash the Other?: Testing the Managerial Power and Optimal Contracting Theories of Executive Compensation*, 30 J. CORP. L. 255, 267 (2005) (noting the theory that when executive compensation is set by an efficient market, it is difficult to describe such compensation as excessive); Loewenstein, *supra* note 34, at 2 (pointing out the theory that free market controls compensation and thus executives cannot be considered overpaid); Nicholas Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959, 975–78 (1980) (noting that market forces dictate executive compensation).

84. AM. BAR ASS'N COMM. ON CORPORATE LAWS, CORPORATE DIRECTOR'S GUIDEBOOK § 4 (6th ed. 2011) (noting that a director's principal responsibility is to hire top management, which includes establishing and evaluating their compensation); Simmons, *supra* note 1, at 310; BUS. ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE 2010, at 7 (Apr. 2010), *available at* http://businessroundtable.org/uploads/studies-reports/downloads/2010_Principles_of_Corporate_Governance_1.pdf ("Making decisions regarding the

supply, and demand for executives is high, companies must expend significant resources to hire and retain them.[85] Moreover, the difference in pay reflects differences in levels of contribution because executives not only may contribute more than other workers, but also, may have a greater impact on corporate performance.[86] This is why it may be inappropriate to measure executive compensation against that of average worker pay or to otherwise use the ratio to characterize executive pay as too lavish.

Third, although many agree that pay must be aligned with performance, it is not clear how best to achieve such a result.[87] Indeed, outrage over executive compensation may reflect an inadequate understanding of executive compensation policies and practices. On the one hand, corporations rely on a variety of different metrics to set pay.[88] Hence, it may be unfair to critique executive pay based on only one metric—its relationship with overall corporate performance. On the other hand, compensation experts cannot necessarily predict the impact of pay practices. Some practices produce unintended consequences. As one scholar points out, there used to be "little doubt" among the most influential corporate-law scholars that emphasizing stock-based pay would align managers' incentives with shareholders' interests.[89] Yet this presumption has been proven false. Such pay not only has spurred rises in compensation packages, but has also created misalignment between executive pay and performance.[90] In light of the complexity associated with executive compensation decisions, defenders of the current system argue that

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selection, compensation and evaluation of a well-qualified and ethical CEO is the single most important function of the board.").

85. Bebchuk & Grinstein, *supra* note 31, at 298; *see* Jensen et al., *supra* note 1, at 32–34 (noting that CEO compensation increased when corporations began hiring CEOs from outside of their company instead of from within their internal candidate pool).

86. *See* Pak, *supra* note 4, at 638–39 (pinpointing the argument that the difference between executive and worker pay reflects executives' greater contribution to corporate success).

87. *See* Dorff, *supra* note 83, at 267 (noting that the question of what constitutes excessive compensation is "almost impossible to answer"); Loewenstein, *supra* note 1, at 206–07 (pinpointing a complex set of questions that must be addressed when seeking to set executive compensation at an appropriate level); Loewenstein, *supra* note 34, at 5 (noting that the supply and demand for workers may have reduced their bargaining power to demand higher wages); Pak, *supra* note 4, at 641 ("[C]orrelating pay to performance may be a herculean task which defies easy comprehension and quick solutions.").

88. Simmons, *supra* note 1, at 310–12.

89. Cunningham, *supra* note 18, at 1190.

90. *See id.* at 1195–97. Professor Cunningham points out that when corporations compensate boards with stock-based pay, managers' incentives may become misaligned with shareholders in at least three ways: (1) managers become fixated on current stock price in a manner that undermines a focus on long-term value; (2) such fixation causes managers to be tempted to distort financial records and financial performance; and (3) managers prefer stock repurchases to cash dividends, even when such repurchases are less beneficial to most shareholders. *Id.* at 1195–96. In short, a focus on stock-based compensation for boards has the unintended consequence of causing boards to focus on issues at odds with shareholders in an effort to buttress stock performance, and thus, boards' overall compensation.

so long as boards make reasonable efforts to align profits with performance, the ultimate pay award should not be viewed as excessive.

Critics nevertheless insist that the current executive-compensation system is flawed. In particular, several commentators have advanced a managerial-power theory demonstrating and undermining the view that pay arrangements result from an arms-length, market-based bargaining system.[91] Instead, the theory indicates that too often compensation reflects dominance by the CEO or other influences that distort pay arrangements.[92] In other words, boards are captured by management and make decisions that benefit executives at shareholders' expense.[93] At least some evidence supports this board-capture theory, revealing a significant divide between pay and performance.[94] Thus, anecdotal evidence and studies demonstrate that during the financial crisis executive pay remained the same at many companies even as their profits or revenues fell.[95] Other studies show that bonuses and overall compensation at some firms did not vary significantly even as profits diminished.[96] But others indicate that pay and bonuses at many other companies rose sharply even though shareholder returns and profits decreased.[97]

Ultimately, as Lucian Bebchuk and Holger Spamann note, after the financial crisis, the notion that that our current pay system is problematic mostly because of a pay-for-performance disconnect has become "widely accepted."[98] As this next Section pinpoints, there is also general agreement that accountability may be the cure to this misalignment.

D. Accountability as Cure for the Excess

Directors have a fiduciary responsibility to ensure that CEO and executive pay is set at an appropriate level. Some even consider decisions related to the selection and compensation of the CEO and senior executives to be the

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91. *See* BEBCHUK & FRIED, *supra* note 18, at 64–66; Andrew Bethune, *An Efficient "Say" on Executive Pay: Shareholder Opt-In As a Solution to the Managerial Power Problem*, 48 HOUS. L. REV. 585, 595–98 (2011); Dorff, *supra* note 83, at 267–68; Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 866–67 (2008).

92. *See* BEBCHUK & FRIED, *supra* note 18, at 61–62.

93. *See id.*

94. *See* Barris, *supra* note 18, at 65; Dorff, *supra* note 83, at 268–69.

95. *See* Lucian A. Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REG. 257, 257–62 (2010); Janice McClendon, *The Perfect Storm: How Mortgage-Backed Securities, Federal Deregulation, and Corporate Greed Provide a Wake-Up Call for Reforming Executive Compensation*, 12 U. PA. J. BUS. L. 131, 138–39 (2009); *see also* Story & Dash, *supra* note 65.

96. *See* CUOMO, *supra* note 63, at 1.

97. *See* EQUILAR, INC., *supra* note 82, at 6.

98. *See* Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 249–50 (2010) (noting that, in the aftermath of the financial crisis, the view that there are flaws in the compensation arrangements has become "widely accepted").

board's primary function.[99] Public company boards delegate this function to the compensation committee, though all directors are ultimately responsible for executive pay decisions.

In light of this responsibility, if executive compensation is excessive, then boards have failed in their fiduciary obligations. Hence, executive pay critics consistently assert that boards have done an inadequate job not only with respect to devising compensation packages, but also in relation to developing appropriate executive pay policies and practices.[100]

The most dominant rationale for this inadequacy is the board-capture theory. Pursuant to this theory, managers have considerable influence over boards in part because managers play a significant role in the director nomination process.[101] Because boards feel beholden to CEOs and other senior executives, they fail to provide any meaningful check on executive compensation packages.[102] Instead, executives dictate the terms of those packages.[103] Moreover, directors are too often at an informational disadvantage when assessing and approving compensation packages.[104] As a result, they defer to executives or other corporation managers who may have more expertise and experience.[105] The board-capture theory posits that executive pay arrangements are not the result of an arms-length bargaining process but instead tend to benefit executives at the expense of the corporation and its shareholders.

The antidote to board capture is to enhance board accountability, ensuring that boards are properly incentivized to focus on the interest of the corporation and its shareholders when crafting pay policies.[106] As the SEC noted, the financial

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99. BUS. ROUNDTABLE, *supra* note 84 ("Making decisions regarding the selection, compensation and evaluation of a well-qualified and ethical CEO is the single most important function of the board."); AM. BAR ASS'N COMM. ON CORPORATE LAWS, *supra* note 84 (noting that a director's principal responsibility is to hire top management, which includes establishing and evaluating their compensation).

100. *See* THE CONFERENCE BD., *supra* note 5, at 9; BEBCHUK & FRIED, *supra* note 18, at 61.

101. BEBCHUK & FRIED, *supra* note 18, at 80; Thomas & Wells, *supra* note 18, at 852–53.

102. BEBCHUK & FRIED, *supra* note 18, at 80; Thomas & Wells, *supra* note 18, at 852–53.

103. *See* BEBCHUK & FRIED, *supra* note 18, at 80; Thomas & Wells, *supra* note 18, at 852–53.

104. *See* Thomas & Wells, *supra* note 18, at 851.

105. BEBCHUK & FRIED, *supra* note 18, at 80; *see also* Thomas & Wells, *supra* note 18, at 852–54.

106. Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. CORP. L. 647, 672–73 (2005); *CEO Compensation in the Post-Enron Era: Hearing Before the S. Comm. on Commerce, Sci., and Transp.*, S. Hrg. 108-893, 108th Cong. (2003) (statement of Damon A. Silvers, Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations) ("[W]e believe that solutions to the problem of executive pay require at minimum good disclosure to investors and the public and real accountability of boards . . . ."), *available at* http://www.gpo.gov/fdsys/pkg/CHRG-108shrg97981/html/CHRG-108shrg97981.htm.

crisis caused many to question whether boards of directors are truly held responsible for the decisions that they make, including "whether boards need to be more accountable for their decisions regarding such issues as compensation structures . . . ."[107]

Reforms therefore seek to enhance board accountability by reducing boards' dependency on managers and increasing the extent to which they feel compelled to pay heed to the concerns of shareholders, concerns of the public, and the interests of the corporation more generally.[108] In its report on responses to the financial crisis, one group of governance experts emphasized that "[*g*]*reater board accountability to shareholders is essential to improve executive compensation practices*."[109] Indeed, reformers believe that increased disclosure surrounding executive compensation will make directors more accountable for those decisions by increasing shareholder and public awareness of the nature of their decisions and potential problems related thereto.[110] The compensation reforms under Dodd–Frank also seek to enhance board accountability. Reflecting this aim, the compensation reforms in Dodd–Frank appear under the heading "Accountability and Executive Compensation."[111]

Although fiduciary duty law is the primary accountability mechanism under state law, most reforms ignore or actively shun such law. Instead, reforms have focused on other measures, including, most recently, say on pay. Part II discusses say on pay and its potential to enhance accountability, while Part III reveals why fiduciary law has been shunned in favor of say on pay.

II. SAY ON PAY AND ACCOUNTABILITY

A. Say on Pay Has Its Day

During the financial crisis, many different reforms emerged to enhance board accountability related to executive compensation. Those reforms ranged from outright restrictions on pay packages to enhanced disclosure related to

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107. Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm'n, Speech by SEC Chairman: Statement at SEC Open Meeting on Facilitating Shareholder Director Nominations (May 20, 2009), *available at* http://www.sec.gov/news/speech/2009/spch052009mls.htm.

108. *See* Simmons, *supra* note 1, at 335–37 (noting perception that most believe executive compensation reform should focus on subjecting compensation decisions to greater accountability).

109. *SEE* IRA MILLSTEIN ET AL., MILLSTEIN CTR. FOR CORP. GOVERNANCE & PERFORMANCE, AGENDA FOR PRIVATE SECTOR REFORM: OMNIBUS POLICY RECOMMENDATIONS FOR A POST-CRISIS MARKET 14 (2009), *available at* http://millstein.som.yale.edu/sites/millstein.som.yale.edu/files/Policy%20Briefing%20No%206-Omnibus.pdf.

110. Stephen Labaton, *Spotlight on Pay Could Be a Wild Card*, N.Y. TIMES, Apr. 9, 2006, at BU1 (quoting former SEC Chairman Christopher Cox as saying, "when people are forced to undress in public, they'll pay more attention to their figures").

