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ELIMINATING THE EXECUTIVE OVERCOMPENSATION PROBLEM: HOW THE SEC AND CONGRESS HAVE FAILED AND WHY THE SHAREHOLDERS CAN PREVAIL

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I. INTRODUCTION

How much are you worth? Employers ask that question before offering employment to potential employees. Investors ask that before deciding to invest their assets and savings in the market. The boards of directors for public corporations ask that before approving compensation packages for company executives. . . or do they? Is it not true that the directors of the corporation *should* ask that question and engage in detailed cost benefit analysis to fulfill their duties of care and loyalty to the company's shareholders? Is it not true that the more money an executive receives, the less there is available to distribute in dividends or capital gains to the owners of the corporation?

In a perfect world, every dollar and other form of compensation paid to management, whether as simple as an annual contracted salary or complex as deferred stock option grants, would go through extensive cost-basis analysis by the compensation committee of a board of directors. It is, after all, the fiduciary duty of the board to ensure that management work to achieving the best results for the shareholders. Instead, over the last forty years numerous factors have led to less oversight and control over executive compensation. It now stampedes towards infinity. "The objectives of the firm are to benefit stockholders by attracting capital, performing efficiently and profitably, and complying with the law."[1] That statement, made by a former Chief Justice of the Delaware Supreme Court in an Article written after he retired from the bench, seems to lose its meaning when examining the excessive amount of compensation that executives of publicly traded companies receive. Managers have utilized the same abilities required to maximize the resources and assets of the firm in their approach to maximizing their own compensation.[2]

With the advent and growth of the Internet, lawmakers and other regulators must recognize the potential influence the medium can have on corporate communication and policymaking. Recent changes in many areas of law reflect the new awareness, but those in control of regulating the process remain hesitant to

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[1] E. Norman Veasey & Christine T. DiGugliemlo, *What Happened in Delaware Corporate Law and Governance From 1992–2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1411 (2005).

[2] Charles M. Yablon, *Bonus Questions: Executive Compensation in the Era of Pay for Performance*, 75 NOTRE DAME L. REV. 271, 273 (1999).

open the door to shareholders.[3] This paper examines the executive overcompensation problem in America, and how new mediums of communication and other resources available to Congress, the Securities Exchange Commission (SEC), and shareholders can ensure that corporations work to serve the interests of their true owners. Part II will begin by examining the executive overcompensation problem, from its humble beginnings to where we are now, and provide analysis and theories for why the problem occurs.

Part III will examine the role of the SEC and its obligations to monitor and regulate corporations so they will not take advantage of the capital provided to them by shareholders. Furthermore, it will provide a detailed analysis of the proxy process, including the new Internet-availability rules. The section will also discuss how the SEC failed to take the necessary steps to allow shareholders to benefit from the proxy reform, and provide analysis of future implications due to that inaction. Part IV will examine how previous attempts by the SEC and Congress have failed to control executive compensation. Part V will examine how shareholders, through the proxy system and the new Internet-availability provisions, appear to be the key to controlling executive overcompensation. This section will serve to tie the discussed concepts into a coherent argument for increased shareholder power.

II. EXECUTIVE OVERCOMPENSATION

One of the most recognizable phrases acknowledging the perception of a potentially catastrophic problem came from the movie *Apollo 13*: “Houston, we have a problem.”[4] The phrase signifies the realization that a situation exists that is so out of control and presents such an imminent threat to continuing existence that extensive, decisive, and timely action is required to avert dire consequences. It connects with people of all ages, including those born and raised during the era of Project Apollo at NASA, and to younger generations that experienced the epic event through cinema. To a lesser degree, and to a more limited audience, the term “executive compensation” has begun to develop the same connotation. When hearing the term, those familiar with the circumstances think of grossly excessive and unjustified pay packages that have been the subject of congressional hearings, scholarly articles, research projects, newspaper discussions, and—most importantly— shareholder outrage. Therefore, as executive compensation continues to grow, its effects and connotation might begin to resonate with a wider audience.

There are some—aptly named “marketeers”—that believe any discussion regarding limiting compensation through policy reform is unnecessary, instead

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[3] *See* discussion *infra* Part III.D.

[4] During the actual mission, Pilot Jack Swigert stated, “Houston, we’ve had a problem here,” followed by a response from the Houston Control Center, and a follow up by Captain James Lovell, Jr., “Houston, we’ve had a problem.” Phrase Finder, http://www.phrases.org.uk/meanings/188425.html (last visited Mar. 8, 2008). For dramatic purposes, Director Ron Howard shortened to the more poignant “Houston, we have a problem.” *See Apollo 13: 2-Disc Anniversary Edition (Disc 1), Special Features:Commentary track by Jim and Marilyn Lovell* [DVD].

believing that the market will dictate and determine the appropriate controls.[5] Although this traditionally conservative market-based view works for establishing the value of stocks and bonds in capital markets that are efficient, it has proven to be inadequate at controlling executives' compensation. Specifically, for stocks of publicly traded companies, the market approach works because there are two parties with equal bargaining power, a wide range of information, and indexes that provide real-time updates on sales of similar type. Thus, the law of supply and demand holds.[6] However, regarding executive compensation, a Chief Executive Officer (CEO) exercises tremendous leverage over the board of directors, sometimes sitting on the board himself, in determining his and other executives' compensation packages.[7] The idea that the market will dictate the appropriate result regarding executive compensation is inadequate because regulators have not established the foundation for fair market control.[8]

Two recent examples exemplify the problem. One must only examine the pay received by Stanley O'Neal,[9] former chairman and CEO of Merrill Lynch,[10] and Charles Prince,[11] former CEO at Citigroup,[12] after they stepped down from their respective positions. Regarding Mr. O'Neal, he resigned from a company that lost $8 billion dollars due to losses incurred relating to subprime mortgage investments.[13] A reasonable person would assume that if his company he managed just experienced enormous losses over the past year, that he would not receive millions of dollars in compensation. But that is where reason abandons practice. Not admitting he obtained a windfall while his company suffered through horrible investment consequences and in arguing that his $161 million pay package was appropriate, O'Neal blamed the media for releasing inaccurate reports of his compensation, further stating that the board of directors had determined his pay after fair negotiations. [14] Never did he offer to disclose the "true" amount he

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[5] *See* Susan Lorde Martin, *Executive Compensation: Reining in Runaway Abuses—Again*, 41 U.S.F. L. REV. 147, 157–58 (2006).

[6] *See generally* Nell Minow, *Should Shareholders Have a Say on Pay?—Yes*, INVESTMENTNEWS, May 21, 2007, *available at* http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070521/FREE/70518004/1011 (stating that even "passionate" capitalists should recognize the potential influence shareholders could have on dictating pay terms for executives).

[7] *See* discussion *infra* Part II.B.

[8] This topic will be discussed at length in Part III regarding the SEC's role in regulating and ensuring a fair market.

[9] O'Neal obtained his M.B.A. from Harvard Business School in 1978. Harvard Business School Bulletin, Profile on Stanley O'Neal, http://www.alumni.hbs.edu/bulletin/2001/june/profile.html (last visited Mar. 8, 2008). He was the first in his family to graduate from college. *Id.*

[10] NYSE Ticker: MER.

[11] Prince obtained his B.A., M.B.A., and J.D. from the University of Southern California. Forbes, Charles Prince Profile, http://people.forbes.com/profile/charles-prince/46497 (last visited Apr. 1, 2009). He serves in a managerial or directorial role for many other companies and charitable organizations, including Johnson & Johnson, where he serves on the Compensation & Benefits Committee and the Nominating & Corporate Governance Committee. *Id.* He remains a member of the board for Citigroup. *Id.*

[12] NYSE Ticker: C.

[13] David Ellis, *Mortgage Mess CEOs Defend Pay*, CNNMONEY.COM, http://money.cnn.com/2008/03/07/news/newsmakers/ceo_pay/ (last visited Mar. 10, 2008).

[14] *Id.*

received after stating the media had reported an incorrect figure. Regardless, it is safe to assume that Mr. O'Neal received millions.

Citigroup's CEO Charles Prince stepped down after his company posted a fifty-seven percent drop in quarterly earnings, lost nearly a quarter of its market value, and gave up a large amount of market share to competitors. Instead of anticipating how it would defend a possible derivative action by shareholders who lost thousands of dollars from their portfolios and 401(k) plans, or preparing to disseminate news releases regarding how it prepared to make changes in the following quarter, Citigroup's board gave its departing CEO a pat on the back with one hand and stuffed a mere $68 million in his pocket for his *outstanding* efforts.[15]

These two situations, and the many like them, are unreasonable and unethical, and they should trigger the feelings of inequity and unfairness that all people—save executives of public corporations—should develop through their lifetimes. Boards owe more to their shareholders, who happen to be their bosses, sources of capital, and reason for existing,[16] but, unfortunately, such apathy exists on many boards, and circumstances in which a company posted an enormous loss but gave excessive pay to their CEOs is commonplace.[17] Boards have lost or chosen not to exercise their ability to maintain proper oversight. Now, after examining two not-so-unusual incidents regarding excessive executive pay in America, and noting how it affects normal shareholders, it seems more appropriate to realign the connotation we associated with the term "executive compensation" into the same category as "Houston, we have a problem." Without decisive action, the consequences could be overwhelming.

A. Brief History

At the beginning of the Twentieth Century, the executive overcompensation problem did not exist because of the way businesses, the financial markets, and the economy were structured.[18] As the economy developed, however, and the corporate form became prevalent, the times and norms began changing. As a result, the idea of separating control of the entity from ownership became reality.[19] With this separation of control, a new and very ominous agency problem came into being. In turn, this agency problem became a leading reason that executives have the ability to influence their compensation. To regulate the power that managers have in the absence of ownership monitoring and control, several procedural and

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[15] *Id.*

[16] *See* Carol J. Loomis, *This Stuff Is Wrong*, FORTUNE, June 25, 2001, at 72.

[17] Including those executives earlier mentioned, the names Eisner and Grasso invoke visions of pinnacle examples of excessive executive pay. There are many others, though; so many that a list would continue for pages.

[18] Yablon, *supra* note 2, at 275.

[19] *Id.* at 276; *see also* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Translation Publishers 1932). Berle and Means' book led the surge in scholarship for identifying the new way corporate America would function. It also served as basis for most discussions in Business Organizations classes that discuss the issues presented by the new mode of business. *See also* discussion *infra* Part II.B.1.

regulatory safeguards came into being, including the SEC.[20]

In 1950, a significant change occurred that allowed companies to pay executives and other employees with stock options.[21] This change to the Internal Revenue Code, signed into law by President Truman, is another major reason for why we have our current problem. In the initial years after the change in the law, however, specifically from the early 1950s to the middle 1970s, executive pay grew at a slower rate than regular employee wages.[22] Thus, either companies had not learned the best way to use the options, or directors were still able and willing to negotiate with executives over reasonable figures. During that same time, especially in the 1960s, the economy saw an increase in conglomerate mergers, which led to many companies having nearly unmanageable resources, but in turn, more willingness to provide higher compensation to executives.[23] The logical flow seems to be there: higher responsibilities, higher pay. However, once pay started going up, it never stopped going. This fact, combined with the stagnate stock market which led to companies beginning to take advantage of their ability to pay with options, set the foundation for the current pay situation.[24] Still, although executives received higher salaries than did the rank-and-file workers, the rapid jump and continuing rise of compensation levels of which we are now accustomed to seeing today was not present during that time.

Moving along in the century, executive compensation packages were of major concern in the late 80s—especially during the hostile takeover era—but shareholders took limited action to attempt to control wages. "As business became glamorized in the 1980s, CEOs realized that being famous was more fun than being invisible. . . . Instead of being embarrassed by their appearance near the top of published CEO pay rankings, many CEOs began to consider it a badge of honor."[25] The pay packages represented an accurate portrayal of the culture that existed during the decade. It truly was the "Me! Me! Me! generation of status seekers."[26] One of the most enduring and recognizable songs from the decade represented the prevailing attitude of American culture: *Material Girl* by Madonna.[27] Somehow surviving both the music and self-indulgence attitude of that period, and by the time President Ronald Reagan was set to exit the Oval Office in 1988, the economy showed signs of recession, which made business reporters, shareholders, and Congress examine executive payouts.[28] Continued scrutiny continued to the early 1990s, where political candidates stumped about

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[20] *See* Yablon, *supra* note 2, at 276; discussion *infra* Part III.A.

[21] Geoffrey Colvin et al., *The Great CEO Pay Heist*, FORTUNE, June 25, 2001, at 64.

[22] *Id.*

[23] Yablon, *supra* note 2, at 277.

[24] Colvin et al., *supra* note 21, at 64.

[25] *Id.*

[26] Kingwood College Library, American Cultural History: 1980–1989, http://kclibrary.lonestar.edu/decade80.html (last visited Mar. 28, 2008).

[27] MADONNA, *Material Girl*, *on* LIKE A VIRGIN (Warner Bros. 1984). The chorus so aptly describes the situation: "Living in a material world; And I am a material girl; You know that we are living in a material world; And I am a material girl." *Id.*

[28] SARAH ANDERSON ET AL., EXECUTIVE EXCESS 2003: CEOS WIN, WORKERS AND TAXPAYERS LOSE 3 (2003), *available at* http://www.faireconomy.org/files/pdf/Executive_Excess_2003.pdf.

passing legislation to control out-of-control executive pay packages.[29] However, through the middle 1990s and because of the astonishing bull market conditions, albeit mainly built on the bubble of the volatile high-technology industry, those same shareholders and politicians that voiced concerns in the late 1980s and early 1990s seemed to lose interest in their attempts to limit executive compensation.[30] Human nature explains the response, or lack of response: as long as shareholders' dividends were high, they cared little about the compensation of those who seemed in control and responsible for those gains.[31] That represents the ultimate "what have you done for me lately" attitude that began to take over in the decade. "In the late 1990s, as the stock market took off, CEOs became modern-day heroes. Few really seemed to mind that CEO pay was rising much faster than worker pay, much faster even than corporate profits or the stock market."[32] After the recession in 2002 and continued economic instability that has followed, the attention has once again turned to controlling executive compensation. If we enter a bull economy in the near future, it is very likely the problem will continue with no answers in sight.

Since the late 1980s, executive pay levels have done nothing but dramatically increase, even through periods of recession in 2001 and 2002[33] and notwithstanding tax law changes and increased emphasis on more detailed disclosure to shareholders.[34]–Interestingly, the jump in compensation levels came partly due to an influx of equity-based packages.[35] Although firm size increased, "compensation levels increased far beyond what can be attributed to changes in size and performance."[36] In 10 years, from 1995 to 2005, average CEO pay increased by over 100%, with 60% of the jump having no rational basis.[37] In 2006, the average salary for a CEO of an S&P 500 firm was $15.06 million, representing an 11.5% increase over 2005.[38] The question becomes what has happened since the turn of the 20th Century. Running a business in a way that ownership is separated from control has become the norm for success; why, then, have executive compensation packages continued to rise at extraordinary levels?

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[29] *See, e.g.*, Bill Clinton for President 1992 Campaign Brochures, *available at* http://www.4president.org/brochures/billclinton1992brochure.htm ("Eliminate deductions for companies that . . . reward outrageous executive pay."); *see also* Martin, *supra* note 5, at 148 ("Executive compensation became an issue for the candidates in the 1992 presidential campaign.").

