THE HOUSE OF MOUSE AND BEYOND: ASSESSING THE SEC'S EFFORTS TO REGULATE EXECUTIVE COMPENSATION

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ABSTRACT

What can or should be done, if anything, to address complaints that corporate executives are overpaid? This article argues that with its revised regulations on executive compensation, the Securities and Exchange Commission (SEC) is making progress in the area of disclosing executive compensation. The SEC, however, will not accomplish any substantial reform regarding compensation because shareholders do not have much of a role in establishing executive compensation packages and have little ability to challenge board decisions after receiving the mandated disclosure. This article explores how a gap has arisen in the area of executive compensation regulation by analyzing the revised regulations and the Delaware Supreme Court decision In re Walt Disney Company Derivative Litigation. *It demonstrates how state law regulates gross negligence, waste and, perhaps, bad faith, while federal law focuses on disclosure of certain compensation packages. The different foci of state and federal regulations leave a gap permitting behavior that might be adverse to shareholder interests, yet occurs beyond the shareholders' ability to effectuate changes. Addressing this gap is important because, unlike routine board decisions, compensation decisions have characteristics that may compromise arm's-length contracting. Additionally, while disclosure of compensation data is important, it is by no means the equivalent of merit review. If the SEC is truly committed to reforming executive compensation, it must address the gap in regulation remaining after* In re Walt Disney Company Derivative Litigation. *The SEC and states should work cooperatively to implement more meaningful corporate governance reform to ensure that shareholders have both the information necessary to make informed investment decisions, and the ability to effect changes in company decision making concerning executive compensation.*

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I. INTRODUCTION

Why are corporate executives paid so much and what are we doing about it?[1] Between 1992 and 2000 alone, the compensation of chief executive officers (CEOs) at S&P 500 companies more than quadrupled, from $3.5 million to $14.7 million.[2] In 1991, the average large company

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[1]Issues concerning the composition of and approach to executive pay have been the subject of extensive examination. *See, e.g.*, LUCIAN A. BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION ch. 8, at 95-111 (2004) [hereinafter BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE]; Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615 (2005) (reviewing Bebchuk and Fried, *Pay Without Performance*, and arguing that no reform is needed and that the management power rests solely with the board); William W. Bratton, *The Academic Tournament Over Executive Compensation*, 93 CAL. L. REV. 1557 (2005) (reviewing Bebchuk & Fried, *Pay Without Performance*, and observing that management power matters and evaluating arguments about compensation practice); Lucian Ayre Bebchuk & Jesse M. Fried, *Stealth Compensation Via Retirement Benefits*, 1 BERKELEY BUS. L.J. 291 (2004) [hereinafter Bebchuk & Fried, *Stealth Compensation*] (arguing that corporate boards have been able to camouflage compensation through retirement benefits and other payments); Lucian A. Bebchuk & Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823 (2005) (analyzing the magnitude and composition of executive pension arrangements); Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 1-2 (2000) (reviewing and evaluating the theories of executive compensation); James McConvill, *Executive Compensation and Corporate Governance: Rising Above the "Pay-for-Performance Principle,"* 43 AM. BUS. L.J. 413 (2006) (arguing that pay-for-performance and agency theories are faulty); Stewart J. Schwab & Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 WASH. & LEE L. REV. 231 (2006) (examining the characteristics of a large number of executive employment contracts); Randall S. Thomas, *Should Directors Reduce Executive Pay?*, 54 HASTINGS L.J. 437 (2003) (arguing that gaps between management and worker wages can affect company value).

[2]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 1; Patrick McGeehan, *Options in the Mirror, Bigger Than They Seem*, N.Y. TIMES, Apr. 9, 2006, sec. 3, at 6 (describing how Lehman Brothers has used stock option grants and valuation to obscure compensation to its CEO). Although much of the focus is on the most highly paid CEOs, there are indications that CEOs of smaller companies have also experienced substantial pay gains. *See* Amy Cortese, *Smaller Fish Are Also Doing Swimmingly*, N.Y. TIMES, Apr. 9, 2006, sec. 3, at 7.