111. Dodd–Frank, Pub. L. No. 111-203, tit. X, subtit. E, 124 Stat. 1376, 1899–1908 (2010) (codified at 12 U.S.C. § 5641 (2012) and scattered sections under title 15 of the U.S. Code).

executive compensation.[112] The federal government even appointed a so-called pay czar to oversee and approve the executive pay arrangements at certain companies receiving TARP funds.[113]

Amidst these reforms, say on pay has garnered considerable attention and support. As one commentator noted, say on pay emerged from "a novel idea at the margins of the executive pay debate to center stage as the leading hope for ensuring that shareholders have a voice in the compensation-setting process."[114] Increasingly, shareholders have expressed support for say on pay.[115] In response,

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112. *See* Michael B. Dorff, *Confident Uncertainty, Excessive Compensation & the Obama Plan*, 85 IND. L.J. 491, 529–51 (2010) (describing and critiquing various reforms). Reforms aimed at curbing executive compensation run the gamut. Some reforms, called clawbacks, require executives to return bonuses or other incentive-based compensation if it is later determined that the corporation must restate its earnings or if bonuses or similar compensation were awarded during a period in which it is determined that the corporation has engaged in fraud. *See* Simmons, *supra* note 1, at 347. Other reforms also have focused on ways to limit executive compensation. For example, TARP guidelines have restricted compensation for performance to one-third of an executive's securities compensation package. *See Executive Compensation: Plan, Preform & Pay*, DELOITTE, http://www.deloitte.com/view/en_US/us/Services/additional-services/chief-financial-officer/6297c38dfe289210VgnVCM200000bb42f00aRCRD.htm (last updated July 14, 2010). The Obama administration also cut executive salaries of certain companies receiving government bailouts by about 50%. *See* Stephen Labaton, *U.S. Will Order Pay Cuts at Firms with Bailout Aid*, N.Y. TIMES, Oct. 22, 2009, at A1. Dodd–Frank has various executive compensation disclosure requirements including a provision requiring companies to disclose the median annual total compensation of all their employees, excluding the CEO; the annual total compensation of the CEO; and the ratio between the two. Dodd–Frank § 953(b). In June 2011, the House Financial Services Committee passed an act seeking to repeal Section 953(b) and to make any regulations issued pursuant to it have no force or effect. Cydney Posner, *Bill to Repeal Required Dodd–Frank Disclosure Regarding Internal Pay Equity,* COOLEY, LLP (June 24, 2011), http://www.cooley.com/65216. Disclosure on executive compensation dates back to at least 1992 when the SEC responded to concerns regarding heightened executive pay by passing disclosure rules requiring companies to disclose the compensation of top executives in the proxy statement. *See* Simmons, *supra* note 1, at 342–43.

113. Deborah Solomon, *White House Set to Appoint a Pay Czar*, WALL ST. J., June 5, 2009, at A2. The administration appointed Kenneth Feinberg to be the special master for compensation. Stephen Labaton, *Treasury to Set Executives' Pay at 7 Ailing Firms*, N.Y. TIMES, June 11, 2009, at A1.

114. COMPENSIA, INC., *supra* note 8, at 6.

115. Say on pay initially emerged through the shareholder proposal process, pursuant to which shareholders submit proposals on the corporation's proxy statement to be voted on by other shareholders. The first say on pay proposals appeared in 2006. *See* Reeder, *supra* note 10, at 139; Lisa M. Fairfax, *Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power*, 3 VA. L. & BUS. REV. 1, 11 (2008); Allan Sloan, *Aflac Looks Smart on Pay*, WASH. POST, May 29, 2007, at D01 (noting that such proposals were sponsored by the American Federation of State, County & Municipal Employees). In 2007, shareholders submitted over 60 say on pay proposals, averaging 40% shareholder support. *See* LATHAM & WATKINS LLP, *supra* note 12. By 2009, shareholders submitted more than 100 such proposals, making it the most

some corporations voluntarily adopted it.[116] Although there was some support for say on pay at the federal level,[117] that support increased dramatically during the financial crisis. Thus, in 2009, federal legislation required companies receiving TARP funds to hold an annual say on pay vote until the funds were repaid.[118] As a result, more than 300 companies were required to hold say on pay votes.[119]

In 2010, Dodd–Frank made say on pay a permanent feature of the corporate governance landscape.[120] Under Dodd–Frank, public companies must provide an advisory vote on the compensation of the five most highly compensated executives.[121] This includes the CEO, CFO, and the next three most highly compensated executives. Companies must provide a say on pay vote at least once every three years.[122] However, Dodd–Frank gives shareholders a voice in determining the frequency of the say on pay vote. Thus, companies must conduct a

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dominant shareholder proposal of the year. *See* Reeder, *supra* note 10, at 2; *see also* RiskMetrics Grp., *2009 Proxy Season Scorecard*, RISKMETRICS GRP. (Dec. 15, 2009), http://www.shareholderforum.com/sop/Library/20091215_RiskMetrics-Scorecard.pdf (reflecting that say on pay was the most prevalent shareholder proposal submitted in 2009). In 2009, the average shareholder support for shareholder-sponsored say on pay proposals had risen to about 41%, with almost three times as many proposals receiving majority support as compared to 2008. *See* Randall Thomas et al., *Dodd–Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213, 1242 (2012).

116. In response to a 2006 shareholder proposal, Aflac was the first company to make such an announcement, and in 2008, Aflac became the first company to hold a say on pay vote. *See* Sloan, *supra* note 115; *see also* Press Release, Aflac, Aflac Moves Up 'Say-on-Pay' Shareholder Vote to 2008, *available at* http://www.aflac.com/aboutaflac/pressroom/pressreleasestory.aspx?rid=1078006 (last visited Feb. 17, 2013); Press Release, Cheryl Kelly, AFSCME, More than 50 Companies Voluntarily Adopt "Say on Pay" as Institutional Investors Continue to Press for an Advisory Vote (Mar. 2, 2010), *available at* http://www.waldenassetmgmt.com/social/action/SOP_3-2-10.pdf. By early 2010, more than 50 companies had announced an intention to provide say on pay, including Apple, Blockbuster, and Motorola. *See id.*

117. In 2007, the House passed a say on pay bill. *See* Shareholder Vote on Executive Compensation Act, H.R. 1257, 110th Cong. § 2 (2007), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-110hr1257rfs/pdf/BILLS-110hr1257rfs.pdf. Then-Senator Barack Obama sponsored the companion say on pay bill in the Senate, but it failed to muster the necessary votes. *See* Shareholder Vote on Executive Compensation Act, S. 1181, 110th Cong. (2007), *available at* http://www.govtrack.us/congress/bills/110/s1181. In 2009, members of both the House and Senate proposed say on pay provisions in bills aimed at responding to the financial crisis. *See* Shareholder Empowerment Act of 2009, H.R. 2861, 111th Cong. (2009), *available at* http://www.govtrack.us/congress/bill.xpd?bill=h111-2861; Shareholder Bill of Rights Act of 2009, S. 1074, 111th Cong. (2009), *available at* http://law.du.edu/documents/corporate-governance/legislation/bill-text-shareholders-bill-of-rights-act-of-2009.pdf.

118. *See* 12 U.S.C. § 5221 (2012).

119. *See* Reeder, *supra* note 10; Weaver et al., *supra* note 10, at 24.

120. Dodd–Frank Act § 951.

121. *Id.* § 951(a)(1).

122. *Id.*

nonbinding "say on frequency" vote at least once every six years.[123] Pursuant to the vote, shareholders can recommend whether to have a say on pay vote annually, every two years, or every three years.[124] These say on pay rules took effect on January 21, 2011, for all large public companies but were delayed by two years for smaller companies.[125]

In certain circumstances, Dodd–Frank also requires companies to hold a say on pay vote for golden parachute arrangements in connection with mergers, acquisitions, consolidations, or sale of all, or substantially all, of the company's assets.[126] When shareholder approval is required for such transactions, companies must also seek a separate say on pay vote related to golden parachute arrangements between the target company and executives, unless the golden parachute arrangements were included in disclosures comprising a company's prior say on pay vote.[127] These golden parachute provisions took effect for proxy statements filed on or after April 25, 2011.[128] These say on pay votes on overall compensation and golden parachutes respond to two of the primary shareholder concerns animating the executive pay debate.

B. Say on Pay as Accountability Cure

Although there is considerable debate about the merits of say on pay, advocates support say on pay as a critical mechanism for enhancing director accountability.[129] Based primarily on the U.K. experience, advocates insist that say on pay enhances such accountability and thus better aligns executive pay with corporate performance.[130] The most comprehensive study of the impact of say on pay in the U.K. reveals that say on pay has more closely linked pay and performance, particularly at poorly performing firms.[131] Supporters point to this data as evidence of the positive impact say on pay can have on American

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123. *Id.* § 951(a)(2).

124. *Id.*

125. Dodd–Frank characterizes small companies, and thus companies with delayed implementation of the say on pay rules, as companies with a public float of less than $75 million. *See* Christopher G. Barrett & William K. Hadler, *Final Say-on-Pay Rules Delay Requirements for Smaller Reporting Companies and TARP Recipients*, NAT'L L. REV. (Feb. 15, 2011), *available at* http://www.natlawreview.com/article/final-say-pay-rules-delay-requirements-smaller-reporting-companies-and-tarp-participants.

126. Dodd–Frank Act § 951(b).

127. *Id.* § 951(b)(2).

128. Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Rules for Say on Pay and Golden Parachute Compensation as Required Under Dodd–Frank Act (Jan. 25, 2011), *available at* http://www.sec.gov/news/press/2011/2011-25.htm.

129. *See* Nelson, *supra* note 58, at 154.

130. *See* STEPHEN DAVIS, YALE MILLSTEIN CTR. FOR CORP. GOVERNANCE & PERFORMANCE, DOES 'SAY ON PAY' WORK?: LESSONS ON MAKING CEO COMPENSATION ACCOUNTABLE 10–12 (2007), *available at* http://millstein.som.yale.edu/sites/millstein.som.yale.edu/files/Policy%20Briefing%20No%201%20'Say%20on%20Pay'.pdf; Gordon, *supra* note 12, at 337–54.

131. Ferri & Maber, *supra* note 76, at 21–22.

compensation patterns.[132] Most importantly, supporters contend that such data reveals that say on pay increases board accountability because such data indicates that say on pay votes do a good job of increasing the likelihood that boards will pay closer attention to their obligation to ensure that compensation is appropriately aligned with performance.

Critics question whether say on pay will have any impact on executive compensation practices in the United States. Some insist that the differences between America and the U.K. may undermine the extent to which similar results could occur in America.[133] Others point out that say on pay in the U.K. has had no impact on overall compensation levels, nor has it resulted in more closely connecting pay with performance at companies that perform well.[134]

Critics also fear that say on pay will negatively impact executive pay practices.[135] As an initial matter, some worry about the efficacy of giving shareholders a voice in compensation arrangements.[136] In their view, pay practices can be extremely complex, and shareholders may not have the knowledge to provide valuable input into executive compensation decisions.[137] As a result, shareholders—and hence boards—may inappropriately rely on proxy advisory firms.[138] Among other things, proxy advisory firms offer advice and guidance to shareholders regarding how to vote.[139] However, such advice may lack in quality and integrity, making over-reliance on those votes potentially problematic.[140] In particular, over-reliance on proxy advisory firms may undermine innovation in compensation practices, prompting shareholders to support overly conservative pay practices. Studies of U.K. pay practices confirm that say on pay appears to lead to an over-reliance on proxy advisors coupled with an increase in the homogenization of pay practices, which could lead to suboptimal pay arrangements at some firms.[141]

It is also possible that say on pay could lead to an increased reliance on compensation consultants in a way that could prove counterproductive and ultimately generate an increase in executive compensation at some companies. Not

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132. Gordon, *supra* note 12, at 337–40.

133. *See id.* at 352–53.

134. DAVIS, *supra* note 130, at 21–22; Ferri & Maber, *supra* note 76, at 21–26; Lund, *supra* note 13, at 127–28.

135. Even Ferri and Maber caution against interpreting their results about a positive link between pay and performance to mean that say on pay will lead to superior compensation practices. *See* Ferri & Maber, *supra* note 76, at 3–4.

136. *See* Stephen M. Bainbridge, *Is 'Say on Pay' Justified?*, REGULATION, Spring 2009, at 42, 47; William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 695 (2010); Lund, *supra* note 13, at 129–30.

137. *See* Bratton & Wachter, *supra* note 136, at 695.

138. Gordon, *supra* note 12, at 351–52. Evidence from the U.K. confirms such heightened reliance. *See* DAVIS, *supra* note 130, at 12; Ferri & Maber, *supra* note 76, at 9.

139. FAIRFAX, *supra* note 54, at 60–61.

140. *See infra* notes 230–31 and accompanying text.

141. *See* DAVIS, *supra* note 130, at 12–13; Gordon, *supra* note 12, at 351–52; Lund, *supra* note 13, at 126–27.

only do studies indicate that say on pay leads to increased reliance on compensation consultants,[142] but Dodd–Frank also encourages boards to rely on such consultants.[143] However, such reliance could have negative repercussions. A report commissioned by the House of Representatives revealed a pervasive level of conflicts of interest among compensation consultants.[144] These conflicts corresponded with higher levels of compensation. Thus, CEO salaries at companies with conflicted consultants were significantly higher than the salaries at companies that had engaged nonconflicted consultants.[145] In light of this evidence, Dodd–Frank seeks to tackle the problems associated with conflicts related to compensation consultants by implementing certain independence standards and requiring certain disclosures.[146] If these measures prove ineffective in reducing conflicts of interest associated with compensation consultants, then say on pay could also worsen pay practices at some companies.