[30] *See* Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. 971, 972 (2004); *see also* SARAH ANDERSON ET AL., *supra* note 28, at 3.

[31] McClendon, *supra* note 30, at 972.

[32] SARAH ANDERSON ET AL., *supra* note 28, at 3.

[33] *See* Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. OF ECO. POL'Y 283, 285, 289 (2005).

[34] *See* discussion *infra* Parts IV.A–B.

[35] Bebchuk & Grinstein, *supra* note 33, at 291. As this paper will discuss later, it appears that this jump in equity-based compensation resulted directly from efforts by Congress to control executives' pay through the Internal Revenue Code. *See* discussion *infra* Part IV.B.

[36] Bebchuk & Grinstein, *supra* note 33, at 286.

[37] *Id.* at 287.

[38] AFL-CIO, 2006 TRENDS IN CEO PAY (2007), http://www.aflcio.org/corporatewatch/paywatch/pay/index.cfm?RenderForPrint=1 (last visited Mar. 31, 2008) (citing numbers from THE CORPORATE LIBRARY'S ANNUAL CEO PAY SURVEY 2007 (Corporate Library 2007)).

B. The Failure of the Corporate Board

It is impossible to identify one source or dispositive factor that has led to the undesired developments in corporate America. According to Warren Buffet, executive pay is the acid test for determining whether the American financial markets can monitor and reform themselves.[39] If this indeed is true, our markets are inflated, misleading, and working adverse to those who participate in them. It also indicates that, although no one factor is dispositive, the continued failure of the corporate board to work in shareholders' interests is the leading factor to executive overcompensation. Due to of the nature of ownership of public companies in America,[40] corporate boards, due to the legal principles preventing active shareholder intervention, have significant power.[41] These boards, however, still are unable or unwilling to negotiate at arm's length with executives regarding pay packages.[42]

1. Agency Issues

Many argue that executive overcompensation is a result of an agency problem, which is a perfectly logical conclusion. Adolph Berle and Gardiner Means first addressed this issue, specifically targeting problems inherent with separating ownership from control, in the 1930s,[43] but the principles and ideas they developed remain practical today. Succinctly, the "[n]on-owner managers may be tempted to maximize their own welfare rather than the profits of the firm that employs them, preferring themselves over the shareholders who own the firm."[44] It is impossible to avoid this situation, primarily due to the large amount of business conducted and obligations involved in day-to-day business. The old-fashioned-individually-owned establishments that existed during the 1800s and early 1900s could no longer compete with businesses that moved to the corporate form and ownership through dispersed shareholders. Although shown that the corporate form provides a way to conduct efficient business transactions, which in turn creates economic advantages,[45] some negative consequences exist.

With this type of business, the managers who run operations from day-to-day should act as agents for the firm, but they have other incentives to maximize their own interests.[46] Additionally, the problem of shirking causes those in charge to do

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[39] Letter from Warren Buffett to Shareholders of Berkshire Hathaway, Inc. (Feb. 2004).

[40] *See* discussion *infra* Part II.B.1.

[41] Lucian A. Bebchuk, Reply, *Letting Shareholers Set the Rules*, 119 HARV. L. REV. 1784 (2006).

[42] AM. FED'N OF STATE, COUNTY & MUN. EMPLOYEES, AFL-CIO & THE CORPORATE LIBRARY, ENABLERS OF EXCESS: MUTUAL FUNDS & THE OVERPAID AMERICAN CEO 3 (2006), http://www.aflcio.org/corporatewatch/capital/upload/enablersofexcess.pdf.

[43] BERLE & MEANS, *supra* note 19.

[44] Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 CORNELL L. REV. 1195, 1198–99 (1999).

[45] *Id.* at 1197. Many factors exist for why the corporate form is better suited for large business, namely limited liability for the owners and perpetual life if all continues to go well.

[46] *Id*. at 1199.

as little as possible and still get the job done.[47] Both in turn affect how different groups, in this case management and shareholders, perceive different projects, with the former preferring to maximize short-term wealth to ensure their continued employment, and the latter preferring to maximize long-term stability to ensure a reasonable return on their investment. Shareholders desire management to engage in activities that increase overall firm profitability, but these actions may not result in the immediate profits for which are required in management-driven compensation plans. Thus, management has an incentive to do as little as possible while still maintaining short-term profitability of the firm.[48] Scholars have long argued whether security regulations, legal doctrines, or private agreements can best reduce the divergence in interests between the managers and shareholders, and the debate continues with no single theory better than the next.[49] What is certain is that the agency problem is significant. It affects how managers determine the extent of their efforts to produce profits for the corporation, which business opportunities to engage the firm in, and, most importantly for this paper, how managers bargain—or dictate terms—with corporate boards regarding compensation.[50]

State corporate law statutes design corporate boards to prevent the exact types of actions listed above by giving them control over ratifying and monitoring company executives and other fundamental transactions.[51] Accordingly, by law, boards must make decisions to ensure corporate efficiency and ensure corporate assets are used to benefit shareholders.[52] However, boards often do not have the ability to engage in effective monitoring that would benefit the shareholders. Most members have other jobs that require their full attention, and corporate business falls on the scale of priorities; further, some members serve on multiple boards in addition to full time jobs.[53] Because of that, increasing passivity prevails on boards at every publicly traded company in America.[54] "Management, no longer checked, freely engages in conduct that is slothful, ill-directed, or self-dealing—all to the corporation's detriment."[55]

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[47] Gregg D. Polsky, *Controlling Executive Compensation Through the Tax Code*, 64 WASH. & LEE L. REV. 877, 887 (2007).

[48] *See* Martin, *supra* note 5, at 153–54 (quoting Adam Smith, who, in 1776, recognized the problems created by the divergent interests of two parties in business).

[49] *See, e.g.*, *id.* (discussing the contractual theory); MELVIN A. EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS (1976) (discussing the need for legal intervention); BERLE & MEANS, *supra* note 19, at 233–40 (discussing needed regulations to control corporate managers). These three works span across sixty-seven years of economic and corporate theory, yet we still encounter problems that pre-existed each work.

[50] *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 16 (2004).

[51] Butler & McChesney, *supra* note 44, at 1201.

[52] Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 S.M.U. L. REV. 127, 128 (1996).

[53] BEBCHUK & FRIED, *supra* note 50, at 17.

[54] Elson, *supra* note 52, at 128.

[55] *Id.*

2. *Managerial Power Theory*

A leading theory for explaining why corporate boards fail to control executives is the product of Professors Lucian Bebchuk [56] and Jesse Fried;[57] it emphasizes the concept that management exercises unchecked power in negotiations with the board, and directors' interest lies with the CEO and not to the corporation.[58] Included in this theory is the recognition that directors, realizing their fate relates directly to the personal relationship they have with the CEO, seek to please management to ensure sustainability of their position.[59] Managers use their power to overcome the proper arm's length bargaining over compensation, which requires directors to disguise excessive compensation amounts from shareholders by camouflaging the payments as stock options and other deferred compensation.[60] The point of hiding the excessive payments is to limit the "outrage" (as Bebchuk and Fried call it) by shareholders when they realize what the executives have received.[61] The theory holds that the only true restraint on executive compensation is shareholder outrage.

The theory suggests that executive overcompensation occurs because passive

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[56] From his biography on the Harvard Law School website:

> Professor Bebchuk is the William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance and Director of the Program on Corporate Governance at Harvard Law School. Bebchuk is a Research Associate of the National Bureau of Economic Research and Inaugural Fellow of the European Corporate Governance Network.
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> Trained in both law and economics, Bebchuk holds an LL.M. and S.J.D. from Harvard Law School and an M.A. and Ph.D in Economics from the Harvard Economics Department. He joined the Harvard Law School faculty in 1986 as an assistant professor, becoming a full professor in 1988, and the Friedman Professor of Law, Economics and Finance in 1998.
>
> Bebchuk's research focuses on corporate governance, law and finance, and law and economics, and he has published more than seventy research articles in academic journals in law, economics, and finance.

Harvard Law School's Faculty Biographies, http://www.law.harvard.edu/faculty/bebchuk/bio.shtml (last visited Mar. 29, 2008).

[57] From his biography at the University of California School of Law:

> Jesse M. Fried is a Professor of Law at the University of California, Berkeley, and Faculty Co-Director of the Berkeley Center for Law, Business and the Economy (BCLBE). He holds an A.B. and A.M in Economics from Harvard University, and a J.D. from Harvard Law School. Fried joined the Berkeley faculty in 1997 following two years in practice and a two-year Olin Fellowship at Harvard Law School.
>
> Fried's main areas of research are executive compensation, corporate governance, corporate bankruptcy and venture capital.

UC Berkeley School of Law, http://www.law.berkeley.edu/faculty/friedj/homepage.htm (last visited Mar. 29, 2008).

[58] BEBCHUK & FRIED, *supra* note 50, at 61–79; *see also* Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2028 (2007) (outlining and describing the managerial power theory); Polsky, *supra* note 47, at 890–91 (explaining how the arm's length model and Managerial Power Model are products of the agency problem).

[59] BEBCHUK & FRIED, *supra* note 50, at 80–86.

[60] *Id.* at 61, 67.

[61] *Id.* at 64.

boards agree to salary packages without the semblance of objective discussion,[62] and then try to cover for their laziness by camouflaging payments.[63] The directors, even those on the compensation committees, are self-admittedly "'in the pocket of the CEOs'" and never engage in arm's length bargaining.[64] Undoubtedly, this invites CEOs to dictate terms to the board. Further complicating the problem, CEOs usually sit on the boards for which they are supposedly "bargaining" with over compensation.[65] Nothing could represent a higher level of conflicting interests, especially given the amount of money and other capital assets public corporations have at their disposal.[66]

Another way in which managerial power influences pay is that the law, by allowing for various anti-takeover measures and other obstacles, insulates managers from potential removal.[67] With no plausible threat of removal due to poor performance by directors, outsiders, or even shareholders, management has no other reasons or influences to make them take lower pay.[68] Thus, anyone that would potentially challenge an excessive pay package can do nothing but wait for the executive to leave.[69] Assuming one had the ability to challenge, "[S]ince at least the 1960s courts have been far more deferential to the board's decision to enter such [compensation] contracts" even if evidence exists of hardly objective bargaining.[70] It is a circular analysis, with the conclusions ending the same every time: executives take home millions, directors maintain the status quo, and shareholders receive less for their investment. Additionally, the legal ramifications surrounding board passivity are either insignificant or non-existent. Provided companies disclose all compensation in their public filings,[71] and the board of

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62 Susan J. Stabile, *One for A, Two for B, and Four Hundred for C: The Widening Gap in Pay Between Executives and Rank and File Employees*, 36 U. MICH. J.L. REFORM 115, 128 (2002) ("executive 'overcompensation is basically the fault of passive boards that agree to salary packages on demand, without spirited negotiations'").

63 BEBCHUK & FRIED, *supra* note 50, at 68. The camouflaging of benefits can come through granting equity instruments or it can come in the form of lucrative retirement packages. *Id.* at 95–111. Furthermore, the hidden benefits can come in the form of loans to executives, even though provisions in Sarbanes-Oxley bar their use. 15 U.S.C. § 78m(k) (2008). Existing loans at the time of the prohibition, however, are exempted from this ban. BEBCHUK & FRIED, *supra* note 50, at 112.

64 Stabile, *supra* note 62, at 128.

65 *See* BEBCHUK & FRIED, *supra* note 50, at 38–41.

66 Not only do executives exercise a great amount of control during their negotiations, some have a great amount of control over who will be their successor. *See, e.g.*, Kip Walton, *Disney Sues Disney: Shareholders After Another Election*, DAILY FIN. NEWS, May 10, 2005, http://www.dailyfinancenews.com/Disney-Sues-Disney_s757.html (last visited Apr. 2, 2008) (discussing how ousted CEO Michael Eisner handpicked his successor, whom the board voted for with no questions asked). Therefore, shareholders can go through the painstaking effort and costs associated with a proxy contest only to have the management or board member they somehow remove pick his successor.

67 BEBCHUK & FRIED, *supra* note 50, at 83–85 (referring to Poison Pills).

68 *See id.* at 45–46. Why would anyone take lower pay when what they make is legal and for what was "negotiated?" If we were to accept the notion of proper negotiation, this paper would be as useless as a politician's promises.

69 *See generally id.* at 45–52 (describing the limited power shareholders have to intervene in the corporate affairs of a publicly traded business).

70 Aaron D. Jones, *Corporate Officer Wrongdoing and the Fiduciary Duties of Corporate Officers Under Delaware Law*, 44 AM. BUS. L.J. 475, 501 (2007).

71 *See* discussion *infra* part IV.A.

directors does not engage in gross misconduct that would give rise to liability,[72] executives and directors are truly free to do whatever they please.

Though the managerial power theory seems to address why executives are able to obtain such high pay packages, some believe that the only problem is the inability of directors and compensation committees to negotiate in the best interests of the corporation.[73] Although this theory ignores the reality that these same directors have well-developed negotiating and analytical skills, especially when it comes to allocating resources, large contracts, and general business techniques, the end results are still the same as with the Managerial Power Theory: the executives have all the control and power in the board room.[74] "To break management's grip on the board and stimulate real oversight, an appeal must be made to the director's same sense of personal self-interest,"[75] pride, or security, all of which management currently controls. Until there is a major change, in either the law or the governance structure of corporations, the problems will continue to exist.

3. Group Dynamics Theory

In recent years, the executive compensation problem has received attention from psychologists to determine what exactly causes the lack of bargaining. This is much more theoretical than the Managerial Power Theory because it bases not on specific tendencies of management or boards, but on examining general human tendencies. The Group Dynamics Theory opines that executive overcompensation occurs as result of a flaw within a group's psychological behavior.[76] Because the group—board of directors—desires to act as a cohesive unit, any decisions, whether major or minor, become products of "groupthink;" however, management does not exercise the degree of control as suggested with the Managerial Power Theory, but simply manipulates the group in one way or another.[77] Groupthink is a phenomenon that can best be quantified by examining a group of people with similar interests all wanting to make a process run smoothly, so each member agrees on uniform terms, even though some member had some objections to the result. This process is used to ensure and facilitate unanimous "clubby" decisions.[78] Another interpretation, more simply stated, is that this phenomenon is the "good old boy" theory. The executive neither dominates nor dictates terms to

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[72] Jones, *supra* note 70, at 477; *see infra* note 240 and accompanying text. Examples from Delaware Law are used because most companies referred to herein are incorporated in Delaware.

[73] *See, e.g.*, Michael C. Jensen , Kevin J. Murphy & Eric G. Wruck, *Remuneration: Where We've Been, How We Got Here, What Are the Problems, and How to Fix Them* 53 (Harvard Fin., Working Paper No. 44-2004, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=561305 ("poor negotiating expertise on the part of remuneration committees may explain more of the increase than captive board members catering to entrenched managers").

[74] *See id.* at 54; BEBCHUK & FRIED, *supra* note 50, at 24–30.

[75] Elson, *supra* note 52, at 133.

[76] Dorff, *supra* note 58, at 2029.

[77] *Id.* at 2030.