CEO earned 140 times the wage of the average company employee; by 2003 it was 500 times.[3] In 2005 alone, the average CEO's pay rose 27%, compared to a rise of 38% in 2004, while ordinary workers' wages remained stagnant.[4] Quite often, these increases in compensation continue even when the corporation is struggling.[5] The question persists whether executive compensation rewards CEO performance or gains unrelated to the efforts of the executive.[6]

The debate concerning executive compensation packages consistently makes the news.[7] Whether the large increases in compensation

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[3]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 1. *But see* Loewenstein, *supra* note 1, at 5-6 (arguing that comparisons to rank and file workers are not helpful because CEO payment involves stock options, and average worker pay does not).

[4]Eric Dash, *C.E.O. Pay Keeps Rising, and Bigger Rises Faster*, N.Y. TIMES, Apr. 9, 2006, sec. 3, at 5 (citing Pearl Meyers' survey of 200 large corporations).

[5]*Id.* (noting that boards at auto, retail, and telecommunications companies increased CEO compensation in the wake of bad financial results); Eric Dash, *Off to the Races Again, Leaving Many Behind*, N.Y. TIMES, Apr. 9, 2006, sec. 3, at 1 (detailing the rising compensation practices of ConAgra Funds even during financial difficulties); Tommy McCall, *Pay For Performance? Sometimes, but Not Always*, N.Y. TIMES, Apr. 9, 2006, sec. 3, at 6 (presenting situations where stock prices fell, yet CEOs were still paid well). *But see* Loewenstein, *supra* note 1, at 6-7 (arguing that analysis of pay to performance is not helpful because it is difficult to assess what is performance).

[6]*See, e.g.*, McCall, *supra* note 5, at 6 (CEO pay is often "greater than shareholder return by more than 10 points"); J. Alex Tarquinio, *Pay for Oil Chiefs Spiked Like Prices*, N.Y. TIMES, Apr. 9, 2006, sec. 3, at 10 (describing the huge CEO compensation packages for those in the oil industry in 2005). Of course, a high pay package itself does not indicate that the CEO's pay is too much or not competitive. *See, e.g.*, Loewenstein, *supra* note 1, at 1-2; Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, HARV. BUS. REV., May-June 1992, at 28; Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, HARV. BUS. REV., Mar.-Apr. 1986, at 125; Robert Thomas, *Is Corporate Executive Compensation Excessive?*, *in* THE ATTACK ON CORPORATE AMERICA 276, 278 (M. Bruce Johnson ed., 1978) ("Competition among corporations . . . sets the level of executive compensation."); Nicholas Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959, 975-78 (1980) (market forces will eliminate "excessive" compensation). *But see* GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF AMERICAN EXECUTIVES (1991) (arguing that overpayment exists); Rik Kirkland, *The Real CEO Pay Problem*, FORTUNE, June 30, 2006, at 78, 83 (noting that 80% of Americans think that CEOs are paid too much).

[7]*See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006); *see also Disney Investors Seek Reversal of Ovitz Ruling*, L.A. TIMES, Jan. 26, 2006, at C4 (noting the tremendous global interest of executive compensation litigation); Benjamin Pimentel, *HP Sued over Fiorina's $42 Million in Exit Pay; Shareholders Say Company, Directors Disregarded Own Rules with Golden Parachute*, SAN FRANCISCO CHRONICLE, Mar. 8, 2006, at C1 (explaining that two institutional investors sued Hewlett-Packard over Fiorina's severance package, which was allegedly in violation of board policy); Sanders v. Wang, No. 16,640, 1999 Del. Ch. LEXIS 203 (Del. Ch. Nov. 8, 1999) (shareholder challenge to granting of stock plan benefiting executives); *see also, e.g.*, Kirkland, *supra* note 6, at 81 (noting that "the outrage has grown so intense that the country's top CEOs are now vigorously debating the problem in private").