Despite these criticisms, reformers have gravitated to say on pay based on their belief that it could enhance board accountability. By giving shareholders a voice in the compensation decision, say on pay is designed to ensure that directors feel greater responsibility toward shareholders, thereby increasing the likelihood that directors consider shareholder concerns in their compensation decisions.[147] Thus, say on pay is viewed as an antidote to board capture.

C. Say on Pay and Shareholder Derivative Suits

Some shareholders are also seeking to use say on pay to bolster director accountability through fiduciary duty rules. By August 2011, at least nine companies had been subjected to a lawsuit following a say on pay vote. Those companies include: Bank of New York Mellon;[148] Black and Decker;[149] Beazer

142. Gordon, *supra* note 12, at 351–52.

143. *See* Dodd-Frank Act § 952(b)–(c).

144. MAJORITY STAFF OF H.R. COMM. ON OVERSIGHT & GOV'T REFORM, EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS, i, 4 (2007), *available at* http://www.erieri.com/PDF/Executive-Consultant-Conflicts.pdf.

145. *Id.* at 6–7 (noting that the median salary and median salary increase were higher at companies with highly conflicted compensation consultants).

146. *See* Dodd–Frank Act § 952(a).

147. Elisse B. Walter, Comm'r, U.S. Sec. & Exch. Comm'n, Speech by SEC Commissioner: "Restoring Investor Trust Through Corporate Governance"—Remarks Before the Practicing Law Institute (Feb. 18, 2009), *available at* http://www.sec.gov/news/speech/2009/spch021809ebw.htm (noting that say on pay promotes increased board accountability); *see also* Gordon, *supra* note 12, at 337–40.

148. CLAUDIA H. ALLEN, NEAL, GERBER & EISENBERG LLP, THE LATEST IN EXECUTIVE COMPENSATION: "SAY-ON-PAY" BECOMES "SUE-ON-PAY" 1 (Oct. 2011), *available at* http://www.ngelaw.com/files/Uploads/Documents/Article_Say%20on%20Pay_Allen_1006.pdf.

149. *Stanley Black & Decker, Inc. Investor Files Lawsuit Against Directors Over Executive Pay*, S'HOLDERS FOUND., http://shareholdersfoundation.com/case/stanley-black-decker-inc-investor-files-lawsuit-against-directors-over-executive-pay (last visited Mar. 4, 2013) (describing case).

Homes USA, Inc.;[150] Cincinnati Bell, Inc.;[151] Hercules Offshore, Inc.;[152] Jacobs Engineering Group, Inc.;[153] KeyCorp;[154] Occidental Petroleum Corp.;[155] and Umpqua Holdings Corp.[156] The Bank of New York Mellon lawsuit stands out as the only such suit brought after a successful say on pay vote; the other suits followed failed say on pay votes. However, in each of the cases shareholders allege significant deviations between corporate performance and executive pay. By the end of 2011, the number of suits arising after a negative say on pay vote had risen to at least 15, representing 35% of all companies with failed say on pay votes.[157]

Such suits highlight shareholders' belief that say on pay votes should have repercussions for directors' duties. All of the cases have claims involving

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150. Shareholder Derivative Complaint on Behalf of Beazer Homes USA, Inc., Teamsters Local 237 Additional Security Benefit Fund v. McCarthy, No. 2011CV197841 (Ga. Super. Ct. Fulton Cnty. dismissed Sept. 15, 2011), *appeal docketed*, No. A12A00894 (Ga. Ct. App. Jan. 5, 2012), *available at* http://www.davispolk.com/files/uploads/ExComp/03_15_11_Beazer.pdf.

151. Verified Shareholder Derivative Complaint on Behalf of Cincinnati Bell, Inc., NECA-IBEW Pension Fund v. Cox, No. 1:11-CV-00451 (S.D. Ohio dismissed July 18, 2012), *available at* http://articles.law360.s3.amazonaws.com/0255000/255911//mnt/rails_cache/https-ecf-ohsd-uscourts-gov-doc1-14313621420.pdf.

152. *See* Verified Shareholder Derivative Complaint on Behalf of Hercules Offshore, Inc., Matthews, Sean (Derivatively on Behalf of Hercules v. Hercules Offshore Inc.), No. 201134508 (Tex. Dist. Ct. Harris Cnty. dismissed Jun. 11, 2012), 2011 WL 2455436, *available at* http://www.davispolk.com/files/uploads/ExComp/06_06_11_Matthews.pdf.

153. Shareholder Derivative Complaint on Behalf of Jacobs Engineering Group, Inc., Witmer v. Martin, No. BC454543 (Cal. Super. Ct. L.A. Cnty. dismissed Mar. 6, 2012), 2011 WL 3922597, [hereinafter Jacobs Engineering Group, Inc. Complaint], *available at* http://www.davispolk.com/files/uploads/ExComp/02_04_11_Jacobs.pdf.

154. *See* Verified Derivative Shareholder Complaint on Behalf of KeyCorp, King v. Meyer, No. CV-10-730994, (Ohio Ct. C.P. Cuyahoga Cnty. July 6, 2010), *removal docketed sub nom. In re* KeyCorp Derivative Litigation, No. 1:10CV01786 (N.D. Ohio Aug. 12, 2010), 2010 WL 4526934, *available at* http://www.davispolk.com/files/uploads/ExComp/07_06_10_King.pdf.

155. *See* Verified Shareholder Derivative Complaint on Behalf of Occidental Petroleum Corp., Gusinky v. Irani, No. BC442658 (Cal. Super. Ct. L.A. Cnty. dismissed Mar. 11, 2011), [hereinafter Occidental Petroleum Corp. Complaint], *available at* http://www.davispolk.com/files/uploads/ExComp/07_29_10_Occidental.pdf.

156. Verified Shareholder Derivative Complaint on Behalf of Umpqua Holdings Corp., Plumbers Local No. 137 Pension Fund v. Davis, No. 3:11-CV-633 (D. Or. dismissed Apr. 2, 2012), *available at* http://clients.oakbridgeins.com/clients/blog/umpqua.pdf.

157. GOOD ET AL., *supra* note 22, at 2; *see also* Beth I.Z. Boland & Sarah G. Kim, *How Companies Can Reduce Their Risk of Shareholder Litigation After a Failed "Say on Pay" Vote*, BINGHAM (June 11, 2012), http://www.bingham.com/Alerts/2012/06/Reduce-Risk-of-Shareholder-Litigation-After-Failed-Say-On-Pay-Vote (discussing the 17 say on pay suits in 2011).

fiduciary duty breaches.[158] As an initial matter, shareholders argue that failed say on pay votes reflect an independent business judgment that may negate the validity of the company's pay decisions and that such a vote should therefore rebut any presumption that the directors complied with their fiduciary duty to act in the best interests of the corporation.[159] Second, in light of the business judgment embedded in the shareholders' negative vote, shareholders contend that directors breached their duty by approving compensation packages that were inconsistent with the company's disclosed compensation policies.[160] Third, shareholders allege that directors breached their duty because compensation packages resulted in a waste of corporate assets.[161]

Despite shareholders' efforts to link say on pay with directors' duties, say on pay suits have been dismissed at the pleading stage with overwhelming frequency.[162] Most commentators appear to agree with such dismissals, arguing that say on pay suits have no traction both as a descriptive and normative matter.[163] This Article contends that such dismissals are a mistake because they ensure that fiduciary duty law plays virtually no role in the current reform effort. The next two Parts address the rationales for disregarding the role of fiduciary duty law in this area, and then challenge the validity of those rationales.

III. THE APPARENT IRRELEVANCE OF FIDUCIARY DUTY

At first glance, there are very good reasons to be both pessimistic and dismissive regarding the impact of fiduciary duty law on director decision-making regarding compensation matters. As an initial matter, courts appear unwilling to play a strong role in this area, suggesting that shareholders will face significant hurdles in their fiduciary duty litigation. Dodd–Frank and other reforms exacerbate

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158. Each of the suits names the executive compensation consultants as defendants, alleging that they aided and abetted the directors' conduct and that they breached their contracts with the corporation. *See* Nelson, *supra* note 58, at 156.

159. *See id.*

160. *See id.*

161. *See id.*

162. GOOD ET AL., *supra* note 22, at 2; Boland & Kim, *supra* note 157 (noting that only one of 17 suits had survived the motion to dismiss stage).

163. *See* Peter M. Saparoff et al., *Lessons Learned from Initial "Say-on-Pay" Litigation*, MINTZ LEVIN SECURITIES REGULATION ALERT (July 18, 2011), http://www.mintz.com/newsletter/2011/Advisories/1251-0711-NAT-LIT/web.htm (characterizing allegations as "relatively thin"); Michael D. Blanchard et al., *Say on Pay: Shareholder "No" Votes Now Leading to Derivative Actions Challenging Executive Compensation*, BINGHAM (July 7, 2011), http://www.bingham.com/Media.aspx?MediaID=12582 (referring to the chances of succeeding say on pay suits that include corporate waste claims as being slim); Martin Rosenbaum, *If the Shareholders Say "Nay-On-Pay," Get Ready for "Sue-on-Pay,"* ON SECURITIES (June 27, 2011), http://www.onsecurities.com/2011/06/27/if-the-shareholders-say-nayonpay-get-ready-for-sueonpay/; Kyoko Takahashi Lin & Gillian Emmett Modowan, *Perceived Pay-for-Performance Disconnect Brings Say-On-Pay Shareholder Derivative Suits*, DAVIS POLK BRIEFING: GOVERNANCE (June 24, 2011, 12:29 PM), http://www.davispolk.com/briefing/corporategovernance/?entry=69 (referring to suits' validity as questionable).

this problem. Moreover, some may insist that fiduciary duty law is unnecessary, given say on pay's impact on compensation decisions. This Part fleshes out each of these arguments, while Part IV demonstrates their flaws.

A. Fiduciary Duty Law's Hands-Off Approach to Compensation Decisions

Under existing law, court interpretations of directors' duties appear to foreclose any possibility that say on pay would have an impact on directors' fiduciary duty. In Delaware, shareholder derivative actions involve grappling with two overarching issues: procedural rules embodied in the demand process, and substantive rules.[164] Courts' analysis of both sets of rules makes it exceedingly difficult for shareholders to successfully bring claims and hold directors liable for breaching their duties,[165] appearing to confirm the supposition that say on pay suits will have little impact on director accountability.

1. The Demand Hurdle

The rules surrounding demand make it difficult to use fiduciary duty law to curb director behavior because those rules make it difficult to even bring lawsuits in this area. Before shareholders can bring a derivative suit they must make a demand on the corporation or demonstrate with particularized facts that demand is futile and therefore excused.[166] Shareholders make a demand by requesting that the corporation assess the merits of their claims.[167] If the corporation determines that the suit should not proceed, the corporation can seek to terminate the suit by filing a motion to dismiss.[168] Shareholders can only defeat such a motion if they prove that the corporation's decision to dismiss the lawsuit was wrongful.[169] Such a standard is extremely deferential to corporations, making

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164. *See* Lisa M. Fairfax, *Spare the Rod, Spoil the Director?: Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 408–11 (2005).

165. *Id.* at 401–15; *see also infra* note 170.

166. *E.g.*, Aronson v. Lewis, 473 A.2d 805, 807–08 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 253–54 (Del. 2000); *In re* Citigroup S'holder Derivative Litig., 964 A.2d 106, 120 (Del Ch. 2009); *see also* Carol B. Swanson, *Juggling Shareholder Rights and Strike Suits in Derivative Litigation: The ALI Drops the Ball*, 77 MINN. L. REV. 1339, 1349 & n.55 (1993).

167. Swanson, *supra* note 166, at 1349–50. In other words, demand involves attempting to convince directors to bring suit against themselves or their current or former colleagues. *Id.* The demand requirement is aimed at encouraging shareholders to rely on the corporation's internal procedures to resolve disputes. *Id.*; *Aronson*, 473 A.2d at 812. The demand requirement is also aimed at reinforcing the corporation's inherent power to determine whether and to what extent it should bring suits to address alleged injuries to the corporation. *See In re Citigroup*, 964 A.2d at 120.

168. Zapata Corp. v. Maldonado, 430 A.2d 779, 784 (Del. 1981) ("Consistent with the purpose of requiring a demand, a board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful.").