[78] IRVING L. JANIS, GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES 247 (2d. ed. 1982).

the board, but simply becomes such a part of the group that all decisions receive glossy analysis.[79] The foundation is there, and "[g]roupthink seems likely to develop on many corporate boards,"[80] mainly due to the members homogeneous composition.[81]

In this situation, it is not that the executives force directors into making poor decisions, but that the pressure to act as a uniform group makes the board decide as it does. Thus, the Group Dynamics Theory does share some attributes with the Managerial Power Theory, most notably that the results are the same: executives receive excessive payments without the arm's length bargaining process. Furthermore, this theory recognizes that directors, provide they, in the first place, would engage in objective bargaining, "have little incentive to spend time working through the details of a complex compensation package, much less to dream up alternatives to the traditional forms of compensation."[82] This is due to the overarching intent of following the group. Not one director wants to cause unrest by going against the unanimity.[83] Thus, the status quo remains as such and the lemmings march on.

4. Other Possible Explanations and Justifications

There are several practical explanations why executives receive lucrative pay packages without the benefit of objective analysis, but they all share some similarities with ideas established in the Managerial Power and Group Dynamics Theories. One must only examine the structure and nature of a publicly traded corporation to obtain an idea of why the problem exists. Because of the wide dispersion of shareholders, a power vacuum exists within a corporation, and regardless of whether company executives seek control of the board, because of this vacuum, the default system is one where the CEO dominates the board.[84] This domination is not because the executive intends to dominate the board, or because the group believes it to be the simplest and easiest way to run the company, but it happens as part of the natural human behavior. Again, there are aspects of the governance system that tend to favor this outcome. Mainly, executives maintain domination and control over the proxy process thereby handcuffing the shareholders from the ability to exercise any governing power.[85] Even recognizing this as a leading factor turns one to recognize that there is a failure on the part of

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[79] Dorff, *supra* note 58, at 2036.

[80] *Id.* at 2038.

[81] *Id.* at 2038–39 n.72 (citing KORN/FERRY INTERNATIONAL, ANNUAL BOARD OF DIRECTORS STUDY 10 (2003)). "Public company boards overwhelmingly consist of white, middle-aged men from privileged backgrounds who have spent their careers working for large corporations." *Id.*

[82] *Id.* at 2045.

[83] *Id.*

[84] *See* Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1891 (2001).

[85] *See* Leo E. Strine, Jr., *Response to Increasing Shareholder Power: Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1775 (2006) (noting that proxy contests are so expensive, yet the board and incumbent management have unlimited access to the company's coffers).

the SEC. Of course, extending the blame further for the sake of finding some reason to point to would extend into criticizing and seeking reform of the *laissez faire* approach in the American market economy. This, however, would be complete overkill.

Proponents of another theory, the Optimal Contracting Theory, opine that because public corporations generate mass sums of money and resources, payments to executives indicate an efficient use of the ability to contract with those that will produce a return on assets.[86] Thus, provided the corporation is doing well, any pay structure negotiated, used in the loosest sense of the word, with the executives are efficient and appropriate. This theory also goes to argue that the skills, knowledge, and abilities of top-performing CEOs makes them a scarce resource, in fact, such a scarce resource that companies, acting through their boards, should be willing to pay what the market dictates to retain their valuable commodities.[87] Those that argue executive compensation is not a problem, provided it is the result of a negotiated contract in the best interests of the corporation, prefer this approach. Again, though, we must go back and look at the true essence of the agreements to determine if there is fair negotiation. If it really is an optimal contract, why do the executives still make millions when the companies struggle?

Still yet, another justification comes from the responsibilities and risks of the executive position itself. Recently ousted from his position as CEO at Vivendi Universal and shamed by accusations that he engaged in fraud, Jean-Marie Messier stated before agreeing to serve in that position, "The possibility of being fired by one's shareholders, whether as a result of a takeover or for any other reason, is one of the risks of being a chief executive. We are paid for that. And well paid."[88] He went on to describe that he would never ask for excessive payments when he left his position, but two years later, his attitude changed, and he asked for millions in a severance agreement.[89] It is true that executives should receive some type of risk premium because their jobs are not as secure,[90] but this argument falters for two reasons. First, executives have just as much job security as any other ordinary employee, and second, studies suggest that job security is not as important of a factor to employees, including executives.[91] Why should executives receive a premium for an issue they do not consider important in deciding where to work? However, that has become a given in the current pay structures and likely not to change.

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[86] Dorff, *supra* note 58, at 2029.

[87] *Id.*

[88] Jo Johnson, *Vivendi Universal's Former Chief Executive Denies Any Stain on His Reputation*, FIN. TIMES, Dec. 29, 2003, at 13.

[89] *Id.*

[90] Stabile, *supra* note 62, at 125.

[91] *Id.* at 126-27.

C. Lasting Effects

1. Rank-and-File Inferiority Complex

As executive pay continues to rise, there is an undeniable realization that the rank-and-file employees will begin to feel inferior in their place in the companies. Stated otherwise, the people who actively engaged the public to facilitate the revenue for the company they work for are being left far behind in terms of pay, resulting in feelings that the company does not appreciate their efforts and takes advantage of their abilities. We must only look at the differences in pay between the rank-and-file employees and executives. The CEO-worker pay gap in 2002 was 282–1, 7 times larger than the ratio of 42–1 in 1982.[92] Even more drastically, the CEO-worker pay ratio in 2000 was an astounding 531–1.[93] Though that ratio decreased in years where the American economy struggled thereby indicating some type of reality check on the executives, the differences are still staggering. For a more realistic and quantifiable analysis, compare the growth numbers in executive pay to that of the salaries of ordinary employees, specifically focusing on the minimum wage for ease. "If the federal minimum wage, which stood at $3.80 an hour in 1990, had grown at the same rate as CEO pay, it would have been $14.40 in 2002 instead of $5.15."[94] That figure is astonishing, especially given that it represents a number that is six years old.

Not only are executives making money at an exponentially greater level than the rank-and-file employees are, but they have proven that, when circumstances show impending financial disaster, the executives are more than happy to allow the rank-and-file employees to bear the burden and heartache of experiencing the fall of the company. Specifically, during the Enron crisis, company executives were liquidating their portfolios while the rank-and-file employees were doing all they could to fill up their 401(k) assets with the same Enron stock insiders knew was worth less than the paper in the recycling bins.[95]

The immediate question is whether executives are truly a valuable commodity that corporations should be paying hundreds of millions of dollars. One could argue that many regular employees could do just as well as executives, yet because they do not have the required Ivy League educations, no corporation will give them a legitimate opportunity. This argument is exemplified by evidence that shows executives in Japan and Germany are not separated by the enormous

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[92] *See id.* at 115–18; ANDERSON ET AL., *supra* note 28, at 21.

[93] ANDERSON ET AL., *supra* note 28, at 21.

[94] *Id.* At that hypothetical level, and assuming a minimum wage earner works forty hours a week, with no overtime, and gets two weeks off in a year, the worker's yearly gross income would be $28,800. Adjusted to today's dollars, the minimum wage would be $17.23, and the gross income would be $34, 467.63, both based on the average increase in the Consumer Price Index. Enter calculations at MeasuringWorth.com, http://www.measuringworth.com/uscompare/ (last visited Mar. 16, 2009). Both figures are significantly higher than their true value today. The current minimum wage in Texas is $6.55. U. S. Dept. of Labor, Minimum Wage Laws in the United States, http://www.dol.gov/esa/minwage/america.htm#Texas (last visited Mar. 16, 2009). With the same assumptions as above, the yearly gross income is $14,000.

[95] Stabile*, supra* note 62, at 117; ANDERSON ET AL., *supra* note 28, at 21.

pay gap that exists in the United States.[96] Others argue that the executives are worth every penny they are paid, mainly because there are only a select few that can handle the responsibilities.[97] What is seemingly uniform is that rank-and-file employees feel inferior, both in esteem and in worth. A poll conducted in 2002 concluded that eighty-seven percent of respondents believed that top company executives are paid more than they deserve, and, significantly, the managers earn more at the expense of ordinary workers.[98] Furthermore, empirical evidence indicates that when a CEO cuts employees from his company's workforce, his compensation increases significantly the next year.[99] This indicates that boards reward those executives that cut the workforce, thereby giving executives the incentive to make job cuts, even if they are not justified. This also indicates that management seems to treat ordinary employees as bargaining devices with boards in that if the executives promise cuts to decrease the outflow of company resources, they will be compensated accordingly, even if the firm does not perform better. Ordinary workers will likely begin to feel inferior, thus leading to a decrease in production.[100] Further, this inferiority could lead to a decrease in worker motivation and disrupt effective teamwork.[101] If this occurs, the stability of the American economy could be in jeopardy.

2. International Comparisons

To broaden the context of the executive compensation problem, it is important to examine how the United States' approach compares to that of the rest of the world. This could influence whether the American market maintains its dominance in the ever-globalizing world economy. Just as with rank-and-file employees, executives in America receive significantly higher compensation than their counterparts in Japan, Britain, and Germany.[102] This is hardly surprising. Though most of this comes from the preferential use of stock options in the United States,[103] it also might have a lot to do with the fact that "shareholder rights in the U.S. are weaker than they are" elsewhere in the world.[104] In particular, the

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[96] Stabile*, supra* note 62, at 121 & n.22; *see* discussion *infra* Part III.D.2.

[97] *See, e.g.*, JAMES K. GALBRAITH, CREATED UNEQUAL: THE CRISES IN AMERICAN PAY 6 (1998); IRA T. KAY, CEO PAY AND SHAREHOLDER VALUE: HELPING THE U.S. WIN THE GLOBAL ECONOMIC WAR 19 (1998); Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 5-6 (2000). The same factors that lead to the increase in CEO pay do not apply to rank-and-file employees. Stabile, *supra* note 62, at 122.

[98] ANDERSON ET AL., *supra* note 28, at 3.

[99] *Id.* at 5–7; *see* Table 1.1: CEO Pay at the 50 Companies with the Most Layoffs Announced in 2001. *Id*. at 6.

[100] *See* Stabile, *supra* note 62, at 143-48.

[101] *Id.* at 147.

[102] *See* Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 866 (2002); *see also* Martin, *supra* note 5, at 158–60 (explaining how the SEC should take, as an example of effective executive pay disclosures, the British reform aimed at involving shareholders in determining compensation packages).

[103] Murphy, *supra* note 102, at 866.

[104] *Hearing on Empowering Shareholders on Executive Compensation Before the United States House of Representatives, Committee on Financial Services,* 110 Cong. 9 (2007) (written testimony of Professor Lucian Bebchuk) (hereinafter Bebchuk Testimony), *available at* http://financialservices.

differences in shareholder rights in the United States and the United Kingdom are very distinct. First, shareholders in the United Kingdom have the ability to remove and nominate directors to the board.[105] This fact makes it easier for British shareholders to make directors more accountable. In doing so, the directors take more initiative to ensure that executives' compensation is more reasonable, especially when compared to that in the United States.[106] Second, shareholders in the United Kingdom have the ability to call special meetings and amend corporate charters through resolutions to address issues that cannot wait until the annual meetings.[107] Not only do the shareholders have more power to remove directors they believe are not acting in their best interests, new British reforms have made the normally passive investor a more active player in corporate governance.[108] Finally, boards in the United States have the ability to engage in more decisive and aggressive defensive tactics in response to potential takeovers.[109]

Given the fact that executives in the United Kingdom earn less money than executives in the United States, but, "[b]etween 2000 and 2005, the [Financial Times Stock Exchange] FTSE 100's average annual return was 6.5% while the Dow Jones Industrial Average was 2% during the same period,"[110] it would seem that some explanation is required. The approach taken by the United Kingdom represents the corporate law system in place around the world; only the United States has so many impediments restricting shareholder power.[111]

The best counterargument is that most businesses prefer the American system because it allows the board and management to have more autonomy. Traditionally, companies favored the regulatory controls imposed by the government and SEC, which normally gave companies wide latitude and freedoms,[112] provided the companies followed all disclosure rules. This changed somewhat in the wake of the Sarbanes-Oxley,[113] which established requirements for more oversight and accountability by directors and executives.[114]–It is true that

house.gov/hearing110/htbebchuk030807.pdf.

[105] *Id.*

[106] *See* Martin, *supra* note 5, at 158–59.

[107] Bebchuk Testimony, *supra* note 104, at 5.

[108] Martin, *supra* note 5, at 158. The enhanced disclosures include reports on "the current value of executive pension plans and severance agreements." *Id.* The reports must also indicate whether an executives compensation package was negotiated by a member of the compensation committee or consultant. *Id.* at 159.

[109] Bebchuk Testimony, *supra* note 104, at 5.

[110] Martin, *supra* note 5, at 158-9.

[111] Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 848 (2005).

[112] *See generally* Murphy, *supra* note 102, at 866–67. Professor Murphy discusses the unique approach taken in the United States regarding the accounting methods for options, and explains that this has caused the increasing use of the options because of the tax benefits. *Id.* at 867. "These tax and accounting differences can help explain why U.S. boards are more generous with their option grants than are boards in other countries." *Id.*

[113] Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (codified at various sections in Title 15 and 18 U.S.C.).

[114] *See generally* Sarbanes-Oxley Act of 2002, 18 U.S.C §1514A (Supp. IV 2004). An in-depth discussion on the effects of the Sarbanes-Oxley legislation is well beyond the scope of this paper. What is important for this section is to note that the increasing regulations are forcing issuers to list in other

most of the largest businesses in the world are incorporated in the United States, however a trend has emerged:

> [S]ince the new regulatory mechanisms have been put in place, developments in the U.S. capital market have not been positive. In 2000, 90% of the funds raised by foreign companies through new stock offerings were raised in the U.S. The "90% rule" held in 2005, too, but in reverse—90% of the funds raised by foreign firms through new listings occurred in Europe and other non-U.S. markets. Last year, only two of the world's 25 largest initial public offerings listed in the U.S. since Congress enacted the tighter restrictions.[115]

If this trend continues, and if American companies continue with the pattern of grossly excessive pay packages at the same time as restricting shareholder rights, the United States might indeed lose its place as the dominant financial power in the world.

III. A NEW ERA OF SHAREHOLDER POWER?

A. The Role of the SEC

After the breakdown of the financial markets in 1929, the American confidence in the domestic and global financial markets disappeared.[116] The country entered the Great Depression and, thereafter, Congress announced that they would have hearings to determine possible actions to combat the crises.[117] With the information obtained at the hearings, Congress established the SEC to enforce the new securities laws and promulgate financial regulations in accordance therewith.[118] One of these laws, the Securities Exchange Act of 1934 ('34 Act), provided the SEC with the authority required to establish rules regarding many aspects of post-IPO trading.[119] Section 14 of the '34 Act provides the legal

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countries. This fact provides support to the argument that companies would not abandon their United States listings if required to restrict executive pay or provide shareholders more access rights in governance.

115 R. Glenn Hubbard & John L. Thornton, *Is the U.S. Losing Ground?*, WALL ST. J., Oct. 30, 2006, at A12; *see also* MICHAEL R. BLOOMBERG & CHARLES E. SCHUMER, SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP 17 (2007) (describing that the imposing obligations of Sarbanes-Oxley are negatively impacting new businesses in the United States); HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT (AEI Press 2006).