are problematic has generated much debate. Orin Kramer, the Chairman of the New Jersey State Investment Council, commented:

> And if you say, "Well, for senior executives, compensation has risen three and a half times faster than it has for average workers," then you can say, "That makes sense if either (a) there's a declining pool of people who can do these jobs, or (b) the job got something like three and a half times harder, or (c) maybe they're creating three and a half times as much value as executives used to create." If you have problems with those conclusions, the compensation levels are probably a little bit high.[8]

Shareholders, employees, and the public in general are often displeased with executive compensation levels. Shareholder litigation brought against the Walt Disney Company board over a $130 million severance package to Michael Ovitz attracted much publicity. The recent decision by the Delaware Supreme Court[9] in this case will be dissected for some time. Shareholder complaints over Carly Fiorina's, Hewlett-Packard's former CEO, $42 million severance package have led to new litigation.[10] Employees at struggling companies such as ConAgra Foods in Omaha, Nebraska, have seen their bonuses eliminated, while their wages fail to keep pace with the cost of living. At the same time, former chairman and chief executive, Bruce Rohde, received bonuses, stock options, and subsequently retired with a $20 million package.[11] It is hard to forget the public outrage directed toward former General Electric (GE) CEO Jack Welch when his divorce proceedings revealed that his retirement package included Red Sox tickets, a luxury apartment in New York City, country club memberships, and use of a GE corporate jet.[12]

The current system of executive compensation raises a number of important issues. First, investors rely on the availability of accurate

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[8]Orin Kramer, *Pay Without Performance: The Institutional Shareholder Perspective*, 30 J. CORP. L. 773 (2005). In fact, a Watson Wyatt Worldwide survey of directors and institutional investors found that while only 61% of directors think that executives are overpaid, 90% of institutional investors believe executives are overpaid. WATSON WYATT WORLDWIDE, CORPORATE DIRECTORS GIVE EXECUTIVE PAY MODEL MIXED REVIEWS, June 20, 2006, *available at* http://www.watsonwyatt.com/news/press.asp?ID=16180.

[9]*In re Walt Disney Co.*, 906 A.2d at 27.

[10]Pimentel, *supra* note 7, at C1.

[11]Dash, *supra* note 5, at 1.

[12]Joseph Nocera, *Disclosure Won't Tame C.E.O. Pay*, N.Y. TIMES, Jan. 14, 2006, at C1.

disclosure of complete compensation data to assess company prospects.[13] "Stealth," or undisclosed compensation, is an impediment to shareholder decision making.[14] Second, the "considerable influence" executives have over their pay, and the "influence" used to obtain it, suggests that directors may not be engaging in arm's-length contracting, to the detriment of shareholders and employees.[15] Perhaps most importantly, even where shareholders have access to enhanced disclosure, they lack a substantial role in influencing executive compensation, and have little ability to challenge compensation decisions afterwards.[16]

During a speech given on January 17, 2006, Securities and Exchange Commission (SEC) Chairman Christopher Cox announced proposed revisions to the SEC's existing rules (Existing Regulations) governing the disclosure of executive compensation (Revised Regulations).[17] The SEC subsequently published the Revised Regulations, including a lengthy "Background and Overview" section detailing the SEC's assessment of the problem.[18] The SEC received more than 20,000 public comments to its notice of proposed rulemaking (NPRM) and voted affirmatively to adopt changes to the Existing Regulations on July 26, 2006.[19] Characterizing the Existing Regulations as "out of date," SEC Chairman Cox declared that the SEC's purpose "is to help investors keep an eye on how much of their money is being paid to the top executives who work for them."[20] Chairman

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

[14]For a discussion of "stealth compensation" via retirement benefits, see Bebchuk & Fried, *Stealth Compensation*, *supra* note 1, at 293.