169. *Id.*

it almost impossible for shareholders who make a demand to defeat the corporation's motion to dismiss.[170]

By contrast, if shareholders can demonstrate that the demand is excused, they have a greater likelihood of defeating the corporation's motion to dismiss. Given this likelihood, it makes sense that shareholders would choose to forego making a demand and instead demonstrate that demand is excused as futile.[171] To be sure, proving demand futility does not guarantee that shareholders will have their day in court because corporations can still seek to dismiss the litigation.[172] However, if shareholders can demonstrate that demand is excused as futile, courts evaluate the corporation's motion to dismiss under a more stringent standard, substantially increasing shareholders' potential to move beyond the motion to dismiss stage.[173] Thus, proving demand futility is pivotal to shareholders' ability to maintain a successful derivative action.

In apparent recognition of this reality, say on pay shareholders, generally, do not make pre-suit demands and instead argue that the demands were futile and therefore excused.[174] Under the rules established in *Aronson v. Lewis*, shareholders can establish that demand is excused either by raising a reasonable doubt (1) about the disinterest and independence of the directors on whom they would have had to

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170. *See* John C. Coffee, Jr. & Donald E. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 326 (1981); Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 286 (1986) (noting that procedural rules have rendered liability rules ineffective); Carol B. Swanson, *Corporate Governance: Sliding Seamlessly into the Twenty-First Century*, 21 J. CORP. L. 417, 437 (1996) (noting the difficulty of getting claims through court as a result of procedural rules).

171. *See Aronson*, 473 A.2d at 807–08, 813–15.

172. *Zapata*, 430 A.2d at 786.

173. Courts evaluate the motion to dismiss under a more stringent standard outlined in the two-part framework pronounced in *Zapata v. Maldonado*. *See id.* at 788–89. In the first part of that analysis, *Zapata* shifts the burden to the corporation to prove that its dismissal decision was appropriate, by showing that its committee was independent and disinterested, conducted a reasonable investigation in good faith, and had a reasonable basis for its recommendation. *Id.* In this part, courts require committees to engage in a process that is "like Caesar's wife"—"above reproach" when they evaluate shareholders' claims. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1055 (Del. 2004) (quoting Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985)). Even if shareholders satisfy this burden, under the second prong of *Zapata*, courts make their own independent assessment of whether the claims should be dismissed. *Zapata*, 430 A.2d at 789. Corporations must pass both prongs of *Zapata* in order for courts to honor the motion to dismiss. To be sure, corporations—through their special litigation committees—are very often successful in dismissing lawsuits even when demand is excused. But shareholders who demonstrate demand futility have a much greater chance of avoiding termination of their suit.

174. *See* Nelson, *supra* note 58, at 170.

make a demand or (2) that the challenged transactions resulted from a valid exercise of the board's business judgment.[175]

In their pre-suit demand arguments, shareholders raise assertions under both prongs of *Aronson*. An evaluation of those arguments suggests that shareholders will likely find it difficult to demonstrate demand futility and that reforms enhance this difficulty.

2. Demand Futility and Independence

The first prong of *Aronson* involves shareholders demonstrating that directors lacked the independence necessary to objectively assess the merits of shareholders' claims.[176] Shareholders generally make such a demonstration by pinpointing compromising ties on the part of directors or suggesting that the liability risk created by the derivative suit is so high that directors cannot be trusted to objectively determine whether the suit should proceed to trial. As this Section reveals, satisfying this prong is exceedingly difficult.

a. Independence and Compromising Ties

In their say on pay derivative suits, shareholders do not directly challenge boards' independence by suggesting that directors have financial ties to the corporation or executives that would undermine their ability to be objective. This failure greatly diminishes shareholders' ability to successfully challenge director independence for the purpose of proving demand futility. When determining whether a director lacks independence, courts focus primarily, if not exclusively, on the extent to which such a director has a financial or other material relationship with the corporation or if there are defendants that would interfere with her ability to be objective.[177] When such ties do not exist, it is almost impossible to challenge a director's independence for purposes of demonstrating demand futility.[178] Indeed, in the context of demand futility, the Delaware Supreme Court has not only emphasized that directors are presumed to be independent but has stressed that any ties other than economic or financial ones would normally be insufficient to rebut this presumption.[179] Because courts place significant weight on financial ties in assessing director independence, the failure of the say on pay suits to pinpoint such ties greatly undermines their ability to prove demand futility on this basis.

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175. *Aronson*, 473 A.2d at 814.

176. *Id.*

177. Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 146–47 (2010).

178. *See id.*

179. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1048–54 (Del. 2004) (allegations of social, personal, or business relationships—without more—cannot be used to rebut the independence presumption in the demand futility context); E. Norman Veasey, *Musings from the Center of the Corporate Universe*, 7 DEL. L. REV. 163, 173 (2004) (noting that noneconomic ties such as friendship and social relations did not, standing alone, rebut director independence).

b. Independence and Liability Risks

Shareholders are likely to face an uphill battle in proving demand futility based on allegations regarding liability risks. Instead of focusing on compromising ties, shareholders in each of the say on pay cases contend that demand is futile because directors lack independence because of the high likelihood they will face liability if the derivative action is successful. Although demand can be excused based on the possibility of director liability, this possibility must be extremely likely.[180] Courts have held that the demand will not be excused as futile simply because shareholders would be asking directors to sue themselves.[181] Courts also have repeatedly dismissed shareholder efforts to prove demand futility in executive compensation cases where shareholders have alleged that directors breached their duty by approving wasteful pay packages or otherwise failing to properly evaluate the merits of such packages.[182] Instead, because directors rarely incur liability for compensation-related decisions, courts reason that their liability risks are not very high.[183] In this respect, it is almost a catch-22: Given the low liability risk associated with suits related to executive compensation, shareholders will face an uphill climb to show that directors have sufficient liability risk to justify excusing demand.

3. Demand Futility and the Duty of Care

Shareholders face similar hurdles with trying to satisfy the second prong of *Aronson*. That prong essentially requires shareholders to demonstrate that they are likely to prevail on the merits of their claims by raising doubts that the challenged transactions were consistent with directors' fiduciary responsibilities.[184] This Article examines shareholder allegations that fall into two broad categories: claims involving a breach of the duty of care and claims involving waste.

As an initial matter, it is extremely difficult to demonstrate a breach of the duty of care. When directors engage in misconduct that does not involve a conflict of interest, their actions are evaluated under the duty of care.[185] Directors have a duty of care to act in a reasonably informed manner and to take actions that advance the corporation's best interests.[186] Courts analyze whether directors have breached this duty of care under the business judgment rule.[187] The rule's presumption is that directors have acted in the best interests of the corporation.[188] Courts rely on such a rule based on an extreme reluctance to second-guess the

180. *See Aronson*, 473 A.2d at 815; *In re Citigroup S'holder Derivative Litig.*, 964 A.2d 106, 120 (Del. Ch. 2009).

181. *In re Citigroup*, 964 A.2d at 121.

182. *See id.* at 138; Zupnick v. Goizueta, 698 A.2d 384, 387–89 (1997).

183. *See Zupnick*, 698 A.2d at 387–89.

184. *See Aronson*, 473 A.2d at 811–12.

185. Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985), *overruled on other grounds by* Gantler v. Stephens, 965 A.2d 695 (2009); *Aronson*, 473 A.2d at 812.

186. *See* MODEL BUS. CORP. ACT § 8.30(1), (3) (2004).

187. *Aronson*, 473 A.2d at 811–12.

188. *Id.* at 812.

business decisions of the board.[189] Hence, in evaluating whether decisions satisfy the business judgment rule, courts focus almost exclusively on the process by which directors made their decision.[190] So long as the process is sufficient, courts will not probe the substance of the decision, even if the decision can be viewed as a poor one or a mistake.[191] Indicative of this relatively lax standard, only a handful of cases have found directors liable for breaching their duty of care, and only one case has imposed personal liability on directors for breaching their duty of care.[192] In this respect, the business judgment rule makes it extremely unlikely that shareholders can prove demand futility by demonstrating a potential duty of care breach.

The fact that say on pay cases involve executive compensation claims only makes matters worse. Directors' duty of care includes an obligation to take appropriate care when establishing and approving executive pay packages. For example, a breach of duty of care is when a shareholder claims that directors breached their duty by approving pay packages that were not in the best interest of the corporation. However, when analyzing the kind of process that directors must meet in order to satisfy their duty of care involving executive compensation decisions, courts have been tolerant of extremely lax procedures. With respect to compensation decisions, courts begin by pointing out that directors' decision-making process need not be pristine.[193] Instead, courts have held that directors satisfied their fiduciary duty even when directors follow a process that falls far below best practices.[194] Also, courts have found that directors satisfied their duty of care even after characterizing their process as "casual, if not sloppy and perfunctory."[195] In one case, directors were deemed to satisfy their duty of care even when there were indications that their compensation decision was made without sufficient information and deliberation regarding critical aspects of the

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189. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985); *Aronson*, 473 A.2d at 812.

190. *See Unocal Corp.*, 493 A.2d at 954; *Aronson*, 473 A.2d at 811–12.

191. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 787 (Del. 1981).

192. S*ee* Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099–1100 (1968) (finding only four cases); Bernard Black et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1059, 1062 (2006) (noting that outside director liability is almost nonexistent); Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 591 & n.1–2 (1983) (finding only seven cases in which directors have been held liable for breaching the duty of care); Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 982 (1994) (confirming a study by Joseph Bishop).

193. *See In re* Walt Disney Derivative Litig., 906 A.2d 27, 55–56 (Del. 2006).

194. *Id.* at 55; White v. Panic, 783 A.2d 543, 553 (Del. 2001); Brehm v. Eisner, 746 A.2d 244, 260–62 (Del. 2000); Grimes v. Donald, 673 A.2d 1207, 1215 (Del. 1996), *overruled on other grounds by Brehm*, 746 A.2d at 253; Litt v. Wycoff, No. Civ. A. 19083-NC, 2003 WL 1794724, at *6 (Del. Ch. Mar. 28, 2003).

195. *Brehm*, 746 A.2d at 249.

compensation arrangement.[196] Importantly, the court in one case acknowledged that the challenged compensation appeared to be exceedingly lucrative when compared to the value provided by the executive.[197] Thus, even when there is an apparent pay-for-performance disconnect, Delaware courts require directors to meet a fairly easy procedural hurdle, which almost eradicates any potential to prove demand futility based on a breach of the duty of care.

4. Demand and Waste

The other avenue shareholders can pursue in their demand futility claim is to demonstrate a significant likelihood that the challenged transactions are wasteful. Some of the say on pay lawsuits allege that directors' actions were wasteful because directors approved payment schemes that gave executives significant compensation despite their lackluster performance.[198]

Like the duty of care more generally, proving demand futility with respect to waste is extremely challenging. Waste claims are difficult to prove precisely because courts do not feel comfortable second-guessing board decisions. Thus, a board decision must be truly egregious to satisfy the waste claim. To excuse demand based on waste, shareholders must plead facts that lead to an inference that directors authorized a transaction that is so one-sided that no rational businessperson would conclude that the corporation received proper consideration for the transaction.[199] One court described waste as involving a showing that "there was 'an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.'"[200] Delaware courts have made clear that waste is almost impossible to demonstrate.[201] Hence, proving demand futility based on waste is also nearly impossible.[202]

A demand futility claim based on waste is especially difficult when the transaction involves executive compensation. Courts grant directors wide

196. *See In re Walt Disney*, 906 A.2d at 56–57.

197. *See Brehm*, 746 A.2d at 249.

198. *See, e.g.*, Jacobs Engineering Group, Inc. Complaint, *supra* note 153, at 15; Occidental Petroleum Corp. Complaint, *supra* note 155, at 24.

199. *In re* Citigroup S'holder Derivative Litig., 964 A.2d 106, 136 (Del. Ch. 2009); *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 362 (Del. Ch. 1998).

200. *In re Citigroup*, 964 A.2d at 138 (quoting *Brehm*, 746 A.2d at 263).

201. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 748–49 (Del. Ch. 2005) (noting that corporate waste is very rarely found in Delaware courts); *see also* Andrea M. Matwyshyn, *Imagining the Intangible*, 34 DEL. J. CORP. L. 965, 1005 (2009) (noting that Delaware courts rarely find that directors have committed corporate waste); Julian Velasco, *How Many Fiduciary Duties are There in Corporate Law?*, 83 S. CAL. L. REV. 1231, 1255–56 (2010) (noting that waste requires shareholders to prove an extremely heavy burden that is rarely satisfied).