116 *See* The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Mar. 20, 2008). The information listed states that, "[d]uring the 1920s, approximately 20 million large and small shareholders took advantage of post-war prosperity and set out to make their fortunes in the stock market. It is estimated that of the $50 billion in new securities offered during this period, half became worthless." *Id.* It is hard to fathom that type of breakdown in the twenty-first century; only because of efficient regulation and defensive procedures did our country avoid a complete market crash following the September 11 attacks.

117 *Id.*

118 *Id.*

119 *Id.*

119 *Id.*

provisions that govern the solicitation and requirements of proxies;[120] Regulation 14A contains the rules promulgated by the SEC to carry out the purpose of the securities laws.[121] As Congress intended, the broad and expansive duties of regulating the largest economy in the world fell squarely on the shoulders of the SEC following the depression. It seems important, then, that the SEC use all of its abilities within its delegated power to make the American capital markets efficient, transparent, and fair. As such, the SEC should empower the shareholders of large public corporations with the ability to engage the governance process in a manner uncommon in today's corporate environment.

B. An Overview of the Proxy Process

A proxy allows a shareholder to allow another person to vote on his or her behalf at the annual meeting of a corporation.[122] Due to the nature and characteristics of proxy material, the law imposes a strict standard of compliance in an effort to ensure that shareholders exercise their voting rights.[123] With that in mind, the SEC set out the basic form and requirements that a proxy issued by a company or shareholder must follow in Rule 14a-4.[124] In this rule, the proxy shall indicate who is soliciting the proxy and how this solicitor will act on the proposals contained in the statement.[125] Under the current scheme, if the proxy relates to the election of directors, it must allow the shareholder an opportunity to either vote for or withhold a vote for the nominee.[126] In addition to establishing minimum

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[120] Securities Exchange Act of 1934, ch. 404, 48 Stat. 895 (codified as amended at 15 U.S.C.A. § 78n (West 2009)).

[121] The SEC promulgated various rules, beginning at section 14a-1, to govern proxy solicitations. 17 C.F.R. §§ 240.14a-1 to a-15 (2007); *see also* EDWARD BRODSKY & M. PATRICIA ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES, § 15.4 (2007) (providing a summary of proxy laws established by Congress and rules promulgated by the SEC).

[122] Rose A. Zukin, *We Talk, You Listen: Should Shareholders' Voices Be Heard or Stifled When Nominating Directors? How the Proposed Shareholder Director Nomination Rule Will Contribute to Restoring Proper Corporate Governance*, 33 PEPP. L. REV. 937, 955 (2006) (citing Teresa Carnell & James J. Hanks, Jr., *Shareholder Voting and Proxy Solicitation: The Fundamentals*, 37 MD. B.J. 23, 24 (2004)).

[123] *See id.* at 956.

[124] *See* 17 C.F.R. § 240.14a-4.

[125] *Id.* § 240.14a-4(a)(1),(3).

[126] *Id.* § 240.14a-4(b)(2). Specifically, this entire section states the following:

> A form of proxy which provides for the election of directors shall set forth the names of persons nominated for election as directors. Such form of proxy shall clearly provide any of the following means for security holders to withhold authority to vote for each nominee:
>
> i. A box opposite the name of each nominee which may be marked to indicate that authority to vote for such nominee is withheld; or
>
> ii. An instruction in bold-face type which indicates that the security holder may withhold authority to vote for any nominee by lining through or otherwise striking out the name of any nominee; or
>
> iii. Designated blank spaces in which the security holder may enter the names of nominees with respect to whom the security holder chooses to withhold authority to vote; or
>
> iv. Any other similar means, provided that clear instructions are furnished indicating

requirements for proxy forms, the regulations describe the matters that a proxy vote cannot confer.[127] Specifically, anyone attempting to solicit a proxy must follow the established guidelines.[128] Rule 14a-5 supplements the requirements of Rule 14a-4, describing how an issuer shall present the proxy information.[129] Another important rule is Rule 14a-3, which provides that a proxy statement that follows the above guidelines must accompany the solicitation of a shareholder's proxy.[130] These compliance standards enable the SEC to achieve the goal of maximum disclosure that leads to a better-informed investor.

The proxy system, due to the extensive and specific requirements, provides a double-edged sword. For any shareholder that wants to make a proposal to enter on the corporation's proxy statement, the costs can be insurmountable.[131] Incumbent boards always have a significant advantage over shareholders, even the large block shareholders with vast assets, because shareholders cannot vote against board-sponsored candidates or propose different board candidates.[132] Furthermore, and very importantly, under Rule 14a-8(i)(8), the "town meeting rule," directors may exclude proposals by shareholders that relate to the election of a member to the board of directors.[133] Therefore, not only must a shareholder deal with extensive barriers to having his or her proposal appear on the company statement,

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> how the security holder may withhold authority to vote for any nominee.

Id.

127 *Id.* § 240.14a-4(d).

128 17 C.F.R. § 240.14a-4(f).

129 The SEC states that the information "shall be clearly presented" and "divided into groups according to subject matter" with headings that identify each subject. *Id.* § 240.14a-5(a). The information must be in a standard "roman type at least as large and as legible as 10-point modern type." *Id.* § 240.14a-5(d)(1). The proxy must contain information regarding when shareholder proposals are due and whether the date of the shareholder meeting changes. *Id.* § 240.14a-5(e)(1), (f).

130 17 C.F.R. § 240.14a-3.

131 *See id.* § 240.14a-8. Under the Rules, the SEC says the following concerning shareholder proposals making the corporate proxy statement:

> [I]n order to have your shareholder proposal included on a company's proxy card, and included along with any supporting statement in its proxy statement, you must be eligible and follow certain procedures.
>
> . . . .
>
> (1) In order to be eligible to submit a proposal, you must have continuously held at least $2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal at the meeting for at least one year by the date you submit the proposal. You must continue to hold those securities through the date of the meeting.

Id. If the shareholder does not meet the eligibility or procedural requirements, the "company may exclude [the shareholder's] proposal." *Id.*

Id. From attempting to follow that described process, it is obvious that the costs associated with the requirements make it practically impossible for shareholders to engage in effective corporate governance.

132 Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L REV. 407, 418 (2006).

133 17 C.F.R. § 240.14a-8(i)(8). Shareholders can only submit a proposal if they meet certain requirements. Normally, corporations are required to include the proposal in its proxy report; however, if the company can identify that the proposal falls under one of the exceptions delineated in 14a-8, it may exclude. *See id.* §§ 240.14a-8(i)(1)–(13). The problems presented by this barrier will be discussed at length later in the paper. *See* discussion *infra* Part III.C.

the Rules give companies thirteen possible ways to exclude a proposal.[134]

The SEC does provide limited exceptions for shareholders seeking information but not a proxy solicitation. However, these exceptions are limited to shareholder discussion about how he or she will vote and why,[135] when a shareholder attempts communication without requesting a proxy,[136] and putting definitions on what type of material counts as a "solicitation."[137] In other words, if a shareholder engages in ministerial functions and activities that will have no effect on meaningful corporate governance, the shareholder will not have to bear the expense of the proxy process. Though one could argue that those exceptions extend to roles beyond that, the response to that argument is decisive: These exceptions do not extend to every shareholder.

In the cases where a controlling shareholder or a corporate activist who desires to become a controlling shareholder—one who *truly* wants to affect governance—attempts to solicit proxies, the Rules are not so lenient. Normally, a shareholder "testing the waters," or expressing desires to stay passive, with a memorandum containing his thoughts will have to file an accompanying proxy statement.[138] Additionally, any shareholder who owns the market value equivalent of $5,000,000 must file a brief notice with the SEC that can ruin any type of "stealth approach" for taking over management.[139] This has the effect of tipping off management to potential governance problems, thereby allowing for preemptive strikes or other actions to avoid proxy fights. With one hand, the SEC gives shareholders more reasonable means to affect corporate governance, but with the other hand, the SEC clamps down on those shareholders most capable. The result is maintaining the status quo.

The SEC does allow shareholders seeking to send out proxies to call upon the "disclose or mail" rule, which provides that, upon a written request by a shareholder, a company must disclose the names of its shareholders so that one soliciting proxies will know where to send the information.[140] This will decrease the upfront costs of a challenging shareholder in getting the information for potential proxy recipients, but, when compared to the overall barriers, it does nothing more than further the "feel-good" regulation scheme in place regarding corporate governance. The regulations established by the SEC are well intended, and, if used properly, can be very effective, but they can be too cumbersome and difficult to quantify in lay terms.

If management or a shareholder targets a desired change in board positions, or if a current board member is stepping down and a proxy statement lists potential candidates for replacements, the Rules allow for listing and describing candidates whom shareholders should *not* pledge their vote.[141] Thus, provided a legitimate

[134] *See* 17 C.F.R. § 240.14a-8(i)(1)–(13).
[135] *Id.* § 240.14a-1(l)(2)(iv).
[136] *Id.* § 240.14a-1(b)(1).
[137] *See id.* § 240.14a-1(l)(1)(iii).
[138] *See id.* § 240.14a-3.
[139] *See* 17 C.F.R. § 240.14a-6(g).
[140] *See id.* § 240.14a-7.
[141] *Id.* § 240.14a-4(d)(4).

candidate makes the ballot without the efforts of shareholders, management retains the advantage by exercising its ability to "blackball" anyone it deems unworthy. Taken together, the SEC, through the authority granted to it by Congress, established a system of proxy solicitation that those interested in fighting for votes must follow closely, and these laws greatly influence the role of corporate governance between publicly held corporations and their shareholders.[142] If it fails to follow the rules, a company may face sanctions from the SEC.[143]

C. Online Availability of Proxy Materials

In a massive step forward in pushing for increased shareholder activism, the SEC took steps to make proxy materials available online. In doing so, it opened the door to endless governance possibilities.[144] Specifically to address the costs, time commitments, and difficult standards associated with the traditional proxy, the SEC took action,[145] adopting a "notice and access" model that allows companies the option to make proxy materials available via the Internet.[146] Although this new set of regulations (Internet rules) passed with the specific intent of lowering the costs and increasing the availability of proxies, it could be used for an expansive renovation of the current proxy scheme. This new option became effective on July 1, 2007.[147]

Perhaps the main downfall of the new regulations is that they are optional, which is the most significant change from the original proposed rule.[148] The final rules addressed four main categories: (1) content and delivery requirements of notices; (2) format and posting requirements of notices; (3) safeguards that ensure shareholders know they have a right to request paper materials; and (4) procedures non-insider solicitors must follow to use the online proxy solicitation method.[149]

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[142] *See* Carl Landauer, *Beyond the Law and Economics Style: Advancing Corporate Law in an Era of Downsizing and Corporate Reengineering*, 84 CAL. L. REV. 1693, 1707 (1996) (reviewing LAWRENCE E. MITCHELL, PROGRESSIVE CORPORATE LAW (1995) and MARK J. ROE, STRONG MANAGERS, WEAK OWNERS (1994)).

[143] *See* Zukin, *supra* note 122, at 955.

[144] The new possibilities will be discussed in detail, including how the SEC took back some of the power it originally granted to shareholders, later in the paper.

[145] Specifically, the SEC amended the following Rules:

> 14a-2, 14a-3, 14a-4, 14a-7, 14a-8, 14a-12, 14a-13, 14b-1, 14b-2, 14c-2, 14c-3, 14c-5, 14c-7, Schedule 14A, Schedule 14C, Form 10-K, Form 10-KSB, Form 10-Q, and Form 10-QSB, under the ['34 Act] and Form N-SAR under the ['34 Act] and the Investment Company Act of 1940. [The SEC also added a] new Rule 14a-16 under the ['34 Act].

Internet Availability of Proxy Materials, 72 Fed. Reg. 4148 (Jan. 29, 2007) (to be codified at 17 C.F.R. § 240.14a-16).

[146] 17 C.F.R. § 240.14a-16 (2007).

[147] Memorandum from Mark S. Bergman, Raphael M. Russo & Frances F. Mi, Paul, Weiss, Rifkind, Wharton & Garrison LLP (Jan. 26, 2007), *available at* http://www.paulweiss.com/files/Publication/1b89b45d-9121-4f3d-bc0e-0acbe010353a/Presentation/PublicationAttachment/e013eace-3dc8-4790-9881-0b26a7be6e40/NewE-ProxyRules26-Jan-07.pdf.

[148] *See* Shareholder Choice Regarding Proxy Materials, Exchange Act Release No. 34-56135, 17 C.F.R. pt. 240 (July 26, 2007) (stating that its final rule differed slightly from the proposed in that issuers could decide if they want to take advantage of the Internet Rules).

[149] *Id.*

1. Content and Delivery

The Internet rules allow a company to provide a shareholder with notice of availability (Notice) forty or more calendar days before the annual meeting.[150] No other information can appear on this Notice so that shareholders will not confuse the notice document with the actual proxy card.[151] If so, some shareholders might become confused, returning the notice document in lieu of the proxy card. Just as the requirements for the statutory prospectus before an IPO, the Notice must offer information in "plain English."[152] The company must send the Notice via e-mail or traditional mail, and, ten days after initial delivery, the company can deliver the proxy card to acquire the shareholder's vote.[153]

There were concerns in some comments on the proposed rule that the Notice would invade shareholder privacy and that the Notice would lead to further shareholder apathy.[154] Some comments indicated that shareholders do not have email accounts.[155] Probably the most important comment received dealt with "phishing" by dastardly individuals taking advantage of unwitting shareholders.[156] While all these issues are very important, if examined under a cost-basis analysis, the Internet rules provide more benefits than drawbacks.[157]

2. Posting of Information

There are specific requirements that issuers must meet if they choose to use the Internet rules. For example, issuers must make materials "publicly accessible, free of charge, at the Web site address specified in the notice on or before the time that the notice is sent to the security holder."[158] To comply, an issuer *cannot* use the SEC's EDGAR site and the website must preserve the anonymity of each shareholder that accesses the materials.[159] The information on the web must be substantially the same as the paper version of the proxy materials.[160] The Notice must have the following: a legend in boldface that describes the content represents only a notice and that the proxy statement is available online;[161] a description of

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[150] 17 C.F.R. § 240.14a-16(a)(1).

[151] *Id.* § 240.14a-16(e).

[152] *Id.* § 240.14a-16(g).

[153] *Id.* § 240.14a-16(h).

[154] Internet Availability of Proxy Materials, *supra* note 145, at 4148, 4152.

[155] *Id.* at 4152.

[156] *Id.*

[157] *See generally* Internet Availability of Proxy Materials, *supra* note 145, at 4148, 4162 (providing a discussion regarding the cost-benefit analysis of going to a system of internet availability of proxies).

[158] 17 C.F.R. § 240.14a-16(b)(1).

[159] *Id.* § 240.14a-16(b)(3) (emphasis added). The prohibition on using EDGAR probably comes from the desire of the SEC to not subsidize companies by giving them use to a large-scale online database. The SEC could change its policy and require an EDGAR filing fee that would encourage more companies to post at a single site to increase the ease on shareholders in finding information.