[15]*Id.*

[16]*See infra* Part IV.C.

[17]Cox Speech, *supra* note 13. For the current requirements, see Executive Compensation Disclosure, Release No. 33–6962, 57 Fed. Reg. 48126 (Oct. 21, 1992) [hereinafter 1992 Release]; *see also* Executive Compensation Disclosure; Securityholder Lists and Mailing Requests, Release No. 33–7032, 58 Fed. Reg. 63010, at sec. II (Nov. 22, 1993) (stating that the amendments are "intended to make compensation disclosure clearer, more comprehensive and more useful to shareholders").

[18]Executive Compensation and Related Party Disclosure, 71 Fed. Reg. 6542 (Feb. 8, 2006).

[19]Press Release, SEC, of July 26, 2006, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), *available at* http://www.sec.gov/news/press/2006/2006-123.htm. The SEC's final regulations initially became effective on November 7, 2006, but were later amended by interim final regulations on December 26, 2006. *See* Executive Compensation and Related Person Disclosure, Release No. 33-8765, 71 Fed. Reg. 78,338 (Dec. 29, 2006); Executive Compensation and Related Person Disclosure, Release No. 33-8732A, 71 Fed. Reg. 53,158 (Aug. 29, 2006).

[20]Cox Speech, *supra* note 13.

Cox expressed concern that companies are not disclosing compensation information properly.[21]

The Revised Regulations deal not only with compensation issues, but also with related-party transactions, director independence, and corporate governance.[22] Among other things, the Revised Regulations establish a federal minimum threshold of $10,000 as a trigger for disclosing perks. They also require disclosure of retirement and severance packages, reorganize the overall presentation of disclosed compensation materials, and require disclosure of outstanding equity interests, which includes potential amounts the executive will receive in the future.[23] The Revised Regulations also require certain disclosures aimed at identifying independent directors and ensuring that related-party transactions are more fully disclosed.[24]

Chairman Cox commented that it is not the government's "job" to determine the appropriate level of executive compensation.[25] Rather, it is the role of the shareholders and the board of directors.[26] The SEC's primary initiative is aimed at full disclosure of all issues affecting compensation decisions. Although the SEC initially requested comments to be completed by April 2006, the SEC extended the comment period.[27] After closing the comment period, the SEC will consider and respond to material comments received before finalizing the Revised Regulations, meaning that the revisions likely will not be in force until 2007.

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[21] *Id.*

[22] *Id. See* 71 Fed. Reg. at 53,158. The SEC proposed a transition period for the Revised Regulations with the earliest portions of the Revised Regulations taking effect sixty days after publication of final rules and the remainder of the rules, such as those related to the summary compensation table that will ultimately require a three year presentation, being phased-in over a longer time period so companies will not be required to restate historical data. *Id.* at 53,209.

[23] Press Release, SEC, of Jan. 17, 2006, SEC Votes to Propose Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (Jan. 17, 2006), *available at* http://www.sec.gov/news/press/2006-10.htm; 71 Fed. Reg. at 53,183-89 (summarizing the regulations).

[24] Press Release, SEC, of Jan. 17, 2006, *supra* note 23, *available at* http://www.sec.gov/news/press/2006-10.htm; 71 Fed. Reg. at 53,159, 53,161, 53,197-201. There has been controversy over the effectiveness and meaning of independent directors. *See, e.g.*, Harvey Gelb, *Corporate Governance and the Independence Myth*, 6 WYO. L. REV. 129 (2006).

[25] Cox Speech, *supra* note 13.

[26] *Id.* Cox commented: "It is [the shareholders' and directors'] job, not the government's, to determine how best to align executive compensation with corporation performance, to determine the appropriate levels of executive pay, and to decide on the metrics for determining it." *Id.*

[27] *See* Executive Compensation and Related Person Disclosure, *supra* note 19. As of April 24, 2007, the SEC was still receiving comments to the Revised Regulations.