202. *See* White v. Panic, 783 A.2d 543, 554–55 (Del. 2001); *Brehm*, 746 A.2d at 263–64; Litt v. Wycoff, No. Civ. A. 19083-NC, 2003 WL 1794724, at *6 & n.39 (Del. Ch. Mar. 28, 2003).

discretion in the area of executive compensation.[203] This is because courts believe that they are "ill-fitted to attempt to weigh the 'adequacy' of consideration under the waste standard or, *ex post*, to judge appropriate degrees of business risk."[204] Hence, although there are cases in which courts have acknowledged that executive compensation appears to be extremely lucrative or otherwise unconnected to performance, courts have not been willing to characterize such compensation as wasteful.[205] In fact, the Delaware case that established the demand futility rules involved a compensation agreement that guaranteed an executive's compensation for life and provided that the compensation would not be affected by the executive's inability to perform.[206] Although there were no allegations that he was in poor health, the executive was 75 years old at the time directors approved the agreement.[207] When concluding that shareholders' allegations were insufficient to demonstrate demand futility based on waste, the court did not make any significant probe into the reasonableness of the package, but rather emphasized directors' broad powers to set compensation.[208] This underscores the extreme deference courts grant directors, while highlighting the Herculean task say on pay shareholders appear to face when seeking to prove demand futility.

5. *On the Merits*

Available empirical evidence has failed to unearth cases in which directors have been held liable for committing waste or for breaching their duty related to executive pay practices.[209] This is likely correlated to the difficulties shareholders confront when seeking to overcome the demand hurdle and get their day in court related to such claims.[210] Yet even when shareholders manage to overcome the significant hurdles involved with proving demand futility, available empirical evidence indicates that they are never successful on the merits.[211]

B. Dodd–Frank on Fiduciary Duty

Reforms appear to further undermine shareholder efforts to rely on fiduciary duty rules to curb excessive executive compensation in at least three ways. First, Dodd–Frank seeks to decouple say on pay from issues related to fiduciary duty, undermining any effort to use say on pay as a platform for altering fiduciary duty law related to executive compensation.[212] Dodd–Frank states that the say on pay vote may not be construed (a) as overruling board or corporate decisions or (b) as creating or implying any change or addition to the fiduciary

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203. *See Litt*, 2003 WL 1794724, at *6 n.39.
204. Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997).
205. *See Brehm*, 746 A.2d at 249; BEBCHUK & FRIED, *supra* note 18, at 45–46.
206. Aronson v. Lewis, 473 A.2d 805, 808–09 (Del. 1984).
207. *Id.* at 809.
208. *Id.* at 817–18.
209. *See* BEBCHUK & FRIED, *supra* note 18, at 45; Barris, *supra* note 18, at 84 (noting that no case has held directors liable for waste).
210. *See supra* note 170 and accompanying text (discussing demand hurdle).
211. *See* Thomas & Wells, *supra* note 18, at 880–81.
212. *See* Dodd–Frank Act § 951(c).

duties of the corporation or directors.[213] In this way, Dodd–Frank appears to negate shareholders' efforts to use say on pay to reshape fiduciary duty law.

Second, Dodd–Frank encourages reliance on processes that are likely to increase courts' willingness to defer to directors' compensation decisions, further solidifying courts' relatively hands-off approach to overseeing such decisions. Compliance with Dodd–Frank almost guarantees that directors will be deemed free from compromising ties, which further diminishes shareholders' ability to successfully prove demand futility based on the directors' lack of independence. Dodd–Frank requires compensation committees to be independent from the corporation and its managers.[214] Dodd–Frank also requires that directors select compensation committee consultants and advisors only after their independence is fully considered, including the amount of fees provided to such consultants, business or personal relationships with committee members, the provision of other services, and any potential conflicts of interest.[215] These rules direct the committee to consider ties outside of financial ones.[216] In this respect, Dodd–Frank's rules surrounding independence appear more stringent than those under Delaware law, which does not take social or personal relationships into account in the independence inquiry.[217] More importantly, if boards satisfy such rules, their actions significantly decrease the probability that courts will consider directors to lack independence for demand futility purposes.[218]

Corporate adherence to reforms also increases the likelihood that courts will look favorably upon the process by which directors determine compensation, thereby virtually guaranteeing that courts will not delve too deeply into the substance of those decisions. Post Dodd–Frank, compensation committees report meeting longer, and more frequently, and focusing more attention on compensation matters,[219] thereby increasing the likelihood that they will be deemed to have followed adequate procedures when setting executive pay. Dodd–Frank's director independence requirement, as well as its emphasis on compensation consultants, should further safeguard board decisions from duty of care challenges. Notwithstanding significant evidence questioning the validity of relying on independent directors,[220] courts view reliance on such directors as

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213. *See id.*

214. *Id.* § 952(a).

215. *Id.* § 952(b).

216. *Id.*

217. *See* Fairfax, *supra* note 177, at 146–48 (noting Delaware courts' unwillingness to consider social ties in the independence inquiry); *see also supra* note 179.

218. *See supra* Part III.A.2 (noting how proof of director independence undercuts shareholders efforts to prove demand futility).

219. SPENCER STUART, SPENCER STUART BOARD INDEX 2011, at 7, 27, *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_2011_final.pdf (noting that directors ranked compensation matters as the number one issue on which they had to focus); *see also id.* at 9 (noting increased meeting time and frequency even prior to enactment of reforms).

220. *See* Fairfax, *supra* note 177, at 174–76.

important procedurally.[221] Thus, when independent directors make decisions, courts give their decisions significant deference.[222] Moreover, despite evidence that compensation consultants may encourage excesses in executive pay,[223] courts have suggested that reliance on outside consultants helps insulate compensation decisions.[224] Compliance with these reforms likely weakens shareholders' chances of attacking the validity of directors' decisions.

From this perspective, the provisions underlying Dodd–Frank bolster the view that fiduciary duty law will not play a role in regulating executive compensation. Of course Part IV will illustrate that such a perspective may not be entirely accurate. However, the perceived wisdom regarding the futility of fiduciary duty suits sets the stage for reforms such as say on pay that shun reliance on those suits.

C. The Promise of Say on Pay

The fact that say on pay has impacted director decision-making appears to negate the need for fiduciary duty law.

1. Assessing the Vote Results

Available U.S. data indicates that shareholders have overwhelmingly approved executive pay packages by wide margins. Say on pay votes became mandatory on January 21, 2011.[225] Current data incorporates votes covering nearly two proxy seasons. In the 2011 proxy season, more than two-thirds of companies received 90% or more support for their pay packages.[226] By contrast, only 1.6% of companies had their pay packages rejected for that same period.[227] Similarly, as of September 2012, more than 70% of companies received 90% or more support for their pay packages, with a slightly larger rejection rate of 2.6%.[228]

Moreover, shareholders have approved such packages over the objection of proxy advisory firms. Proxy advisory firms, such as Institutional Shareholder Services ("ISS")—by far the most dominant of such firms—issue

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221. Zapata Corp. v. Maldonado, 430 A.2d 779, 785 (Del. 1981); Barris, *supra* note 18, at 83; Fairfax, *supra* note 177, at 141–43; Usha Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 455–58 (2008).

222. *Zapata Corp.*, 430 A.2d at 785; Barris, *supra* note 18, at 83; Fairfax, *supra* note 177, at 141–43; Rodrigues, *supra* note 221, at 455–58.

223. *See supra* notes 141–45.

224. *See In re* Walt Disney Derivative Litig., 906 A.2d 27, 59–60 (Del. 2006).

225. *See* Barrett & Hadler, *supra* note 125.

226. ALLEN ET AL., *supra* note 56, at 4 (indicating a 91.4% average shareholder support, exceeding the 89.2% support for say on pay votes of TARP companies); COGENT COMP. PARTNERS, *supra* note 55, at 1.

227. ALLEN ET AL., *supra* note 56, at 1; COGENT COMP. PARTNERS, *supra* note 55, at 1; LITTENBERG ET AL., *supra* note 55, at 1. This rate of rejection was similar to the rate of negative votes related to 2010's TARP companies. *Id.*

228. *See* SEMLER BROSSY, 2012 SAY ON PAY RESULTS: RUSSELL 3000 SHAREHOLDER VOTING 2 (2012), *available at* http://www.semlerbrossy.com/wp-content/uploads/2012/09/SBCG-SOP-2012-09-05.pdf.

recommendations regarding how shareholders should vote.[229] There is considerable debate regarding the extent to which such firms influence shareholder voting.[230] Consistent with this debate, many expressed concern that advisory firm recommendations would significantly (and inappropriately) influence shareholders' willingness to approve executive pay arrangements.[231] However, in 2011, 86% of companies that received a negative ISS recommendation garnered approval for their pay packages.[232] Moreover, the average support for companies with a negative recommendation was about 73% in 2011,[233] and roughly 64% in 2012.[234] To be sure, shareholders in 2011 only rejected pay packages at companies that also received a negative proxy firm recommendation.[235] Of course, one can debate whether the recommendation influenced shareholder voting or simply reflected shareholder concerns.[236] Regardless, although a negative ISS recommendation corresponded with lower shareholder support,[237] shareholders nevertheless strongly supported pay packages at the bulk of companies where such recommendations were made.[238] Such support is consistent with the broader trend of shareholders approving highly lucrative pay packages by wide margins.

2. The Impact of Nay on Pay

The U.K. experience suggests that the percentage of negative pay votes in the United States may be more significant than it appears. The rate of rejections in the United States is higher than in the U.K. Over a period of six years, only eight[239] or nine U.K. companies had their say on pay votes defeated.[240] Evidence also suggests that the percentage of negative votes increases as shareholders grow more comfortable exercising their power.[241] If U.S. voting patterns mimic this experience, then the rejection rates may increase over the next few proxy seasons.

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229. Stephen J. Choi et al., *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 650 (2009).

230. *See id.* at 657–58, 696 (discussing critics' concerns related to proxy advisory firms and noting that such firms tend to issue recommendations that are consistent with the issues about which shareholders are concerned).

231. *See* David F. Larcker et al., *The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies* 13–14 (Rock Ctr. for Corporate Governance at Stanford Univ., Working Paper No. 119, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453.

232. LITTENBERG ET AL., *supra* note 55, at 2.

233. COGENT COMP. PARTNERS, *supra* note 55, at 2.

234. *See* SELMER BROSSY, *supra* note 228, at 7.

235. *See id.*

236. *See* Choi et al., *supra* note 229, at 696–97 (noting that proxy recommendations tend to reflect concerns of shareholders).

237. A study by Cogent Compensation Partners found that a negative ISS recommendation resulted in a 27.9% lower level of shareholder support. *See* COGENT COMP. PARTNERS, *supra* note 55, at 2.

238. *See id.*

239. Lund, *supra* note 13, at 126 (pinpointing eight adverse shareholder votes since say on pay's adoption in the U.K.).

240. Delman, *supra* note 6, at 610.

241. *See* Delman, *supra* note 6, at 622–23.

Hence, negative votes are already higher than those in the U.K. and are likely to rise.

The relatively low percentage of negative votes may be viewed as a positive signal, demonstrating that shareholders are exercising their vote responsibly. Some opponents of say on pay were concerned that shareholders would categorically reject pay practices at any firm where there was a pay-for-performance disconnect or where CEO salaries increased.[242] However, many corporations won approval of their pay practices even when there appeared to be a disconnect between pay and performance.[243] Corporations received overwhelming approval of pay packages despite a 33% increase in median CEO salaries at S&P 500 companies.[244] Studies suggest that institutional shareholders have made efforts not only to become more knowledgeable about compensation structures and policies,[245] but also to increase their engagement with directors around compensation matters. As a result, even when a company's pay practices could be viewed as problematic, shareholders approved such practices so long as they received some comfort that corporate managers had considered shareholder concerns and were making efforts to address them.[246] In this respect, the low levels of rejection could be viewed as a positive sign that shareholders have used their rejection power sparingly and responsibly.

Negative say on pay votes not only prompted boards to consider different pay practices, but also led boards to modify their practices in ways that incorporated shareholder concerns.[247] For example, at least one company has added performance metrics to its cash bonus program so such bonuses would be contingent on corporate performance.[248] Another company added performance conditions to previously issued restricted stock and stock options.[249] While it is too soon to determine if these changes will be beneficial or have their intended result, such changes reveal that shareholder rejection influences corporate conduct.

Proxy data reveals that negative votes related to frequency caused companies to alter their frequency recommendations and policies. In the beginning of the 2011 proxy season, many companies recommended that say on pay votes be conducted every three years.[250] However, shareholders tended to reject triennial recommendations, instead clearly preferring annual votes.[251] In light of this rejection, most companies shifted away from triennial recommendations toward annual recommendations in the latter half of the proxy season.[252] Importantly,

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242. *See* LITTENBERG ET AL., *supra* note 55, at 1 (noting concerns about a potential "knee-jerk reaction" from shareholders).