[160] *See id.*

[161] *Id.* § 240.14a-16(d)(1).

the date, time, and location of the annual shareholder meeting;[162] and information regarding where a shareholder can request the paper form of the proxy materials.[163] Rule 14a-6, regarding proxy solicitations, still applies, and companies must comply with all other applicable provisions.[164]

3. Right to Paper Copies

Another important aspect of the Internet rules is the ability for shareholders to request paper copies of the proxy materials.[165] Shareholders can request the traditional printed form of the proxy materials if they desire.[166] The registrant must send the information requested within three business days, either by mail or by e-mail.[167] The burden is on the record owner that requests documents to meet the request for paper proxy materials within a reasonable time.[168] The SEC did aid shareholders by mandating that every notice contain information relating to the timeline of which a shareholder can request paper materials.[169] The cut-off day for requesting copies is one year after the conclusion of the meeting for which the proxy materials were applicable.[170] Additionally, to further aid privacy interests of shareholders, the company issuing paper materials via email cannot use the shareholders e-mail address for any other purpose than proxy delivery.[171]

It is very important that the SEC regulate the manner in which companies treat those that opt out of the Internet rules. As indicated from the comments received by the SEC, many shareholders still find privacy issues with the Internet.[172] Interestingly enough, though, for a shareholder that opts out of the Internet rules, the company can send the same information by e-mail, which could be less secure than a website that requires a secure login.

4. Non-Insider Soliciting Parties

In addition to providing registrants with the ability to access e-proxies, shareholders proposing items to appear in the company proxy report can take advantage of the new Internet rules. "Under the proposed rules, a person other than the issuer who undertakes his or her own proxy solicitation . . . would be able to rely on the . . . 'notice and access' model."[173] As the SEC contemplated, this could

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[162] *Id.* § 240.14a-16(d)(2).
[163] *Id.* § 240.14a-16(d)(5).
[164] 17 C.F.R. § 240.14a-16(i).
[165] *See* 17 C.F.R. § 240.14a-16(j)(2).
[166] *See id.* § 240.14a-16(j)(2).
[167] *Id.* § 240.14a-16(j)(1)–(2).
[168] *Id.*
[169] *Id.*
[170] *Id.* § 240.14a-16(j)(3).
[171] *Id.* § 240.14a-16(k)(2).
[172] Internet Availability of Proxy Materials, 70 Fed. Reg. 74,598, 74,607 (Dec. 15, 2005), *available at* http://www.sec.gov/rules/proposed/34-52926fr.pdf.
[173] Internet Availability of Proxy Materials, 70 Fed. Reg. 74,598, 74,607 (Dec. 15, 2005), *available at* http://www.sec.gov/rules/proposed/34-52926fr.pdf.

aid shareholders involved in a proxy contest with management by lowering the costs associated with the process.[174] The requirements for soliciting persons rather than a company are substantially similar to those listed above. One difference is that the soliciting person may send out a notice by the later of forty days before the shareholder meeting or ten calendar days after the date the registrant first sent its proxy statement.[175] This allows a solicitor to examine the company's statement and then decide if he will initiate an opposing proxy. The Internet rules also require that soliciting parties send copies of proxy materials only to those whom they sent a Notice, thereby eliminating the need for wide availability.[176]

Some practitioners believe that this new ability to solicit e-proxies will encourage more proxy contests, a conclusion which has factual grounding.[177] It will be interesting to watch whether the SEC makes the Internet rules mandatory in the future. This decision will largely turn on whether companies take advantage of the new Internet rules. If the SEC makes the rules mandatory, the climate of corporate governance will forever change in America. Note that these are the key provisions of the new Internet rules. Certainly, this progressive move on the part of the SEC is a new move towards embracing better technology to increase efficiency and information sharing among investors. It is too early to examine the effectiveness of the Internet rules, but it seems certain that some shareholders could see this as an opportunity to play an active role in governance. That is, until the SEC pulled the rug from under the reform.

D. Maintaining the Norm

After taking the time and expending the effort to provide companies and shareholders the ability to engage in active governance by developing a practical approach to proxy solicitation, the SEC, after a long debate, made a decision that made any new policies to encourage active shareholders moot. Why is it that the SEC decided not to go further in its seemingly designed effort to shift more power and control to the shareholders? This section deals with the SEC's struggle with shareholder access to a company's proxy materials for purposes of nominating directors.

1. Background

The first movement to give shareholders more access to the corporate ballot came in 1942.[178] At that time, the proposal would have given minority shareholders the ability to include names of potential directors they desired on the

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[174] *See id.*

[175] 17 C.F.R. § 240.14a-16(l)(2)(i)–(ii).

[176] *Id.* § 240.14a-16(l)(1).

[177] SULLIVAN & CROMWELL L.L.P., PROXY SOLICITATION THROUGH THE INTERNET, Dec. 14, 2006, at 3, http://www.adrbny.com/files/SO19088.pdf.

[178] SECURITIES EXCHANGE COMMISSION, DIVISION OF CORPORATE FINANCE, STAFF REPORT: REVIEW OF THE PROXY PROCESS REGARDING THE NOMINATION AND ELECTION OF DIRECTORS 2 (July 15, 2003), *available at* http://www.sec.gov/news/studies/proxyreport.pdf [hereinafter PROXY REPORT].

company's proxy statement.[179] The SEC did not adopt the suggested proposals.[180] Though it took another thirty-five years, the SEC again took focus on shareholder access to corporate ballots through the proxy process.[181] This time, the Commission examined shareholder communication, shareholder participation, and general corporate governance.[182] The SEC did adopt regulations that required companies to produce disclosure regarding whether they had a nominating committee that would entertain shareholder proposals.[183] It did not, however, adopt or address any other issues to provide for shareholders access.[184] The Commission did acknowledge that if many companies did not adopt nomination committees, it would have to take action to ensure that shareholders had access to the proxy process.[185]

In 1992, the SEC revisited the issue and acknowledged that shareholders were having little success accessing corporate ballots or even getting their proposals to nomination committees.[186] However, the SEC recognized that

> [p]roposals to require the company to include shareholder nominees in the company's proxy statement would represent a substantial change in the Commission's proxy rules. This would essentially mandate a universal ballot including both management nominees and independent candidates for board seats.[187]

The SEC did permit shareholders to utilize Rule 14a-4(d) to indicate board candidates they opposed,[188] but this reform still does not give shareholders the true power to make a difference. Note that shareholders do have the ability to conduct an election contest by following the above-mentioned proxy rules, but, even after the new Internet Rules, the costs associated with this are very large.[189]

2. Recent Challenges and Interpretations

In 2003, the American Federation of State, County and Municipal Employees Pension Plan (AFSCME) requested a no-action letter to determine whether its proposal for including the representative of a group of shareholders owning three percent could be excluded from a proxy statement by American

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179 *Id.*

180 *Id.* The SEC gave no specific reasons for refusing to adopt the proposal, simply stating, "A number of the suggestions proposed by the staff were not adopted." SEC Release No. 34-3347 (Dec. 18, 1942); *see also Securities and Exchange Commission Proxy Rules: Hearings on H.R.s 1493, 1821, 2019 Before the House Comm. on Interstate and Foreign Commerce*, 78th Cong. (1943) (testimony of SEC Chairman Ganson Purcell).

181 PROXY REPORT, *supra* note 178, at 3.

182 *Id.*

183 *Id.*

184 *See* Shareholder Communications, Shareholder Participation, in the Corporate Electoral Process and Corporate Governance Generally, Exchange Act Release No. 34-14970 (July 18, 1978).

185 PROXY REPORT, *supra* note 178, at 4.

186 *Id.*

187 Regulation of Communications Among Shareholder, 53 SEC Docket 2028 (Oct. 16, 1992).

188 *See* PROXY REPORT, *supra* note 178.

189 PROXY REPORT, *supra* note 178, at 5; *see* discussion *supra* Part III.B–C.

International Group, Inc. (AIG), pursuant to Rule 14a-8(i)(8).[190] In response, the SEC "issued a no-action letter in which it indicated that it would not recommend an enforcement action against AIG should the Company exclude the Proposal from its proxy statement."[191] After AIG excluded the proposal, AFSCME sued to compel AIG to include its proposal in the company's proxy report.[192] The district court ruled for AIG, and the case went on appeal to the United States Court of Appeals for the Second Circuit.[193]

The issue on appeal was whether the shareholder proposal "relate[d] to an election" for purposes of Rule 14a-8(i)(8).[194] The court pointed to two contrasting interpretations by the SEC regarding proper exclusions, one from 1976, and one submitted in an amicus brief to the court.[195] The court, based on the conflicting interpretations, held that a company could exclude proposals that related to an instant election, but that the language of the regulation said nothing about excluding proposals for future elections.[196] Thus, it determined that AIG improperly excluded AFSCME's proposals, but it hedged its holding regarding the issue of shareholder's access to the corporate ballot:

> [W]e take no side in the policy debate regarding shareholder access to the corporate ballot. There might be perfectly good reasons for permitting companies to exclude proposals like AFSCME's, just as there may well be valid policy reasons for rendering them non-excludable. However, Congress has determined that such issues are appropriately the province of the SEC, not the judiciary.[197]

Though not entirely punting on the difficult issue, the Second Circuit made a pass on deciding a key issue, thus opening the door to many new interpretations.

3. "Clarification" Provided by the SEC

Realizing that its conflicting interpretations thirty years apart would lead to further litigation, and because the holding of the Second Circuit conflicted with decisions of other circuit courts,[198] the SEC announced that it was going to begin taking comment on possible new changes to the '34 Act Regulations, specifically those regarding shareholders' ability to nominate directors.[199] Its decision to do so must have come in light of the Second Circuit thumbing its nose at the SEC, especially regarding prior interpretations of a very controversial issue. Specifically, the SEC stated that its "position that the election exclusion should not

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[190] American International Group, Inc., SEC No-Action Letter, 2005 SEC No-Act. LEXIS 235, 2005 WL 372266 (Feb 14, 2005).

[191] AFSCME v. AIG, Inc., 462 F.3d 121, 124 (2d Cir. 2006).

[192] AFSCME v. AIG, Inc., 361 F. Supp. 2d 344, 346 (S.D.N.Y. 2005).

[193] *Id.* at 348.

[194] *AFSCME*, 462 F.3d at 125.

[195] *Id.* at 126.

[196] *Id.* at 127–28.

[197] *Id.* at 130–31.

[198] Shareholder Proposals Relating to the Election of Directors, 92 SEC Docket 256, at 9 (Jan. 10, 2008).

[199] PROXY REPORT, *supra* note 178, at 1.

be, and was not originally intended to be, limited" by the Second Circuit's preference on the 1976 interpretation.[200] Further, the Commission cited a recent United States Supreme Court case where the interpretation of agency rules by the Second Circuit was in question.[201] In that case, the Court determined that an agency's interpretation of its own rules is controlling unless the interpretation is clearly erroneous, notwithstanding possible different interpretations over the course of many years.[202] Armed with a favorable Supreme Court ruling and determined to decrease the amount of uncertainty surrounding the shareholder access interpretation, the SEC began analyzing the fate of Rule 14a-8(i)(8).

SEC Chairman Christopher Cox had one time stated that he wanted to expand the influence of shareholders in proxy contests,[203] yet when the vote came before the Commission in July of 2007, he voted both for *and* against the new proposal.[204] The initial proposal by Democrats called for a five percent threshold requirement that shareholders would have to meet to reach the ballot; the initial proposal by Republicans called for a continued bar for shareholders seeking to access corporate ballots.[205] Subsequently, on January 10, 2008, the SEC made its decision, confirming its 1990 interpretation, and further modifying Rule 14a-8(i)(8) to exclude any proposal that "would set up a process for shareholders to conduct an election contest in the future by requiring the company to include shareholders' director nominees in the company's proxy materials for subsequent meetings."[206] Not only did the SEC prevent shareholders from setting up future contested elections, but it also went through with action that opposed the original intent as stated by Chairman Cox, and the SEC continued its blockade against shareholders seeking to engage in nominating directors to a company's board.[207]

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[200] Shareholder Proposals Relating to the Election of Directors, *supra* note 198, at 10.

[201] Long Island Care at Home, Ltd. v. Coke, 551 U.S. 158 (2007).

[202] *Id.* at 2349.

[203] Kara Scannell, *SEC Chairman's Proxy Pitch Loses Steam*, WALL ST. J., Nov. 15, 2007, at C11.

[204] Kara Scannell, *SEC's Solomon? Cox Splits Vote on Proxy Access*, WALL ST. J., July 26, 2007, at C1 (emphasis added).

[205] *Id.*

[206] Shareholder Proposals Relating to the Election of Directors, *supra* note 198, at 13.

[207] Specifically, the SEC stated, "We believe that the clarifying rule amendment is consistent with the agency's longstanding interpretation of the election exclusion and that the references to 'nomination' and 'procedure' in the rule text appropriately reflect the purpose of the exclusion." *Id.* at 18. That might be well and true, but the overarching issue the SEC seemed to avoid was, if it changed its approach regarding the nomination exclusion, it would have had to address many other issues relating to contested election disclosures and new interpretations of several other proxy provisions. *See id.* at 3–6. This paper does not suggest the SEC was lazy, but it does look very suspicious, given its recent move towards empowering shareholders by making proxy materials more readily available. Even in its description of the Election Exclusion in the Proposed Rule that the SEC put out for comment, it reiterated the disclosure issue: "The proper functioning of the election exclusion is critical to prevent the circumvention of other proxy rules that are carefully crafted to ensure that investors receive *adequate disclosure* in election contests." Shareholder Proposals Relating to the Election of Directors, 91 SEC Docket 575 (July 27, 2007) (emphasis added). It continued by stating that, if shareholders wanted to replace directors, they would need to go through the proxy process. *Id.* This could be a reasonable conclusion, and the SEC did make it easier to engage in a proxy contest recently, but the analysis still seems weak.

E. Future Implications

In explaining the proxy system, detailing its new reform, and providing information that leads one to conclude the SEC recognizes the problem of executive overcompensation, it is apparent that the SEC has established the groundwork for increasing shareholder information and participation. The SEC recognized the potential of the Internet, implemented appropriate regulations that would help companies and shareholders open lines of communication, and displayed it was working to attain the goals listed in its mission statement.[208] These changes should signal the beginning of a new era of corporate governance; however, the SEC has reinforced its blockade to limit shareholders' ability to reach the ballot.[209] Thus, the SEC has stalled in taking advantage of the invaluable asset the Internet provides. Why else would the SEC work as it did when it expects shareholders not to respond? In the era of Enron and WorldCom, it is evident that much is required to avert further economic disasters due to weak corporate boards and managers. Greater proxy availability will address the collective action problems.[210] As Professor Bernard Black explains, "Shareholder passivity may be partly a function of the legal rules" that impose great restrictions on investors who want to become active in corporate governance.[211] In the changing proxy environment, it seems very possible that many shareholders will be inclined to read the materials available in a form that allows for paperless examination and become an active participator in the decision-making process. For example, a shareholder that normally takes a passive approach, i.e., checking every box management suggested, upon receiving a proxy request, if he received this solicitation online, might take an extra five minutes of his day to investigate some issues presented.