Response to the SEC's NPRM was positive overall, but commentators have suggested various refinements.[28] Some in Congress, however, believe that the NPRM does not go far enough and that a more comprehensive federal regulation is in order.[29] For example, House Bill 4291 calls for substantial reform that would require a shareholder vote on certain compensation packages.[30] Corporations, corporate counsel, and company advocates—already under siege from shareholder complaints about lucrative compensation packages—appear to have taken the NPRM seriously and filed numerous comments seeking to lessen the impact of the Revised Regulations.[31]

While the SEC was publishing the NPRM, the Delaware Supreme Court issued its decision in *In re Walt Disney Company Derivative Litigation* (*In re Walt Disney*).[32] The supreme court upheld the court of chancery's decision in favor of the corporate defendants and emphasized that classic corporate liability theories, including fiduciary duty, good faith,

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[28]*See, e.g.*, Letter Comment from Lucian A. Bebchuk et al., Professor of Law (Apr. 14, 2006), *available at* http://www.sec.gov/rules/proposed/s70306/lbebchuk5984.pdf (applauding and supporting the SEC's efforts); Letter Comment of Pearl Meyer & Partners, Executive Compensation Consultants, Proposed Amendments for Executive Compensation and Related Party Disclosures (Apr. 10, 2006), *available at* http://www.sec.gov/rules/proposed/s70306/jrich7010.pdf (commending the SEC); Letter Comment of John C.Wilcox, Senior Vice President, Head of Corporate Governance, Teachers Insurance and Annuity Association of America College Retirement Equities Fund (May 17, 2006), *available at* http://www.sec.gov/rules/proposed/s70306/s70306-632.pdf (expressing strong support for the NPRM).

[29]*See* Letter Comment of Rep. Barney Frank, Ranking Member, Committee on Financial Services, U.S. House of Representatives, Executive Compensation and Related Parties Disclosure (Apr. 10, 2006), *available at* http://www.sec.gov/rules/proposed/s70306/bfrank041006.pdf; *see also* Protection Against Executive Compensation Abuse Act, H.R. 4291, 109th Cong. (2005) (referred to the Committee on Financial Services) (amending the Securities Exchange Act of 1934 "to require additional disclosure to shareholders of executive compensation") [hereinafter Protection Against Executive Compensation Abuse Act].

[30]*See* Protection Against Executive Compensation Abuse Act, *supra* note 29.

[31]*See, e.g.*, Letter Comment of Steve Odland, Business Roundtable, Executive Compensation and Related Party Disclosure (Apr. 10, 2006), *available at* http://www.sec.gov/rules/proposed/s70306/sodland041006.pdf; Letter Comment of Linda Rappaport and George Spera, on behalf of CBS Corporation, The Walt Disney Company, NBC Universal (a majority-owned subsidiary of General Electric Company), News Corporation, and Viacom Inc., Sherman & Sterlling, LLP, Proposed Amendments to Requirements for Executive Compensation and Related Party Disclosure (Apr. 10, 2006), *available at* http://www.sec.gov/rules/proposed/s70306/shearmansterling041006.pdf; Letter Comment of Christine P. Richards, Executive Vice President, FedEx Corporation, Proposed Rule: Executive Compensation and Related Party Disclosure (Apr. 10, 2006), *available at* http://www.sec.gov/rules/proposed/s70306/fedex041006.pdf; Letter Comment of W. Wayne Withers, General Counsel and Security, Emerson Electric (Apr. 10, 2006), *available at* http://www.sec.gov/rules/proposed/s70306/emerson041006.pdf.