243. *See* ALLEN ET AL., *supra* note 56, at 10.

244. *Id.* at 4.

245. *See* Delman, *supra* note 6, at 609.

246. *See* ALLEN ET AL., *supra* note 56, at 12.

247. *See id.*; COGENT COMP. PARTNERS, *supra* note 55, at 2.

248. ALLEN ET AL., *supra* note 56 at 5; Nelson, *supra* note 58, at 197.

249. ALLEN ET AL., *supra* note 56, at 5.

250. *Id.* at 13.

251. *See id.*; COGENT COMP. PARTNERS, *supra* note 55, at 2 tbl.2.

252. ALLEN ET AL., *supra* note 56, at 13–14.

although the frequency vote is advisory, most companies also have indicated that they will follow the proposal favored by shareholders.[253]

A negative say on pay vote also has significant spillover effects. Perhaps most significantly, existing evidence reveals that such votes impact shareholder voting for directors. Thus, one study found that at companies where pay packages were rejected, compensation committee directors received on average 13.5% fewer votes than other directors on the ballot.[254]

3. The Impact of Yea on Pay

Even positive votes may reflect the influence of say on pay. For example, positive say on pay votes may be a signal of corporations' increased engagement with shareholders. One potential benefit of say on pay is that it encourages more effective board–shareholder communication, allowing directors and shareholders to reach consensus on pay structures and policies, thereby eliminating the need for conflict and any negative votes.[255] Available empirical evidence reveals that when ISS recommended a negative say on pay vote, many companies filed additional disclosure documents aimed at clarifying and defending their compensation practices.[256] These efforts appeared to be successful because 73% of companies that received a negative recommendation from ISS managed to get shareholder approval of their packages, with an average shareholder support of 73%.[257] Even companies that received positive ISS recommendations reported reaching out to shareholders prior to the say on pay vote.[258] In this regard, positive say on pay votes may reflect companies' more robust communication with shareholders.[259]

Positive say on pay votes also may reveal corporations' decisions to alter pay arrangements in anticipation of such votes. Available empirical evidence

253. *See id.* at 14.

254. LITTENBERG ET AL., *supra* note 55, at 3. The 2011 ISS Report does note that say on pay votes have contributed to a decline in overall opposition to directors because such votes enabled shareholders to signal their discontent with directors by rejecting pay packages rather than seeking to unseat directors. ALLEN ET AL., *supra* note 56, at 30.

255. *See* John Borneman & Mark Emanuel, *Top 5 Lessons from Say on Pay and Shareholder Engagement*, WORKSPAN, Sept. 2012, at 43, 46; MARC S. GERBER ET AL., SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, 2013 INSIGHTS: GOVERNANCE (2013), *available at* http://www.skadden.com/insights/governance-1.

256. LITTENBERG ET AL., *supra* note 55, at 3–4; COGENT COMP. PARTNERS, *supra* note 55, at 2–3.

257. COGENT COMP. PARTNERS, *supra* note 55, at 2–3. According to ISS, 16.7% of companies that received a negative recommendation from ISS also failed to receive majority support for their pay packages.

258. Reese Darragh, *Companies Altering Compensation Plans over Say-on-Pay*, COMPLIANCE WK. (July 28, 2011), http://www.complianceweek.com/companies-altering-compensation-plans-over-say-on-pay/article/208568/.

259. *See* DAVIS, *supra* note 130, at 15; *see also* ALLEN ET AL., *supra* note 56, at 11–12 (noting that say on pay votes should be interpreted as a signal of increased shareholder engagement). Empirical evidence from the U.K. found a noticeable increase in board–shareholder communication in the wake of say on pay rules. Lund, *supra* note 13, at 126–27.

indicates that companies prepared for the 2011 and 2012 say on pay votes by instituting more performance-based compensation plans,[260] changing their compensation processes in a way that better responds to shareholder views.[261]

4. Concluding Thoughts

It is too soon to tell if changes wrought by say on pay will prove beneficial. On the one hand, policies advocated by shareholders may not result in increasing the link between pay and performance or reducing the gap between executive pay and the pay of average workers. On the other hand, even if compensation policies have their intended impact on pay practices, it is not clear whether or to what extent those policies will impact corporate performance or reduce corporate misconduct.

However, say on pay has made directors more sensitive to shareholder concerns, thereby boosting director accountability. Hence, one may legitimately question the necessity of fiduciary duty law. The next Part responds to that question.

IV. RECONFIRMING THE RELEVANCE OF FIDUCIARY DUTY LAW

In contrast to the previous Part, this Part not only makes the normative case for why courts should use say on pay litigation to alter the manner in which they assess executive compensation decisions, but also insists that Dodd–Frank should not serve as an impediment to that alteration.

A. Dodd–Frank as an Invitation

Rather than construing Dodd–Frank as a prohibition against alterations in fiduciary duty law, it could be construed as federal legislators' exercise of deference coupled with an invitation for state courts to re-examine fiduciary duty law. Several corporate governance scholars have sharply criticized previous federal reforms because they intruded on corporate governance matters generally regulated under state corporate law.[262] Dodd–Frank's provisions on fiduciary duty law may be viewed as a response to this criticism. In this respect, it may be a mistake to conclude, as some courts have, that Dodd–Frank aims to preserve the existing framework with respect to fiduciary duty law.[263] This is particularly true

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260. ALLEN ET AL., *supra* note 56, at 12; *see also* SULLIVAN & CROMWELL LLP, SAY-ON-PAY REVIEW OF 2012 PROXY SEASON RESULTS 4–5 (2012), *available at* http://www.sullcrom.com/files/Publication/e294c919-4351-4d6c-a6d1-06914f0f36d6/Presentation/PublicationAttachment/d4a5c6b3-1140-4eb7-8942-d3dc71655a67/Say-on-Pay_Review_of_2012_Proxy_Season_Results_7-20-2012.pdf.

261. *See* ALLEN ET AL., *supra* note 56, at 12; SULLIVAN & CROMWELL LLP, *supra* note 260, at 2; Darragh, *supra* note 258.

262. *See, e.g.*, Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Spring 2003, at 26; Larry Ribstein, *Market-Based Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes–Oxley Act*, 28 J. CORP. L. 1, 57–59 (2002).

263. *See* Nelson, *supra* note 58, at 185 (describing, for example, the Fulton County Superior Court's reasoning in say on pay suits).

given federal legislators apparent disappointment with the accountability mechanism under state law, including fiduciary duty law.[264] Indeed, it is more likely that federal regulators may welcome state reform in this area, and thus that Dodd–Frank should be viewed as an effort to recognize the states' authority in this area. Such clear recognition does not prohibit state courts from making changes to fiduciary duty law. In this respect, Dodd–Frank should not serve as a bar to state court efforts aimed at altering the standard for reviewing fiduciary duty breaches related to executive pay.

B. Debunking the Relevancy Myth

This Section advances the case for enhancing the courts' role in regulating fiduciary duty breaches related to executive compensation decisions from both a descriptive and normative perspective. As a descriptive matter, the Section debunks the widely held belief that courts have been categorically unwilling to scrutinize director pay decisions more closely. This Section also reveals how disclosure rules may reduce a court's concerns regarding its capacity to properly assess such decisions, which increases the likelihood that courts can oversee director decisions in a measured manner. Normatively, the Section highlights several reasons why courts should embrace such oversight, including reasons related to the limits of say on pay, the importance of state regulation, and the importance of an appropriately balanced shareholder voice.

1. A Second Look at Fiduciary Duty

Contrary to the perceived wisdom on this issue, courts have been willing to play a more enhanced role in monitoring pay decisions—at least episodically. The Delaware Supreme Court recently underscored the potential for shareholders challenging compensation decisions to demonstrate demand futility based on waste. In *Brehm v. Eisner*, the Court noted that "there is an outer limit to [the board's] discretion [to set executive compensation], at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."[265] This language appeared to open the door for a more rigorous analysis of compensation claims under the waste doctrine.

In a shareholder derivative action involving Citigroup, the Delaware Chancery Court relied on that dicta from *Brehm v. Eisner* when it allowed shareholders challenging an executive compensation decision to survive a motion to dismiss.[266] In that case, directors approved a $68 million retirement payment for a CEO who retired after the company suffered billions of dollars in losses.[267] The court found that the payment agreement failed to demonstrate the value of the

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264. *See supra* notes 106–10 and accompanying text.

265. 746 A.2d 244, 262 n.56 (Del. 2000) (citing Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962)).

266. *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 136 (Del. Ch. 2009) (citing Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000)).

267. *Id.* at 138.

services being provided in exchange for such a payment.[268] As a result, the court concluded that there was reasonable doubt regarding whether the agreement was one-sided, and thus wasteful, which satisfied the demand futility standard.[269] In light of the historical reluctance to excuse demand based on waste, experts agree that this case seems to weaken the heavy burden imposed on shareholders.[270]

The courts' pronouncements in *Citigroup* and *Brehm* negate blanket assumptions that lawsuits in this area are not viable. Although shareholders clearly confront a heavy burden, it may not be insurmountable. Instead, waste appears to be a viable measure to plead demand futility in a manner that allows a suit to proceed on the merits.

Moreover, outside of these recent decisions, there is evidence that courts have been willing to provide more exacting scrutiny of executive compensation decisions, even if only episodically. Many contend that fiduciary duty law is an inappropriate vehicle for policing pay practices because courts are ill-equipped to evaluate decisions related to compensation, whereas boards are better positioned to analyze the sufficiency of pay arrangements.[271] This concern about judicial competency animates the wide discretion courts afford boards when assessing fiduciary duty claims. However, courts have recognized that when there exists a possibility that directors may abuse their discretion, a more stringent standard of review is necessary. More importantly, courts have applied more exacting scrutiny even in connection with executive compensation matters, suggesting that there are circumstances in which courts are able to overcome these competency concerns.[272] Thus, after reviewing almost 90 years of reported cases, Professors Randall Thomas and Harwell Wells conclude that "[c]ontrary to the received wisdom . . . courts have not been uniformly hostile to challenges to executive compensation. From time to time, courts have applied heightened scrutiny to either the process or substance of executive compensation decisions."[273] This evidence reveals that although the complexity of compensation decisions has made courts reluctant to interfere with them, there have been times when courts have overcome that reluctance and thus looked more closely at executive pay practices.

2. Help from Corporate Disclosure

Say on pay suits primarily challenge board decision-making by referring to corporate disclosures regarding pay policies and suggesting that there is a

268. *See id.*

269. *See id.* at 139.

270. *See, e.g.*, Steven C. Caywood, Note, *Wasting the Corporate Waste Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation*, 109 MICH. L. REV. 111, 119 (2010).

271. Lewis v. Vogelstein, 699 A.2d 327, 332, 336 (Del. Ch. 1997); *see* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (noting the importance of boards exercising their business judgment in context of claims related to executive pay); *See also* BEBCHUK & FRIED, *supra* note 18, at 45 (discussing inadequacy of courts regarding executive compensation).

272. *See* Thomas & Wells, *supra* note 18, at 880.

273. *See id.*

disconnect between a particular pay package and such disclosures.[274] Along these same lines, such disclosures enable courts to analyze the appropriateness of board decisions with reference to a board's own stated policies. Such an analysis may help alleviate the courts' concerns about capacity for several reasons. First, it does not require courts to assess the appropriateness of compensation per se—an assessment that is not only challenging, and potentially outside of the realm of judicial competency given the wide divergence in views regarding appropriate pay levels, but also one that may be better determined by the directors who are elected by shareholders. Second, by focusing on whether a particular compensation package is compatible with disclosed policies, these disclosures enable courts to defer to the directors' decision regarding appropriate pay policies at their companies. Third, it does not require courts to apply a one-size-fits-all model of compensation, and thus does not stifle private ordering or innovation by corporations. To be sure, focusing on corporate disclosure does not resolve all the complexity issues associated with seeking to measure the appropriateness of executive compensation, particularly because such disclosure may be too broad to provide meaningful guidance.[275] However, at the very least, it does provide a critical starting point in this area, and in many cases a robust measuring tool for analyzing executive compensation. By providing courts with at least the beginnings of a yardstick by which to measure each pay package, corporate disclosures not only facilitate court oversight in this area, but also may enable that oversight to be less onerous and intrusive.