The Internet provides access to much information, both reliable and questionable in nature. If a shareholder has a proposal for changing a policy or norm on the company's proxy statement, an investor that usually acquiesces might engage in a Google search to research any issues presented, thus producing a better-informed and reasoned vote. The Internet rules will not provide the definitive result to make every passive investor engage in informative governance and it will not overcome, by itself, the collective action problem, but it should encourage a new movement and approach towards more meaningful and beneficial corporate governance. Mainly, the increased access and lower costs will help those shareholders that have holdings beyond that of what the everyday passive investor would have, such as pension funds, insurance companies, and other institutional investors. This in turn could change the environment that currently exists where the voting rights that shareholders hold—emphasized in the theoretical educational setting and corporate finance courses as the benefit that overcomes the disadvantage of only having a residual claim to corporate assets—

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[208] See the discussion above.

[209] See discussion above and below.

[210] *See* Phyllis Plitch, *SEC's Online Plan to Cut Costs May Rally Dissident Investors*, WALL ST. J., Dec. 27, 2005, at C3; discussion *infra* Part IV.B.

[211] Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 566 (1990).

have largely become ceremonial.[212]

IV. INEFFECTIVE APPROACHES TO CONTROLLING EXECUTIVE COMPENSATION

Because the SEC continues to take its line against allowing shareholders the ability to access the corporate ballot, there must be some other way to control the executive overcompensation problem. This section of the paper provides analysis of the various ways and means executive compensation could be controlled, but has not due to a myriad of reasons. Specifically, the next sections analyze the ineffectiveness of the new SEC disclosure rules and the enormous loopholes and exceptions installed in the Internal Revenue Code (IRC) by Congress that have both failed in their attempt to control executive compensation. Although possible solutions to aid the shortcomings will be provided, the main problem seems to be the dedication of the SEC and Congress to address the issue.

A. SEC Disclosure Rules

One constant trait of the SEC is its consistent use of rulings to address issues that come about in the market. One issue the SEC routinely addresses is how executive compensation disclosure should appear on '34 Act companies proxy materials. Though the executive compensation issue was not as pervasive through the early part of the twentieth century, it has become increasingly important as the pay packages increase to gargantuan proportions. Beginning in 1938, the SEC has regularly issued releases and final rulings regarding compensation disclosures, sometimes aiming to increase narrative disclosure, sometimes aiming for tabular or graphical disclosures, and sometimes both.[213] The idea each time is to encourage companies to list information in plain English that would be easily understandable, but not overly uniform as to appear like boilerplate language.[214]

Thus, in 1992, the SEC adopted another new set of rules under Regulation S-K "[t]o improve shareholders' understanding of all forms of compensation paid to senior executives and directors, the criteria used by the board of directors in reaching compensation decisions, and the degree of relationship between compensation and corporate performance."[215] Specifically, the regulations provide

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[212] *See* Seth W. Ashby, Note, *Strengthening the Public Company Board of Directors: Limited Shareholder Access to the Corporate Ballot vs. Required Majority Board Independence*, 2005 U. ILL. L. REV. 521, 528 (2005).

[213] *See, e.g.*, Disclosure of Executive Compensation, SEC Release No. 33-6486, 48 Fed. Reg. 44,467 (Sept. 23, 1983) (calling for the use of tables to describe compensation not based in equity); Amended Proxy Rules, Exchange Act Release No. 34-4775, 17 Fed. Reg. 11,430, 11,431 (Dec. 11, 1952) (requiring tables for pension and deferred compensation); Amended Proxy Rules, Exchange Act Release No. 34-3347, 7 *Fed. Reg*. 10,653 (Dec. 18, 1942) (requiring tables in the disclosure forms); Amended Proxy Rules, Exchange Act Release No. 34-1823, 3 Fed. Reg. 1991, 1992 (Aug. 13, 1938) (providing the first rules regarding disclosure of how boards determine executive compensation).

[214] For purposes of this paper, the last three releases will be discussed.

[215] Executive Compensation Disclosure, 57 Fed. Reg. 48,126 (1992) (codified at 17 C.F.R. §§ 228, 229, 240, 249). Regulation S-K disclosures include items that a '34 Act company must disclose to the SEC but do not fall within the traditional definition of financial information. *See* Regulation S-K, MoneyGlossary.com, http:// www.moneyglossary.com/?w=Regulation+S-K (last visited Mar. 29, 2008).

that companies must list the compensation paid to the top executives in a Summary Compensation Table to allow shareholders the ability to examine easily any proposed pay packages.[216] A board's compensation committee must also include, per the regulations, reports on how well the executives met the company's performance standards.[217] Finally, the compensation committee must list the cumulative total return to shareholders in the form of a line graph and another graph to allow shareholders to examine the return of the S&P 500 or return of any peer companies in the registrant's industry.[218]

In 2003, the SEC again adopted rules in an attempt to "increase shareholder awareness of and involvement in the executive compensation decision-making process."[219] Additionally, the Self-Regulatory Organizations ("SROs")—NYSE and NASDAQ—procured new standards to expand shareholder approval requirements for executive compensation.[220] These new changes came in the wake of the Enron disaster and related specifically to the full disclosure of all equity payments to executives.[221] In 2006, the SEC again proposed new rules to "provide investors with a clearer and more complete picture of compensation to principal executive officers, principal financial officers, the other highest paid executive officers and directors."[222] These disclosure rules seek to provide information on deferred compensation for the three recent fiscal years.[223] Importantly, these new rules require disclosure of personal benefits executives receive in excess of $10,000, but "[a]n item is not a perquisite or personal benefit if it is integrally and directly related to the performance of the executive's duties."[224] There is also a requirement that companies disclose executives' total compensation.[225] The purpose of this requirement "is to eliminate the 'holy-cow moment' when shareholders learn the CEO is about to collect" massive amounts of deferred compensation.[226] Requiring disclosure of total compensation might be the most successful requirement to date because it will give shareholders a quantifiable and

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[216] Executive Compensation Doctrine, 57 Fed. Reg. 48,127 (1992).

[217] *Id.*

[218] *Id.*

[219] McClendon, *supra* note 30, at 976.

[220] *Id.* A discussion on the role of SROs is well-beyond the scope of this paper. It is of note, that in the American market, SROs play a very important role in "private" regulation of companies that list with them. They are important mainly because they provide another layer of regulation and protection to an industry that tends to freak people out when times are bumpy and their savings seems to be wilting away. The SEC and SROs piggyback on each other when it comes to implementing new regulations and disclosure rules, sometimes one looking to the other to implement major controversial changes. What is certain is that SROs are necessary to the market, and their effectiveness could expand if the SEC fails to put more power in the shareholders' hands.

[221] Disclosure of Equity Compensation Plan Information, SEC Release No. 8,048, 17 C.F. R. § 228-29, 240, 249 (Feb. 1, 2002), *available at* http://www.sec.gov/rules/final/33-8048.htm; *see also* Janet Whitman, *Stock Options Face Scrutiny in Wake of Enron*, WALL ST. J., Apr. 3, 2002, at B7B.

[222] Executive Compensation and Related Party Disclosure, Exchange Act Release No. 33-8655, 71 Fed. Reg. 6,542, 6,543, 17 C.F.R. §§ 22-29, 239-40, 245, 249, 274) (Feb. 8, 2006).

[223] *Id.* at 6,543.

[224] *Id.* at 6,553.

[225] *Id.*

[226] Martin, *supra* note 5, at 152 (quoting Gretchen Morgenson, *A 'Holy Cow' Moment in Payland*, N.Y. TIMES, Feb. 19, 2006, § 3, at 1).

comparable number as opposed to a figure discounted to its present value or adjusted for "other" accounting purposes. Still, some figures might lose context within all of the information provided.

In short, the SEC has sought to make executive pay package disclosure simple to read, analyze, and understand—which happens to be the same purpose of the SEC for the past seventy years.[227] Sometimes the simplest representations do not convey the overarching problems they seek to address. The tables and graphs include objects such as options and grants, which to the normal shareholder has little meaning.[228] The trouble with the disclosure rules is that companies have simply just taken their other filings, including the 10-K and 10-Q, and just relisted some information and rearranged other materials.[229] This boilerplate language complies with the law, but does little to expose the outrageous behavior of some companies regarding executive pay packages. Although the SEC has consistently tried to address the use of boilerplate language, it consistently fails to pass regulations that press companies to use specialized and specific drafting. Additionally, with the many regulations, the SEC still takes the position that it seeks to improve only disclosure and not institute wage controls.[230] Therefore, to the SEC, transparency is the key to effective governance and to controlling executive compensation. The many rules and interpretations are well intended but, given the number and frequency, they seem ineffective.

Before discussing whether the SEC could control executive compensation through transparency, and given Chairman Cox's statements that the market should always control, does the SEC have any intention in even trying to help control the problem? Further, does the SEC think there is a problem? It is logical to conclude that the SEC recognizes a problem because of the many regulations, interpretations, and proposals it has issued over the past seventy years. Provided that background, there are steps the SEC could take to produce better results.

The SEC could call for disclosure of useful information in a manner that one can analyze independent from any other items, such as the pay ratios of the executives compared to other employees.[231] By only requiring disclosure of the executives' compensation, sometimes in a percentage form, the current rules allow for a company to skew the real figures. The disclosures do not require companies to state performance targets; thus, shareholders have no clue whether the executives are meeting the outlined objectives[232] that the shareholders approved.[233]

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[227] *Id.* at 150.

[228] *See id.* at 150.

[229] *See* Scott P. Spector, *The Compensation Committee Report*, *in* A PRACTICAL GUIDE TO SEC PROXY AND COMPENSATION RULE 4.2 (2d ed. Supp. 2000).

[230] Christopher Cox, Chairman, SEC, SEC Chairman's Opening Statement: Proposed Revisions to the Executive Compensation and Related Party Disclosure Rules (Jan. 17, 2006) (transcript *available at*. http://www.sec.gov/news/speech/spch011706cc.htm). SEC Chairman Cox is the poster-boy marketer: the "market is capable of disciplining excessive compensation, provided that the market has adequate information." Kara Scannell, *SEC to Propose Overhaul of Rules on Executive Pay*, WALL ST. J., Jan. 10, 2006, at A2.

[231] Stabile, *supra* note 62, at 162.

[232] For a company to deduct payments to executives beyond $1 million, they must submit performance standards for approval to the shareholders. *See* discussion *infra* Part IV.B.

The SEC should require detailed disclosure of these targets and any other goals. It seems that there is a lack of dedication with the SEC's rules that makes them resemble only "feel-good" rulemaking. There is little indication that making compensation packages widely known would make transparency even work.[234] With the SEC's lack of initiative to require full **and** material disclosures combined with its recent decision to allow companies to continue barring shareholder board nominations, the SEC has proven it to be ineffective, assuming it wants to make the effort, in controlling executive overcompensation.

B. Recent Congressional and Presidential Efforts

Congress has recently decided to play its hand in the effort to control executive compensation. Both the House and Senate introduced legislation in April 2007 to amend Section 14 of the '34 Act. The House version, sponsored by Representative Barney Frank, provided for a separate shareholder vote to approve executive compensation packages. However, the effect of this provision was greatly hedged by the remaining portion of the proposed legislation. The shareholders' votes would be advisory. Specifically,

> The shareholder vote shall not be binding on the corporation or the board of directors; nor be construed (1) as overruling a board decision; (2) to create or imply additional fiduciary duty by such board; (3) to restrict or limit shareholder ability to make proposals for inclusion in proxy materials related to executive compensation.[235]

The legislation also included a provision requiring shareholder approval of golden parachutes, but again, any votes by the shareholders would be advisory. The Senate version, which consisted of the exact same provisions of the bill introduced in the House, was introduced by-then Illinois Junior Senator Barack Obama.[236] The Senate version was never sent to Committee, and the House version was never voted on by the Senate after it passed the House.[237] After the congressional session ended, the bills were cleared from the books.[238] They were not reintroduced.[239] Instead, now-President Obama proposed and the Treasury Department issued regulations limiting executives pay at financial institutions that accepted government assistance through TARP.[240] The regulations provide a limit

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[233] Martin, *supra* note 5, at 162; *see* Joann S. Lublin, *Boards Tie CEO Pay More Tightly to Performance—Options Grants May Depend on Meeting Financial Goals; Moving Beyond a "Pulse"*, WALL ST. J., Feb. 21, 2006, at A1.

[234] Temple University, News Communications, *Accounting Professor: Transparency Won't Necessarily Control CEO Pay*, *available at* http://www.temple.edu/newsroom/2007_2008/10/stories/execcomp.htm.

[235] H.R. Res. 1257, 110th Congress (2007), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_reports&docid=f:hr088.110.pdf.

[236] S. Res 1181, 110th Congress, (2007), *available at* http://thomas.loc.gov/cgi-bin/bdquery/z?d110:SN01181:@@@L&summ2=m&.

[237] Govtrack.us, http://www.govtrack.us/congress/bill.xpd?bill=h110-1257.

[238] *Id.*

[239] *Id.*

[240] Office of the Press Secretary, Treasury Announces New Restrictions On Executive

of $500,000 in total compensation for senior executives, plus restricted stock, and require the companies to meet strict disclosure requirements.[241] These restrictions and requirements only apply to companies that received and will receive assistance from the government.[242] Thus, it will not have any affect on most American corporations. Though it will take time to determine if this type of restriction will be extended to other industries, it appears that Congress may again someday introduce legislation to allow shareholders access to the corporate ballot. However, with the economy in a deep recession, congressional attention to other issues is taking priority over any potential legislation regarding executive pay. It appears that until the economy recovers, there will be little attention by Congress to shareholder rights. Even if Congress does act, if it implements laws that have language similar to that quoted above from HR 1257, it may not be enough. Furthermore, although the President has taken a hard line with respect to compensation limits for executives at companies receiving government assistance, it is difficult to determine if the executive branch can maintain the ability to monitor and limit executives' pay at publicly traded corporations.

C. Internal Revenue Code Section 162(m)

The IRC allows for the deduction of all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . a reasonable allowance for salaries or other compensation for purposes actually rendered."[243] For corporations with enormous cash resources and payrolls of accountants, this business deduction would appear to provide an unfair competitive advantage. However, Congress played its hand in an effort to control executive compensation. Though the success of the effort is highly questionable, as is using the IRC for social and political policy, it shows that Congress recognized a problem exists. At the suggestion of the House Committee on Ways and Means, it passed as part of the Revenue Reconciliation Act of 1993, subsection (m) to section 162 (162(m)), which was added to the IRC in an effort to limit corporate tax deductions allowed as part of executive compensation.[244] This provision came about to address the perceived crisis that American industries were becoming less competitive internationally, yet executive pay was soaring to new record highs.[245] The provision appears straightforward, but it has caused much critique because of its ineffective ability to influence executive compensation.[246]

Compensation, http://www.whitehouse.gov/the_press_office/TreasuryAnnouncesNewRestrictionsOnExecutiveCompensation/.

[241] *Id. See also* U.S. Department of the Treasury, Treasury Announces TARP Capital Purchase Program Description, http://www.treas.gov/press/releases/hp1207.htm.

[242] *Id.*

[243] I.R.C. § 162(a)(1) (2009).

[244] Steven Balsam & David Ryan, *Limiting Executive Compensation: The Case of CEOs Hired After the Imposition of 162(m)*, J. OF ACCT. AUDITING & FIN. (Fall 2007), *manuscript available at* http://astro.temple.edu/~ryan/162m.pdf.