[32]906 A.2d 27 (Del. 2006).

and waste theories, apply equally to the executive compensation arena.[33] Yet the court reiterated that in most cases only a procedural inquiry of the practices employed by the board awarding the compensation would be undertaken, rather than any substantive review of the compensation package. While SEC Chairman Cox has stated that the federal government is not in the business of policing executive compensation decisions,[34] the Delaware Supreme Court seems to have declared its intent to stay out of the business in any meaningful way.[35]

The SEC's position and the result in *In re Walt Disney* raise issues regarding the gatekeeping of executive compensation matters. If the SEC's rules only mandate disclosure, does state law provide an alternative means by which the shareholders can meaningfully challenge executive compensation approved by the board of directors? As evidenced in *In re Walt Disney*, shareholders face a difficult task in challenging the board of directors' decisions regarding compensation packages if the decision is made in good faith and with reasonable information. Will the Revised Regulations substantially change compensation practices?

This article critically evaluates the proposed rulemaking on executive compensation announced on January 17, 2006, by SEC Chairman Cox. The article looks at the limits of disclosure as a mechanism to police executive compensation packages. The article focuses on the SEC's assertion that previous rules are simply out of date, therefore justifying mere updating, rather than comprehensive overhaul. The SEC has stated that it is focusing on information disclosure (wage information, not wage controls), and this article outlines the issue of accountability to shareholders even in the face of disclosure, presenting additional alternatives to the SEC's chosen method. The article concludes that while the Revised Regulations will require the disclosure of more executive compensation data, the importance of which cannot be understated, beyond that, the rules fail to give shareholders any additional options to address concerns. The Revised Regulations are only a piece of the executive compensation picture as they do not provide for meaningful accountability to shareholders.

Part II focuses on federal and state jurisdiction over and regulation of executive compensation decisions. The SEC maintains that its jurisdiction over executive compensation is limited to information disclosure. The SEC argues that the board and shareholders are vested with actual decision-making authority over such matters, presumably under state

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[33] *Id.*

[34] Cox Speech, *supra* note 13.

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

corporate law. As evidenced in *In re Walt Disney*, the SEC has failed to acknowledge the gap between SEC authority over compensation disclosure and the limited shareholder remedies existing under state law. Because broad protections exist under state law for board decisions (including those on compensation matters), which will be unaffected by the Revised Regulations, there will be a regulatory gap leaving too much latitude for board decisions.

Part III looks at the benefits of the SEC's Revised Regulations in terms of increased information disclosure on a wide variety of compensation topics, including crucial areas of perquisites and retirement and severance packages. Part IV canvasses some of the apparently unanticipated consequences of this dual federal and state regulation of executive compensation, focusing on reasons why the Revised Regulations will not fix the problem of excessive compensation. Finally, Part V addresses the relative strengths of the various alternatives available to the federal and state governments to address the gap in regulation, particularly with regard to federal intervention, allowing shareholder referendums on executive compensation matters, increasing shareholder power vis-à-vis directors and the issues raised by self regulation. Ultimately, this article concludes that while the SEC's Revised Regulations represent an important first step toward reform in the area of disclosure of executive compensation data, not much will change for the investing public. Additional action by the state or federal governments will be needed if we truly want to involve shareholders in executive compensation decisions.

II. EXECUTIVE COMPENSATION JURISDICTION AND REGULATION

A. *The SEC and Its Rulemaking Authority*

The SEC's authority traditionally centered on disclosure requirements of the 1933 Securities Act (1933 Act)[36] and the 1934 Securities Exchange Act (Exchange Act).[37] Nevertheless, the SEC has, on occasion, been accused of creatively construing its own jurisdiction to

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[36]Securities Act of 1933, 15 U.S.C. § 77a (1988). Felix Frankfurter promoted the 1933 Act as able "[t]o build on self discipline by all agencies engaged in marketing securities by compelling full publicity of 'every essentially important element attending the issue of new securities' so that the public may have an opportunity to understand what it buys." Felix Frankfurter, *The Federal Security Act*, FORTUNE, Aug. 1933, at 53; *see also* ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 40-41 (Simon & Schuster 1982) (describing the circumstances that prompted the regulation of securities).