3. The Limits of Say on Pay

The foregoing two Subsections demonstrate why directors can oversee board decisions. The next Subsections illustrate why courts should engage in such oversight. As an initial matter, although say on pay votes (whether negative or positive) appear to influence corporate decision-making related to executive compensation, it would be unwise to rely exclusively on say on pay to fill the accountability gap. Corporations can, and have indicated that they will, ignore say on pay votes. Say on pay votes, like most shareholder proposals, are nonbinding.[276] As a result, corporations are not required to change their practices or policies because of a negative vote. Empirical evidence reveals that in the past corporations routinely ignored shareholder proposals even when they received significant shareholder support over several years.[277] Such evidence underscores the fragility of the say on pay vote. Hence, such votes may be only a partial solution to

274. *See* Nelson, *supra* note 58, at 173.

275. *See id.* at 195.

276. *See* Dodd–Frank § 951(c).

277. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 854–55 (2005) (looking at shareholder resolutions regarding staggered boards). *But see* Andrew R. Brownstein & Igor Kirman, *Can a Board Say No When Shareholders Say Yes?: Responding to Majority Vote Resolutions*, 60 BUS. LAW. 23, 68–70 (2004) (noting that just because directors ignore votes does not mean that they are acting inappropriately).

excessive pay practices, which underscores the continued need for fiduciary duty law.

Fiduciary duty litigation also may serve as a critical supplement to say on pay. Indeed, companies whose pay practices were rejected by courts failed to consider shareholder concerns both before the shareholder vote and afterwards. However, such companies have announced significant changes to their executive compensation practices following the institution of shareholder derivative suits.[278] In this respect, lawsuits may be more effective at prompting responses from particular companies. There also is a possibility that the threat of lawsuits may enhance the influence of the say on pay vote by encouraging directors to pay heed to shareholder concerns in order to avoid such suits. In this way, lawsuits may have a critical role to play even with the existence of say on pay.

Given that say on pay cannot completely fill the accountability gap, it is critical that fiduciary duty law have some role in policing executive compensation. Because fiduciary duty law is the primary accountability mechanism at the state level, it seems inappropriate to allow courts to excuse themselves from their policing responsibilities.

4. Counteracting Bias

There is a strong likelihood that compensation decisions as a general matter may be negatively influenced by compromising ties, warranting increased scrutiny of such decisions. When there is a possibility that directors' decisions may result from bias, or may be influenced by their relationships with managers, Delaware courts apply a higher level of scrutiny to those decisions.[279] In this respect, while courts may afford directors deference based on a concern about their competency to judge business decisions, courts put aside that deference and concern for decisions or cases in which deference may not be appropriate.

Compensation decisions are precisely the kind of decisions where that deference needs to be put aside for at least two reasons. First, there is a high probability that director decisions on this issue are influenced by relationships that undermine directors' objectivity and therefore merit closer judicial attention. Indeed, when assessing the kinds of relationships that may undermine a director's objectivity, courts focus only on economic or financial relationships.[280] Thus, despite social science research revealing the compromising nature of social ties

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278. *See* LITTENBERG ET AL., *supra* note 55, at 4.

279. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 785–86 & n.14 (Del. 1981). Such heightened scrutiny occurs when directors are in a position to exert undue influence over shareholders, or when directors approve conflict-of-interest transactions that confer benefits upon them not enjoyed by shareholders. Fairfax, *supra* note 177, at 142–43 (noting heightened judicial review for transactions involving self-dealing); *see also* Rales v. Blasband, 634 A.2d 927, 935–36 (Del. 1993); Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L.Q. 821, 846–48 (2004).

280. *See supra* note 179.

and structural bias,[281] courts have been largely unwilling to consider the impact of such ties when evaluating director behavior.[282] As a result, courts have deferred to compensation decisions made by directors who have strong social ties with executives. For example, Disney's board chair Michael Eisner orchestrated the compensation package of Michael Ovitz, who received some $140 million after having served as president for little more than a year.[283] In assessing Eisner's independence, the court gave no weight to the fact that Eisner had been friends with Ovitz for some 25 years.[284] By failing to appropriately consider the compromising nature of these noneconomic ties, the court gave undue deference to Eisner and missed an opportunity to challenge his compensation decision. Such a failure should be rectified. Courts should consider the impact of noneconomic ties in the same way they consider the impact of other ties that undermine directors' objectivity and therefore necessitate more exacting judicial scrutiny. To be sure, courts' refusal to consider noneconomic ties applies to all decisions. However, that refusal may be particularly problematic for executive compensation decisions because of the extreme deference courts appear to grant those decisions.

Second, there is a high probability that director decisions in this area are influenced by inappropriate biases that skew such decisions in favor of management. Like noneconomic ties, courts tend to ignore theories suggesting that directors who are former or current executives tend to have a bias toward giving managers the freedom to make decisions, and are otherwise unduly influenced by management in ways that result in their approval of higher compensation.[285] Ignoring this evidence is particularly problematic given that a significant number of directors are active or former executives.[286] Directors who are current or former executives are not only most likely to serve on the compensation committee, but are also most likely to chair that committee.[287] A 2010 board study revealed that 63% of committee chairs were active or retired CEOs.[288] In light of the evidence indicating such directors' bias with respect to pay practices, their domination on the compensation committee is troubling. Moreover, such domination bolsters the case for courts to apply more searching scrutiny in this area.

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281. *See* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Pyschological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83, 85 (1985); Fairfax, *supra* note 177, at 146–53; Velasco, *supra* note 279, at 860 & n.164.

282. *See* Fairfax, *supra* note 177, at 146–53.

283. *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 349–52 (Del. Ch. 1998).

284. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 699 (Del. Ch. 2005).

285. *See* Claire Hill & Richard Painter, *Compromised Fiduciaries: Conflicts of Interest in Government and Business*, 95 MINN. L. REV. 1637, 1655 (2011).

286. *See* BEBCHUK & FRIED, *supra* note 18, at 33.

287. *See id.*; Michael B. Dorff, *Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 BUFF. L. REV. 811, 890 (2003).

288. *See* STUART, *supra* note 219, at 28.

5. The Importance of a State Voice

Another critical reason why fiduciary law should be revitalized is that there are benefits to relying on regulation at the state level through the enforcement of state fiduciary duty laws, as opposed to looking exclusively at federal regulation. Relying on fiduciary duty law enables us to take advantage of these benefits.

Enhancing fiduciary duty law may be an important mechanism for counteracting any of the potentially negative repercussions of increased shareholder influence in this area. Shareholders are clearly concerned about excessive executive compensation. Moreover, they have clearly demonstrated that they will agitate for reform in this area. This is reflected in the dominance of executive compensation issues in the shareholder proposal process.[289] More importantly, many critical shareholder empowerment campaigns were rooted in shareholder frustration with executive compensation.[290] This includes the majority-vote movement, the acceleration of withhold-the-vote campaigns, and the campaign to eliminate discretionary broker voting.[291] Importantly, these campaigns have garnered support where many others have not.[292] One critical reason why shareholders have increased their activism is their frustration with the courts' unwillingness to play a more significant role in the process. Importantly, the Delaware Supreme Court's decision in *Disney* to refrain from holding directors liable for their haphazard decision-making and their approval of a seemingly excessive pay package ignited shareholder fury and accelerated shareholders' activism surrounding a host of executive pay reforms.[293] In this regard, if courts indicate a willingness to play a more effective role in managing executive compensation, it is likely to reduce shareholder activism in this area, which can be costly and distracting to both shareholders and corporations.

State courts also should reconsider their approach to fiduciary duty law in order to avoid further federal intrusion in this area. The public outrage and corresponding wave of federal reforms clearly underscore the federal government's deep concern with corporate pay practices, as well as the government's increased willingness to police those practices in ways that intrude on states' traditional authority. To be sure, in light of the efforts made under Dodd–Frank to preserve states' role in fiduciary law, such intrusion may be construed as measured. However, there is no guarantee that further inroads will not

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289. *See* Reeder, *supra* note 10, at 141.

290. *See* REPORT AND RECOMMENDATIONS OF THE PROXY WORKING GROUP TO THE NEW YORK STOCK EXCHANGE 8 (June 5, 2006) [hereinafter WORKING GROUP REPORT], *available at* http://www.nyse.com/pdfs/PWG_REPORT.pdf (discussing broker voting issues with reference to executive compensation votes); Fairfax, *supra* note 72, at 61–70 (discussing genesis of withhold the vote and majority voting campaigns).

291. *See* Fairfax, *supra* note 72, at 61–70; *see also* WORKING GROUP REPORT, *supra* note 290.

292. *See* Fairfax, *supra* note 72, at 66–67; *see also* Bebchuk, *supra* note 277, at 854 (noting shareholder proposals eliminating staggered boards).

293. Fairfax, *supra* note 72, at 61–88.

occur. Instead, it is entirely possible that if state courts persist in not playing a role in better policing compensation arrangements, public outrage could prompt more drastic federal intrusion. Viewed through this lens, Dodd–Frank may be viewed as a warning that state inaction could lead to a minimization of state's role in this area.

Significant federal intrusion could be problematic. Indeed, the primary justification for federalism in general and the enabling nature of state corporate laws in particular is that they foster innovation and healthy risk-taking.[294] By contrast, federal regulations, which often come in the form of uniform mandates, are viewed as stifling innovation in a way that could lead to suboptimal decision-making. Notably, the dominant critique of federal intervention in corporate law centers around the undesirability of displacing the innovation that often stems from private ordering with federal mandates. This critique highlights the necessity of the states' role in corporate governance practices.

However, to the extent there is any validity to the federalism claim, it is likely that fiduciary duty law also must play a central role in corporate governance practices. There is considerable debate regarding whether corporations and states have sufficient incentives to innovate at optimal levels.[295] In the context of executive compensation, there is every reason to believe that federalism—that is, the notion that states and corporations should be allowed to generate policies free from federal intrusion—may have encouraged excessive risk-taking and permitted inefficient pay practices, particularly with respect to pay policies for banks.[296] However, federal mandates not only may encourage inefficient homogenization of such practices,[297] but they may also encourage undue reliance on mechanisms that

294. Brett H. McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. CORP. L. 99, 100 (2004); Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 246–47 (2006); *see also* Michael Abramowicz, *Speeding up the Crawl to the Top*, 20 YALE J. ON REG. 139, 147–52 (2003) (discussing innovation and its benefits to shareholders).

295. Much of this federalism debate related to corporate law focuses on the competition for state charters, and the question of whether that competition produces a race to the top or a race to the bottom. *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974) (setting forth the race to the bottom theory); Jonathan R. Macey & Geoffrey Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 479–83 (1987) (finding flaws with both theories); Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle,* 1 J.L. ECON.& ORG. 225, 280–81 (1985) (finding that state competiton results in a race to the top); *see also* Abramowicz, *supra* note 294, at 153–59, 168–70 (explaining limits on firm and state innovation and referring to the race as a "crawl"); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 271 (1977) (advancing the race to the top theory).

296. *See* Bebchuk & Spamann, *supra* note 6; Karl S. Okamato, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 185 (2009); Tung, *supra* note 6.

297. *See* Gordon, *supra* note 12, at 325–26 (noting that a federal mandate may lead to a "one-size-fits-all" practice that could prove problematic).

undermine accountability and increase the potential for excessive pay.[298] These observations suggest that even though the benefits of federalism may be overstated, such benefits may nevertheless exist and thus should be harnessed.[299] State fiduciary duty law has a vital role to play in such an endeavor.[300] Corporate fiduciary law serves as the primary check on corporate innovation and risk-taking, ensuring that such actions occur within acceptable boundaries.[301] From this perspective, federalism may be undesirable if we cannot depend upon state fiduciary duty law to police corporate innovation. More importantly, the federal government may be less inclined to allow states and corporations the freedom to innovate if it cannot be assured that fiduciary duty law will play a role in curbing excesses associated with such innovation.

C. Say on Pay as the Perfect Storm

This Section argues that say on pay is an ideal platform for courts to use in their efforts at reinvigorating their oversight regarding compensation matters for several reasons. Because directors' fiduciary responsibilities include appropriately considering shareholder concerns, the results of shareholders' vote on compensation matters should play some role in courts' analysis regarding whether directors effectively performed such responsibilities. The rarity of shareholder rejection in this area only underscores the importance of ensuring that boards and courts pay closer attention to such rejections when analyzing board adherence with their duties. Finally, the fact that the absolute number of negative say on pay votes has been relatively low necessarily limits the number of potential cases in this area, increasing the likelihood that courts may be able to provide important signals regarding pay practices in an environment where the costs of litigation may be lower as compared to the potential cases that can be brought with regard to compensation matters more generally.

1. Shareholder Concerns and the Say on Pay Vote

One justification for increasing judicial scrutiny in the context of say on pay suits relates to the importance of ensuring that boards consider shareholder concerns in their pay decisions.