[245] *Id.*

[246] *See, e.g.*, *Hearing Before the S. Fin. Comm. on the Effectiveness of § 162(m)*, at 1 (Sept. 6, 2006) (Testimony of Steven Balsam, Professor of Accounting, Temple University Fox School of Business), *available at* http://www.senate.gov/~finance/hearings/testimony/2005test/090606testsb.pdf

1. The Provision

In relevant part, section 162(m) provides that no publicly held corporation may deduct any amount over $1 million paid to employees whom are included within the statutory definition of "covered employee."[247] Included in this definition are the CEO and the four highest paid executives.[248] For purposes of section 162(m), a "publicly held corporation" is one registered pursuant to the '34 Act.[249] Not included in the statutory cap are non-taxable fringes,[250] qualified retirement plans, and shareholder-approved performance-based compensation.[251] Unfortunately, the exceptions swallow the rule. No compensation made in the form of commissions or upon meeting the performance goals count toward the statutory limit.[252] The language of the section shows Congress' desire to place emphasis on publicly held corporations gearing executives' pay to center around their performance.[253] To deduct under the performance goals exception, the company must follow statutory guidance. First, a compensation committee composed of at least two independent directors must determine the material terms for which the company will compensate the executive.[254] Next, the company must disclose the terms of the pay and obtain approval by a majority of shareholders.[255] Finally, the compensation committee must certify that the performance goals were satisfied.[256]

2. The Ineffectiveness of 162(m)

The exceptions provided in the IRC account for why Congress, through the IRC, has been ineffective in regulating or restraining the excessive executive compensation. First, companies have shifted to either all commission-based pay, or have established easily attainable performance goals to ensure any payments in excess of the statutory cap may still be deducted.[257] If Congress really intended to

("section 162(m) has been at best, only marginally effective in limiting executive pay or in making it more responsive to performance") [hereinafter Balsam Testimony]; Polsky, *supra* note 47, at 920 ("empirical evidence confirms the intuition that 162(m) is not helpful to shareholders"); McClendon, *supra* note 30, at 1017 (calling for a repeal of section 162(m) because of its emphasis on performance-based compensation packages); Susan J. Stabile, *Is There a Role for Tax Law in Policing Executive Compensation?*, 72 ST. JOHN'S L. REV. 81, 101 (1998) (arguing that the I.R.C. has no role in regulating compensation).

[247] I.R.C. § 162(m)(1) (2008).

[248] *Id.* § 162(m)(3)(A)–(B). In determining whether an individual is the chief executive officer or one of the four highest paid officers, the Tax Regulations cross-reference the disclosure rules promulgated by the SEC and discussed earlier in the paper. Treas. Reg. § 1.162(c)(2)(ii); *see* discussion *supra* Part IV.A.

[249] *Id.* § 162(m)(2).

[250] *See id.* § 132(a).

[251] Balsam & Ryan, *supra* note 244.

[252] I.R.C. § 162(m)(4)(B)–(C).

[253] *See* Martin, *supra* note 5, at 160.

[254] I.R.C. § 162(m)(4)(C)(i)–(ii).

[255] *Id.* § 162(m)(4)(C)(ii).

[256] *Id.* § 162(m)(4)(C)(iii).

[257] *See* Balsam & Ryan, *supra* note 244, at 3; *see also* Stabile, *supra* note 246, at 88–89.

limit compensation, it should have taken a hard-line approach and removed the many exceptions. Even the argument that safeguards exist so that independent directors examine the packages and shareholders approve the performance goals holds little weight. As noted, shareholders play a ministerial role in examining proposals, and boards, including independent directors, exercise hardly any true negotiating power. Thus, section 162(m) is wholly ineffective.

Even if the shareholders do not approve any performance packages, or if the independent directors reject a payment package that is performance-based, some companies have simply ignored the statutory limitation and paid in excess of the statutory cap.[258] This raises the issue of a "why bother" attitude in implementing a provision like section 162(m) if it will hardly be acknowledged. The indifference exercised by some companies is mindboggling. Furthermore, data supports some critics' argument that Congress' efforts actually caused an increase in executive pay because of the wide latitude it gave to performance-based compensation.[259] Not only does data show that compensation package amounts are increasing, companies have engaged in "grossing up" payments to executives to cover any other potential taxes for which they would be liable. The effects are astounding. In "an irony unknown to most . . . CEOs, who may be making hundreds of times what the average worker receives, may pay nothing in taxes because shareholders pay the taxes for them."[260]

Even within the Treasury Regulations, which the United States Treasury Department promulgated to clarify provisions in the IRC, there is additional language that seems to cut against the intended purpose of section 162(m), and against the overall purpose and goals of the tax system. Specifically, "in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earning or profits, the excessive payments will be treated as a dividend."[261] This is troubling because, instead of discouraging excessive payments, companies have incentives, if they will not fit under any exception in section 162(m) and are indifferent to the consequences, to pay in masked dividends under the Treasury Regulations. By doing so, instead of the executive paying tax at the highest tax bracket,[262] the companies can assure their executives pay tax on the largest portion of their income at the dividend level.[263] Thus, not only are companies able to manipulate the IRC, they can provide additional benefits to their executives by lowering their tax bill. The result has cost the federal government billions in tax revenue over the past fourteen years.[264]

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[258] Martin, *supra* note 5, at 160.

[259] *See* Polsky, *supra* note 47, at 920; Brian Grow & Eamon Javers, *Executive Pay Practices Under Scrutiny: Companies' Skirting of a Tax Rule Meant to Spur Performance-Based Pay Contributed to the Options Scandal*, BUS. WK. (Sept. 5, 2006).

[260] Martin, *supra* note 5, at 160–61.

[261] Treas. Reg. § 1.162-8 (West 2008).

[262] Married individuals filing joint returns enter the highest tax bracket when their income exceeds $250,000. I.R.C. § 1(a)(2) (2008).

[263] *See id.* § 1(h)(11)(D)(i).

[264] Grow & Javers, *supra* note 259.

The Internal Revenue Service has established a compliance program to root out the many incidents of corporations establishing simple performance goals, disregarding the statutory cap, or grossing up pay to executives.[265] Corporations are exercising too much leverage over Congress, shareholders, and the economy. Further revision is required if Congress really desires to put some dent into the increasing overcompensation problem. Specifically, the IRC must not give such leeway to options and other performance-based compensation. It could require that options price at market-adjusted levels and then reclassify as ordinary remuneration.[266] The performance goals exception could require stringent disclosure and increased performance-based requirements that use completely objective criteria. Additionally, corporations should be required to detail any tax benefits given up or penalties incurred by choosing to ignore section 162(m). With the current situation, any of these suggestions seem highly unlikely, but if any changes occur, what is the probability that any court or the IRS would be willing to intervene? Building upon the deferential attitude and business judgment rule, courts, even specialized administrative courts like the tax court, hesitate to intervene in market-driven decisions.[267] As written, section 162(m) overlooks—perhaps by choice—the true problems associated with performance-based compensation. It has not led to a reduction in CEO compensation,[268] and if no modification is reasonable, Congress must reevaluate using the IRC for this purpose.

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[265] *Id.*

[266] *See* Balsam Testimony, *supra* note 246, at 3.

[267] *See* In re Netsmart Techs., Inc. S'holders Litig., 924 A.2d 171, 192 (2007) (stating that the business judgment rule deference exercised by courts is a bare rationality standard); Paramount Commc'ns v. QVC Network, 637 A.2d 34 (Del. 1994). The *Paramount* court stated:

> There are many business and financial considerations implicated in investigating and selecting the best value reasonably available. The board of directors is the corporate decisionmaking body best equipped to make these judgments. Accordingly, a court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.

Id. at 46. The court continued:

> [W]here the traditional business judgment rule is applicable and the board acted with due care, in good faith, and in the honest belief that they are acting in the best interests of the stockholders . . . , the Court gives great deference to the substance of the directors' decision and will not invalidate the decision, will not examine its reasonableness, and will not substitute our views for those of the board if the latter's decision can be attributed to any rational business purpose.

Id. at n.17 (citing Nixon v. Blackwell, 626 A.2d 1366, 1378 (Del. 1993); Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1288 (Del. 1988); Unocal Corp. v. Mesa Petroleum Corp., 493 A.2d 946, 955–56 (Del. 1985)). The business judgment rule is probably one of the most recognized and used advantages by corporations, and a main reason that so many corporations incorporate in Delaware. It has been widely adopted, and it is unlikely a tax court would change from precedent.

[268] Balsam & Ryan, *supra* note 244, at 7.

3. Policy Concerns

A broader argument can be made that Congress should not use the IRC to attempt to control executive compensation. Using the IRC for reasons not associated with tax policy seems questionable.[269] "It is clear that [section] 162(m) is not grounded in tax policy considerations; . . . executive compensation ought to be deductible in full . . . . Rather, the provision is simply a penalty that is administered through the [IRC]."[270] Not only does section 162(m) have no basis in tax policy, it has been wholly ineffective.[271] If Congress starts extending the purposes of the IRC beyond that of tax considerations, this could lead to confusion and outcry by the American people. Americans are adverse to paying taxes, recall the American Revolution, and if Congress makes a habit of using the IRC to regulate additional private-party compensation, healthcare, or education—all reasonable in the face of section 162(m)—the American market could suffer irreparable harm due to massive protest. Maybe the SEC should have the lead in this purpose. Still, some argue that any type of compensation decisions should be entirely up to market determination, thus keeping Congress out of the equation.[272] As previously discussed, this approach has failed to control the problem.[273] Although well intended, 162(m) proves to be ineffective because of wide exceptions, corporate indifference, and potential improper politically based uses for the IRC.

V. INCREASING THE SHAREHOLDERS' ROLE IN CORPORATE GOVERNANCE

First, this paper provided analysis and discussion for why passivity on corporate boards has led to overconfident and powerful executives that dictate compensation terms to directors.[274] Then the paper outlined the role the SEC plays in corporate governance, particularly in the proxy area.[275] Next, it described how the SEC refused to make the next logical step in the new era of governance by continuing to allow boards to ignore shareholder proposals regarding nominating

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[269] *See e.g.*, Polsky, *supra* note 47, at 884; McClendon, *supra* note 30, at 1017 (noting that other regulatory schemes exist for better controlling executive compensation packages); Yablon, *supra* note 2, at 281, 293–95 (indicating the negative influence §162(m) has had on executive pay); *cf.* Stabile, *supra* note 246, at 95 ("Congress consistently uses the tax laws to accomplish objectives that are not tax related.").

[270] Polsky, *supra* note 47, at 884.

[271] *See* discussion *supra* Part IV.C.2.

[272] *See, e.g.*, Stabile, *supra* note 246, at 98. Professor Stabile has a very interesting approach. She first condemns those that argue the I.R.C. has no place in regulating political issues, but then describes that the government should stay clear of regulating anything related to compensation. *Id.* at 94, 98–99. This position is defended by saying that, provided a corporations' shareholders have full knowledge of executive pay packages and do not object, the decisions should be treated as legitimate. *Id.* at 101. This contradicts her earlier argument that Congress should regulate executive compensation as a matter of social policy to prevent the widening gap in pay between the top and bottom in a corporation. *Id.* at 99–100. It appears to be a conservative approach to market regulation, but a liberal approach to societal welfare, which is a position that might be impossible to sustain.

[273] *See* discussion *supra* Part II.B.

[274] *See* discussion *supra* Part II.B.

[275] *See* discussion *supra* Part III.B–C.

directors.[276] Then, the paper discussed how the SEC, through requiring increased disclosure, and Congress, though its efforts in the IRC, failed to control executive overcompensation.[277] Those sections cumulatively laid the foundation for an argument that the internet, a re-interpretation of one SEC Rule, and shareholders, working together, hold the key to limiting executive compensation. Shareholders must be motivated and be given the ability and opportunity to monitor and control passive corporate boards that rubber-stamp poor management decisions. If the SEC were to allow shareholders the ability to reach the ballot, the nomination process would resemble a type of campaign, where potential directors would explain to voting shareholders how they intend to increase firm efficiency.

A. The Meaning of Corporate Governance

Governance in the corporate context developed in the 1980s to describe the struggle between shareholders and directors to establish the "structure, relationships, norms, control mechanisms, and objectives of the corporate enterprise."[278] An idea by some concludes that companies perform with the shareholders remaining at all times on the sideline, deferring to management and the board with unquestioned trust.[279] This position holds that, provided shareholders have the power to make changes, they will drain the corporation of capital by constant demands.[280] In response, how can anyone argue that the exorbitant pay packages given to executives do not do the same thing? At least the efforts of shareholder activists would target removing one draining source in hopes of replacing it with something more sustainable and accountable. However, before increasing the activity of the average shareholder to address this issue, a glaring problem exists: the collective action problem. For any possible way to increase activism, there is a need to either increase the power shareholders have with their limited voting rights, or make any efforts by shareholders to participate have little cost.

The true meaning of corporate governance is lost on corporations and foreign to shareholders. The "traditional" approach to governance in the State of Delaware is one that provides managers with great authority to pursue different business

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[276] *See* discussion *supra* Part III.D.

[277] *See* discussion *supra* Part IV.A–B.

[278] Veasey & DiGugliemlo, *supra* note 1, at 1411.

[279] *See, e.g.*, Lynn A. Stout, *Corporations Shouldn't Be Democracies*, WALL ST. J., Sept. 27, 2007, at A17. Professor Stout wrote this commentary in strong opposition to the proposed SEC rules regarding nominations of directors by shareholders. *See id.*

[280] *Id.* Professor Stout defends her position by claiming that the United Kingdom, well known for its openness to shareholder rights, "would be a corporate powerhouse," but instead, countries like the United States and Japan, both notoriously shareholder right adverse, dominate the landscape. *Id.* This argument fails to recognize the realities of the situation. The United States came into major financial power after World War II, which was an event that completely devastated the economies of Europe—and Japan. However, the Japanese were able to recover much more quickly due to their amazing development of technologically advanced products. Things have worked against the British more so. The tide is turning, though, as evidenced by the fight of the NYSE and the London Stock Exchange for listing dominance.

opportunities and little restraint.[281] Shareholders have a limited role, including the ability to vote on fundamental transactions—namely mergers; elect directors annually—normally by proxy; obtain access to company records—as required by the SEC; and sue directors for not upholding fiduciary duties—severely limited by state exculpatory clauses.[282] The traditional approach is one that favors executive autonomy. This has its basis in wanting directors and managers to make riskier decisions and not fear intervention from possible annoying shareholders concerned about potential losses.[283] In fact, Vice Chancellor Leo J. Strine, Jr. of the Delaware Court of Chancery[284] stated, "The primary goal of corporate law . . . is not to prevent failure at each and every firm to the fullest extent possible, but to facilitate maximum creation of durable societal wealth by all firms."[285] Though that has a positive ring, the truth is that the traditionalists have completely quieted the shareholders. To have true corporate governance, as contemplated by the meaning of the term, the shareholders must have more influence.

B. Overcoming the Collective Action Problem

The most logical argument against allowing shareholders more power is that, even given the opportunity, the collective action problem would not lead to results. The collective action problem occurs when dispersed shareholders, who lack the power to make significant changes individually, remain passive in their decisions, even though they might oppose a proffered position. It is easy to understand why this would be such a problem in the context of publicly traded companies in the United States. The idea of a publicly traded company having a majority shareholder is almost unconceivable in today's standards. Still, for any changes to occur regarding executive pay packages, the shareholders that own larger blocks of shares must have the opportunity to affect change they desire. As the system stands, they have no power and must put complete reliance on the board of directors, who normally have interests aligned with executives.

To overcome the collective action problem, the SEC, as part of needed overhaul, could, in the '34 Act Regulations, offer shareholders economic incentives for engaging in governance. It could offer reimbursement for costs associated with replacing boards when private shareholders go through the proxy process.[286] This could aid in preventing the free-rider problem from negatively affecting those shareholders that are willing to be active. As already established, the proxy rules changed significantly in the past two years, and Internet rules will greatly decrease the costs associated with proxy contests.

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[281] *See* Strine, Jr., *supra* note 85, at 1762.

[282] *See id.*

[283] *See id.* at 1763.

[284] The Delaware Court of Chancery is widely known as the preeminent court for corporate disputes. It is a court of equity, specifically dealing in injunctions and declaratory relief. For a "short" history and other information, *see* William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery: 1792–1992*, http://courts.delaware.gov/Courts/Court%20of%20Chancery/?history.htm.

[285] Strine, Jr., *supra* note 85, at 1764.

[286] Bebchuk, *supra* note 41, at 1799.

This new system would most benefit the large-owner shareholders, such as pension funds and insurance companies. For example, the state pension fund in California, the California Public Employees' Retirement System (CalPERS), would likely take advantage of new rules that allowed it more access to corporate ballots. CalPERS uses its financial clout—$131 billion in over 1800 American companies—to engage in corporate governance by simply posting a list of companies whose policies it disagrees with, most recently targeting the Xerox Company and others.[287] It is reasonable to assume that if the SEC opened the door, CalPERS would increase its governance activities. This example is one of many that would likely occur.

This paper does not suggest that the average shareholder—Ordinary Joe—who invests with a life-long friend that is his broker will care enough to engage in challenging an incumbent board of directors. That position would be unreasonable and unrealistic. However, the large-block owners—insurance firms, brokerage firms, mutual funds—do have an incentive to become more active, especially if the SEC allows them to do so. The aim is not to increase the governance activities of Ordinary Joe, but to increase the activity of those who deal with the money of ten thousand Ordinary Joes. The large-block owners would have various incentives, one of them including advertising and goodwill possibilities where they describe their activism in the market. Through their advertising, the Ordinary Joes might be more willing to invest with a large-block shareholder than with a passive large-block owner. Furthermore, these large-block investors are likely to engage in the type of behavior required to change a corporation only after it observes long-term deficiencies in its business structure.[288] Even that type of power, if provided, would alter the way most companies engage in business. It seems simple, but also effective.

A main proponent for keeping the status quo, especially regarding measures to address the collective action problem, is Professor Stephen Bainbridge.[289] He observes:

> If investors valued the rights [to increasing power in corporate governance], we would expect to observe entrepreneurs who are taking a company public to offer such rights either through appropriate provisions in the firm's organic documents or by lobbying state legislatures to provide such rights off the rack in the corporation code.[290]

This argument fails to recognize, first, that an entrepreneur might not have the same interests as a large-block shareholder that aims to affect corporate policy. Primarily, this type of investor would desire to retain control over the corporation, unwilling to cede any control to the shareholders, in an effort to retain as much

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[287] David R. Baker, *JDS aims to change pay system*, SAN FRANCISCO CHRONICLE, Oct. 17, 2003, at B3.

[288] *See* Bebchuk, *The Case for Increasing Shareholder Power*, *supra* note 111, at 876.

[289] Professor Bainbridge is a Professor of Law at UCLA School of Law. UCLA School of Law Faculty Profile, http://www.law.ucla.edu/home/index.asp?page=409. He is a supporter of the current "director primacy" regime. *See* Stephen M. Bainbridge, *Response to Increasing Shareholder Power: Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006).

[290] *Id.* at 1737.

control over the business plan as possible. This might not be such a bad thing, at the beginning, because drastic intervention from shareholders could lead to confused goals or irreconcilable changes in practice. It is only after a company establishes itself, produces, and then becomes too comfortable with those that got it there, will any outside influence be important.

Second, as already shown, if Congress cannot and will not address the issue, why would state legislatures be able to do any better? Delaware would never dream of such a position, given that the majority of its state income comes from the revenues it receives on corporate charters.[291] In the ever-increasing incorporation competition among states, aptly named the race-to-the-bottom, a move to increase shareholder power in Delaware would assure that a state like Nevada would become the new hotbed for incorporation.[292] The fact is that the directors and managers of publicly traded companies do not want their shareholders to have more power. This is exactly why the SEC should review its analysis and decision to allow companies to continue to exclude shareholder proposals, namely when they relate to the election of directors. No state that seeks the revenue from franchise taxes and corporate charters would be willing to put themselves on the "cutting edge" of shareholder rights reform, mainly because of the competitive nature of the business. This is why federal intervention to level the field among all players is required. Regardless of the form, the substance is that the shareholders, once comfortably passive, seem ready to take a more active role in the businesses they own.

C. Nominating Directors to the Board

The board, and only the board, has the power to hire and negotiate pay packages with the CEO.[293] Therefore, the SEC should reexamine its position and interpretation of Rule 14a-8(i)(8) and implement a workable system that addresses the growing movement to increasing shareholder activism. The current position—"Under a few specific circumstances, the company is permitted to exclude [shareholders'] proposal, . . . [i]f the proposal relates to an election for membership on the company's board of directors or analogous governing body"[294]—is directly adverse to the idea of effective corporate governance. At the beginning of research, the SEC sat mulling over challenges to its interpretation to Rule 14a-8(i)(8). Since that time, the SEC has delivered a devastating blow, citing disclosure concerns as the cornerstone of the opposition,[295] to possibly active shareholders, like the AFSCME, that desired to make changes in the structure of a

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[291] *See id.* at 1742 (acknowledging that the more charters incorporated in a particular state, the more taxes and fees it collects).

[292] *See* Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 396 (2003); *see also* Bainbridge, *supra* note 289, at 1742 (calling the completion for charters between states "competitive federalism").

[293] Dorff, *supra* note 58, at 2028; *see, e.g.,* DEL. CODE ANN. tit. 8, § 141(a) (2007). ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors.").

[294] 17 C.F.R. § 240.14a-8(i)(8) (2007).

[295] *See* discussion *supra* Part III.D.

publicly traded company.[296]

As the current governance system stands, shareholders have no other (legitimate) way to influence or replace directors. For instance, the business judgment rule insulates directors from liability.[297] Shareholders may also let their feet do the talking and sell their equitable ownership in a company to another. Even if they do so, the problems remain. Finally, unlike the directors that sit on a current board, shareholders must bear proxy costs without the aid of corporate finances.[298] In response to the SEC's proposal for shareholder access, and "[r]eflecting concern over the lack of accountability of corporate directors and recent corporate scandals, the commenters generally urged the Commission to adopt rules that would grant shareholders greater access to the nomination process and greater ability to exercise their rights and responsibilities as owners of their companies."[299] If so many urged this position and recognize that it could help solve the problems, why did the SEC refuse to take the steps to make it happen?

For many years, leading scholars have argued that giving shareholders more opportunities to participate in true corporate governance—nomination of directors—would provide a more informed investor that could lead to a more efficient market.[300] In a survey done in 1985 of directors at large corporations, only seven percent stated that their contributions are critical to their respective companies' success.[301] In this same survey, forty-eight percent of the respondents said that they expected CEO pay to reach $1 million soon, "and also expected stockholders to raise a storm when it did."[302] Researchers conducted this survey on the heels of *Smith v. Van Gorkom*,[303] a case where the Delaware Supreme Court showed signs of moving towards a system where directors would be more accountable for their actions.[304] Because legislative action shortly after the decision weakened the effect, as we stand twenty-three years later, CEO pay has

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[296] *See* discussion *supra* Part III.

[297] *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("the business and affairs of a Delaware corporation are managed by or under its board of directors . . . . The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors").

[298] Bebchuk, *supra* note 111, at 856.

[299] PROXY REPORT, *supra* note 178, at 5.

[300] *See, e.g.*, Bebchuk, *supra* note 41; Jill Fisch, *The Role of Shareholder Primacy in Institutional Choice,* QUEEN'S UNIV. L. & ECON. RESEARCH, Paper No. 2004-03, 2004, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=704745; Tod Perry & Marc Zenner, *CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?*, 35 WAKE FOREST L. REV. 123 (2000); Melvin Avon Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989); *see also* Aaron Bernstein, Shareholder Power: *A Look at the Rise of Activists Shareholders,* Oct. 1, 2007, http://www.directorship.com/power-to-the-shareholders (noting the importance of shareholders that actively engage in the governance process).

[301] John A. Conway, *Behind Boardroom Doors*, FORBES, Nov. 18, 1985, at 8.

[302] *Id.*

[303] Smith v. Van Gorkom, 488 A.2d 858, 888 (Del. 1985) ("the Trial Court's conclusion that the Board reached an informed business judgment on . . . cannot be sustained"). This case represented a very sharp wake-up call to the passive boards in Delaware. A little later, though, and possibly to ensure that the state retained the business of the incorporated business, the Delaware legislature provided that a corporation may seek to avoid the result from Van Gorkom by including an exculpatory clause in their articles of incorporation. DEL. CODE ANN. tit. 8, § 102(b)(7) (2007).

[304] *Smith*, 488 A.2d at 888.

skyrocketed past that estimate, yet the predicted outcry seems to have either never happened or been ignored.

The market is ready for directors to step up and begin true arms-length bargaining with executives. One way to ensure this occurs is to allow shareholders to "purge" boards that continually refuse to act in the shareholders' best interests.[305] With the threat of removal by shareholders a legitimate threat, boards would likely exercise more discretion in their dealings with executives. The SEC did very well in opening the proxy process up to the Internet—a step that would undoubtedly aid shareholders in their ability to exercise power over the board. As evidenced by the failure on the part of Congress, through the IRC, and the SEC, through increasing disclosure rules, reaching directors appears to be the only viable solution in controlling executive overcompensation. The new chairwoman of the SEC, Mary Schapiro, stated that she favored pushing for the agency to implement increased proxy information to allow shareholders to affect board elections.[306] Specifically, she said, "Speaking for myself, I believe the SEC has not gone far enough in this . . . area, and so I intend to make proxy access - meaningful opportunities for a company's owners to nominate its directors - a critical part of the Commission's agenda in the coming months."[307]

D. Implications for the Future

The proxy system is still a very expensive process, and the better solution would be for the SEC to reverse its recent interpretation of Rule 14a-8(i)(8) and require companies to include shareholder nominees in company proxy materials.[308] After examining the effectiveness of this approach through several proxy seasons, the SEC could begin working towards a system where shareholders will have access that is more direct. Some of the catches with any new system, which the SEC would have to work through, will be working out incompatibilities with old rules and new rules. These include rules regarding disclosure, ownership trigger disclosures, and anti-fraud provisions.[309] None of which, however, represent an impediment too difficult to overcome through trial and error. More significantly, some of the suggested changes could involve the SEC going into areas where Congress has not delegated it authority.[310] If so, this issue could fall upon

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[305] *See* Balsam & Ryan, *supra* note 244, at 4.

[306] Robert Holmes, SEC to Consider Uptick Rule in April: Schapiro, http://www.thestreet.com/story/10477908/1/sec-to-consider-uptick-rule-in-april-schapiro.html.

[307] *Id.*

[308] This represents one approach the SEC proposed as an alternative for allowing shareholders unrestricted access to the corporations' ballots. *See* PROXY REPORT, *supra* note 178, at 7.

[309] *See generally id.* at 11. Many comments brought up concerns of the '34 Act Rule 16a-1(a)(1) regarding a certain percentage trigger of ownership. This provision allows for those holding more than ten percent of beneficial shares to be exempt from additional filing requirements. In the case an ordinary shareholder obtained more than ten percent, assuming that this level was the trigger for the ability to nominate directors to the board, that shareholder would incur great burdens in the increased disclosure requirements. *See* 17 C.F.R. § 240.16a-1 (2007). This would also cause concerns regarding the limitation on short-swing profits and short sale provisions. *See* PROXY REPORT, *supra* note 178, at 11.

[310] PROXY REPORT, *supra* note 178, at 11.

Congress to pass legislation redefining the scope of the Securities Laws to enable the SEC to work in the best interests of the shareholders. However, of note, the new chairwoman of the SEC, Mary Schapiro, stated that she favored pushing for the agency to implement increased proxy information to allow shareholders to affect board elections.[311] Specifically, she said, "Speaking for myself, I believe the SEC has not gone far enough in this . . . area, and so I intend to make proxy access - meaningful opportunities for a company's owners to nominate its directors - a critical part of the Commission's agenda in the coming months."[312] It will be interesting to see if the SEC follows through with this approach.

Only time will tell whether American shareholders will be willing to increase their activity and be willing to pressure boards of directors to do better jobs negotiating with executives regarding pay packages. Unfortunately, if the shareholders were to decide that a change is necessary, the SEC and Congress have yet to provide the foundation for them to engage in appropriate corporate governance. We can take the example provided by shareholders in the United Kingdom as evidence that, given the opportunity, the shareholders would become more engaged in the governance process.[313] If both the SEC and Congress realize a problem exists, which seems to be the case given their recent activity in the area, one can only speculate as to when they will decide better steps must be taken for corrective action. They can begin by giving shareholders the ability to exercise the power they already own by providing the capital to corporations that are the backbone of the American economy.

VI. CONCLUSION

Executive overcompensation is a problem in the United States. It has gone up at rapid paces while corporate profits and rank-and-file salaries have gone down. The true solution to the problem lies with shareholders and their ability to exercise control and influence over directors who continually fail to work in the best interests of the company. The attempts by Congress and the SEC have failed to provide the effective means for controlling excessive executive compensation because the IRC and SEC disclosure rules can easily be avoided through good lawyering and inventive techniques. The SEC could redeem itself, reinterpret its latest ruling, return power to the shareholders, who will then be more likely to become active participants in corporate governance, and continue to work towards solutions to lowering executives' pay.

The large-block shareholders seem ready to nominate qualified directors who promise to engage in arms-length bargaining with management. If these directors promise to control management, and the shareholders have substantial ability to affect the outcome of the voting at companies' annual meetings, the larger shareholders would likely engage in the process. In doing so, the directors would actually be serving those they are required to by law. This would return the

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[311] Holmes, *supra* note 306.

[312] *Id.*

[313] *See* discussion *supra* Part II.C.2.

compensation decision techniques to one truly driven by the market as opposed to the monopoly in bargaining power we have today. Even the self-professed marketeers cannot deny that truth.

The idea that the American economy and publicly held corporations work in a free market is only partly true. Congress and SEC today exercise stringent oversight on companies, ensuring each meet listing requirements and other safeguards, largely because of the events leading to the Great Depression. They should now allow shareholders to take advantage of the new mediums available to reverse the long-held corporate governance ideology in the United States. If the status quo continues, then our problem will persist. I hope that we can target solutions, as the Apollo 13 crew did, before it is too late, because the consequences of inaction could be severe.