Corporate governance experts agree that boards have an obligation to consider shareholder concerns, and courts should ensure that boards take that obligation seriously. In 2009, The Conference Board convened a task force of

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298. Thus, critics contend that federal reforms focus on director independence resulting in reliance on compensation consultants that prove inefficient and could even lead to increased compensation packages. *See supra* notes 134–35.

299. *See* Michael Abramowicz et al., *Randomizing Law*, 159 U. PA. L. REV. 929, 946–47 (2011) (noting that at times states do innovate); *see also* McDonnell, *supra* note 294, at 101 (noting that while there are flaws with corporate federalism, it produces important benefits).

300. *See* Steven J. Cleveland, *Process Innovation in the Production of Corporate Law*, 41 U.C. DAVIS L. REV. 1829, 1851–56 (2008) (noting that courts are critical to federalism by offering guidance to corporate managers).

301. *See* Bainbridge, *supra* note 17, at 1046.

corporate governance experts to address problems associated with executive compensation pay processes and oversight.[302] The task force issued a report and recommendation, which contained five guiding principles, including one focused on maintaining credible board oversight.[303] As part of the oversight principle, The Conference Board argued that in order for boards to perform their oversight roles effectively, they should "[t]hink and act like an owner."[304] Hence, governance experts agree that directors fulfill their oversight responsibilities only when they appropriately consider shareholder concerns.[305]

The negative say on pay vote reflects a very important embodiment of shareholder concerns. The fact that shareholders' assessment diverges significantly from the directors' assessment suggests that directors may not be "thinking [or acting] like owners" in the manner recommended by The Conference Board.[306]

2. The Strength of the Signal

Shareholder rejection is significant not only because it is relatively rare, but also because it is often difficult for shareholder proposals that run counter to managerial recommendations to obtain majority shareholder approval. Such difficulties arise from the fact that shareholders have diverse interests and may not agree on particular policies,[307] as well as the fact that most shareholders tend to follow management recommendations.[308] Historically, there were very few issues on which shareholders managed to garner majority support.[309] From this perspective, the fact that a majority (and in many cases a substantial majority) of shareholders agree that a pay package is problematic should be viewed as significant and should be given weight when assessing the appropriateness of executive compensation packages.

3. Minimizing the Impact of Litigation

Because a negative say on pay vote is relatively rare, any heightened scrutiny surrounding litigation related to such votes will be reserved to a subset of companies and their compensation decisions. Thus, even if shareholders decided to aggressively pursue litigation in this area, the absolute number of potential cases is limited. This potentially minimizes the amount of litigation in this area, while enabling courts to send an important message about the boundaries of acceptable pay practices. Importantly, it generally only takes one case to set the tone regarding the appropriate role of directors. Thus, even if there are relatively few

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302. *See* THE CONFERENCE BD., *supra* note 5, at 3.
303. *See id.* at 5, 23.
304. *Id.* at 23.
305. *See id.*
306. *See id.*
307. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (2006).
308. *See* Paul H. Edelman & Randall S. Thomas, *Corporate Voting and the Takeover Debate*, 58 VAND. L. REV. 453, 474–75 (2005).
309. *See* Patrick J. Ryan, *Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy*, 23 GA. L. REV. 97, 120 (1988).

challenges in this area, Delaware only needs to consider and decide one case in order to make a lasting impact on director behavior. This means that paving the way for increased litigation of this variety is more ideal than litigation regarding compensation issues more generally simply because the latter pool is far greater than the pool involving say on pay suits.

Of course, some may be concerned that the mere fact that say on pay votes could impact fiduciary duty law will influence shareholder voting. On the one hand, shareholders may be concerned about the serious repercussions that could stem from their vote and hence may be more reluctant to reject pay packages. On the other hand, some shareholders may use the say on pay vote strategically to increase their chances of success in the litigation process. As a result, litigation-minded shareholders may increase the frequency with which they reject pay packages. To be sure, it is difficult to make predictions in this area. However, current evidence suggests that there may not be significant cause for concern. While the number of negative say on pay cases increased from 2011 to 2012, the total percentage of failed say on pay votes remained relatively small at 2.6%.[310] Commentators have also indicated that shareholders have refined their analysis of problematic pay practices,[311] which inturn suggests that any suits based on these negative votes may be qualitatively better, making it easier for courts to provide signals regarding how directors may have fallen short of their obligations.

D. Toward Reform

In light of the foregoing discussion, this Article argues that Delaware courts should use say on pay votes to alter the standard by which they examine compensation decisions. Delaware courts may find that such an alteration is beneficial because it enables them to reestablish their prominence in this area. The following discussion sets forth modest and radical proposals for reform.

1. A Modest Proposal

Shareholders have argued that their negative say on pay votes should rebut the presumption afforded under *Aronson* that the directors' decision resulted from sound business judgment and hence satisfy demand futility.[312] This Article stops short of advocating that such a vote should entirely satisfy the demand futility rules, which is consistent with at least one court's formulation of the pre-suit demand requirement.[313] Indeed, directors should not be compelled to follow shareholder preferences when they could prove detrimental to the best interests of the corporation. This is particularly true if the shareholder vote was rejected by a bare majority. Also, courts should take into account whether and to what extent directors have considered shareholder concerns when making their pay decisions. Hence, there may be circumstances in which directors have appropriately

310. *See* SELMER BROSSY, *supra* note 228, at 2.
311. *See* SULLIVAN & CROMWELL LLP, *supra* note 260, at 1.
312. *See* Nelson, *supra* note 58, at 176.
313. *See* ALLEN, *supra* note 148, at 3.

considered shareholder concerns and thus their actions should be viewed in a favorable light despite a negative say on pay vote.

Nevertheless, the negative say on pay vote should be given considerable weight in the demand-futility context, particularly when the percentage of negative votes is substantially more than a majority. As the preceding Section suggests, the rarity of such shareholder rejection coupled with the directors' obligation to consider shareholder concerns in their decision-making process justifies giving the say on pay vote considerable weight in the demand-futility inquiry. Moreover, the potential that pay decisions will be colored by bias and other inappropriate influences should prevent courts from affording their traditional deference to director decisions in this area. In this respect, the say on pay vote not only should trigger reduced deference but should also carry significant weight in courts' assessment regarding whether to excuse demand as futile.

Altering the rules related to demand futility should have a significant impact on fiduciary duty law. Changing those rules increases the likelihood that shareholders can move beyond the motion to dismiss stage. As a result, such a change not only increases the potential for favorable settlements in this area but also increases the likelihood that fiduciary duty rules will deter inappropriate director behavior by revealing that such rules pose a credible threat of liability.

Altering rules at the demand futility stage also may be viewed as the ideal response to judicial competency concerns, and thus altering such rules may have a better chance of being embraced. Because the demand futility assessment does not require courts to make an ultimate judgment either about the adequacy of the executive compensation at issue, or about the appropriateness of director conduct, there is a stronger likelihood that judges will feel comfortable applying enhanced scrutiny at such a stage. This is underscored by the fact that courts have been willing to impose more exacting scrutiny at the demand futility stage for claims related to excessive compensation in certain circumstances.[314] Thus, there is precedent for this kind of reform.

2. A Radical Proposal

It is also possible that courts can use the say on pay rules to shift the burden of proof at the substantive stage of a say on pay lawsuit. In their say on pay suits, shareholders have suggested that directors should be required to prove that their compensation decisions are consistent with their compensation policies. Thus, shareholders have pinpointed corporate compensation policies as disclosed in the proxy statement and other public documents and have argued that particular compensation arrangements are inconsistent with such policies. In each case, although corporations purport to embrace a pay-for-performance philosophy, directors approve pay packages that do not make sufficient allowances for poor performance.[315] In the shareholders' view, the inconsistency between policy and

314. *See* Thomas & Wells, *supra* note 18, at 880.

315. When shareholders contend that there is a pay-for-performance disconnect, this disconnect often stems from the fact that executive compensation is not conditioned on

practice is indicative of a breach of directors' duties. Moreover, in making this argument, shareholders appear to suggest that a negative say on pay vote should require directors to demonstrate the validity of their decisions, at least as measured against their purported policies.

Consistent with such a suggestion, it is possible for Delaware (or other) courts to use the negative say on pay vote to shift the burden of proof so that directors do have to defend their pay practices. On the one hand, this Article's discussion regarding the complexity of compensation decisions underscores the difficulty of encouraging courts to delve into the substance of compensation decisions. As a result, any reform that requires courts to judge the sufficiency of pay decisions may be viewed as problematic. On the other hand, a burden-shifting reform has appeal. Indeed, shareholders tend to reject pay packages at companies where there is a severe disconnect between pay and performance. When this disconnect is at odds with corporate policy, it may be reasonable to require directors to explain that divergence. Such a requirement will make it unnecessary for courts to judge the adequacy of compensation. Rather, they will assess the adequacy of the board's explanations about compensation—a potentially less onerous task. Moreover, because shareholders tend to reject pay packages in which the disconnect between pay and performance is significant, it is likely that courts will be focused on the most egregious cases, which may make assessing those cases much easier.

Of course, any reform that encourages Delaware courts to challenge directors' decisions on their face, or otherwise seeks to hold directors liable for those decisions, faces an uphill battle. Indeed, while courts have been willing to apply increased rigor at the demand or procedural stage, courts have not been willing to overturn the substance of a compensation decision.[316] Therefore, this proposal is more radical and less feasible. However, there are sufficient reasons for courts to enhance their scrutiny of pay arrangements, and negative say on pay votes offer an ideal starting point, particularly because they may represent a relatively small universe of cases.

CONCLUSION

Although outrage over excessive executive compensation has prompted reforms, those reforms have ignored the role of fiduciary duty law. Instead, executive compensation reforms have sought to enhance board accountability through measures outside of that law. This Article contends that such an effort is a mistake and insists that fiduciary duty law should play a role in curbing excessive executive compensation.

Say on pay is one of the most prevalent executive compensation reforms. In the wake of negative say on pay votes, some shareholders have brought lawsuits

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performance metrics or goals, resulting in executives being paid high levels of compensation even when financial performance dips. Pay-for-performance seeks to craft pay packages so that they are contingent on performance goals. *See, e.g.*, SULLIVAN & CROMWELL LLP, *supra* note 260, at 9–10.

316. *See id.* at 13 n.17.

against directors, arguing that the negative say on pay votes indicate that such directors have breached their fiduciary duty. This Article argues that these lawsuits may present a welcome opportunity for courts to reshape fiduciary duty law and reconfirms that law's relevance to the executive compensation debate.

To be sure, courts historically have been reluctant to interfere in the executive pay decision. However, this Article advances several reasons why that interference is necessary and appropriate, particularly in the context of say on pay suits. Say on pay is an ideal platform for courts to reinvigorate fiduciary duty law related to compensation matters. Corporate governance experts believe that directors' duties with respect to executive compensation include appropriately considering shareholder concerns. The say on pay vote is an important embodiment of those concerns. A negative say on pay vote is a strong signal that something is awry with pay practices, particularly because such votes are relatively rare and require that a broad cross-section of shareholders agree on the inappropriateness of executive pay. Because negative votes are relatively low, any heightened scrutiny surrounding litigation in this area will be reserved to a subset of companies and their compensation decisions, potentially minimizing the amount of litigation in this area, while enabling courts to send an important message about the boundaries of acceptable pay practices. Then too, because corporations disclose their pay practices, courts can limit their determination to whether particular compensation packages are consistent with such practices. Such limitation may be an important response to concerns that courts may be less equipped to judge the adequacy of given compensation packages per se. In this regard, say on pay offers a way for courts to play a relatively limited, albeit critical, role in overseeing executive pay.

As this Article argues, Delaware courts should embrace the opportunity presented by say on pay for several important reasons. As an advisory measure, say on pay may be insufficient on its own to impact the range of problematic pay practices at companies simply because companies are not required to alter their behavior as a result of negative say on pay votes. To be sure, even if say on pay could do a lot of work in this space, it seems inappropriate to let fiduciary duty law off the hook, particularly given than courts are supposed to play a role in policing these decisions. And contrary to conventional wisdom suggesting that courts have categorically refused to pass on the sufficiency of executive pay decisions, empirical evidence does show that courts have been willing to apply more exacting scrutiny to pay decisions at least episodically. This suggests that courts are willing and able to play a more significant role in this area. But they just need the right prompts. Moreover, compensation practices likely benefit from state regulation, which may allow for greater flexibility in pay practices. However, state courts' enforcement of fiduciary duty law is instrumental to that regulation and flexibility. Indeed, shareholders' push for federal intervention may have stemmed from their dissatisfaction with state accountability mechanisms. From this perspective, the best way to ensure that states, and by extension corporations, can be laboratories for fostering healthy innovation (at least some of the time), is to ensure that state courts do a more robust job of policing those laboratories.