[37]Securities Exchange Act of 1934, 15 U.S.C. § 78a (1988).

regulate.[38] As far back as the 1960s, the SEC began to take an expanded view of its jurisdiction beyond traditional disclosure by bringing cases aimed at protecting the public against "fraud" generally.[39] In general, courts have shown substantial deference to a federal agency's interpretation of its own statutory authority.[40] This deference, with respect to the SEC, has not been unlimited, and in *Santa Fe v. Green*,[41] the United States Supreme Court concluded that federal securities laws do not "federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[42]

Today, Chairman Cox describes the SEC's mission as follows: "to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation."[43] Believing that "[a]n educated investing public ultimately provides the best defense against fraud and costly mistakes," the SEC primarily focused its regulatory reach on requiring companies to disclose extensive information of general public education programs by the SEC and the public.[44] The SEC's specific jurisdiction to regulate disclosure of executive compensation lies generally in the 1933

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[38]*See, e.g.*, Philip C. Berg, *The Limits of SEC Authority Under Section 14(a) of the Exchange Act: Where Federal Disclosure Ends and State Corporate Governance Begins*, 17 J. CORP. L. 311 (1992); Kathleen A. Lacey & Barbara Crutchfield George, *Expansion of SEC Authority into Internal Corporate Governance: The Accounting Provisions of the Foreign Corrupt Practices Act (A Twentieth Anniversary Review)*, 7 J. TRANSNAT'L L. & POL'Y 119 (1998).

[39]*See In re* Cady Roberts & Co., 40 S.E.C. 907 (1961); SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[40]*See, e.g.*, NationsBank of N.C. v. Variable Annuity Life Ins. Co., 513 U.S. 251, 256-57 (1995); Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842-43 (1984); *see also* Thomas W. Merrill, *Judicial Deference to Executive Precedent*, 101 YALE L.J. 969, 980-93 (1992) (analyzing cases using a deferential standard after *Chevron*); Mark Seidenfeld, *A Syncopated* Chevron*: Emphasizing Reasoned Decision-Making in Reviewing Agency Interpretations of Statutes*, 73 TEX. L. REV. 83, 94-103 (1994) (explaining court's deference in reviewing agency decisions).

[41]430 U.S. 462 (1977).

[42]*Id.* at 479. For a discussion of the SEC's attempts to regulate corporate governance matters, see Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 86-87 (2005); *see also* Bus. Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (SEC rule on voting power exceeded authority under the Exchange Act).

[43]U.S. Securities and Exchange Commission, 2005 Performance and Accountability Report, at 2, *available at* http://www.sec.gov/about/secpar2005.shtml (last visited Jan. 28, 2007).

[44]*Id.* at 5.

Act, the Exchange Act, and the Investment Company Act of 1940, as amended.[45]

The SEC adopted the Existing Regulations in 1992, which focus on disclosure and use a series of formatted tables that capture compensation data over several years.[46] The SEC has itself criticized the tables as "highly formatted and rigid."[47] The Existing Regulations include a Performance Graph and Compensation Committee Report, which relay in a detailed manner compensation and corporate performance, as reflected by stock price.[48] The SEC criticized the Compensation Committee Report requirement as leading to boilerplate discussion and characterized the Performance Graph as "outdated."[49] The SEC also questioned the fact that the Compensation Committee Report has been furnished to, rather than filed with, the SEC by the compensation committee of a company, such that Exchange Act liability for misstatements fails to attach.[50] When adopting the Existing Regulations, the SEC considered whether furnishing the data would help spur more open and robust conversation, but ultimately retained the furnished aspect for at least some of the disclosure.[51]

By continuing the longstanding disclosure approach to executive compensation, the SEC is remaining consistent with its stated mission and tradition. On the other hand, by failing to go farther with executive compensation and seeking congressional authority as needed, the SEC may be using its regulatory authority over disclosure matters, while accomplishing very little. If one accepts the SEC's conclusion that it has limited power to regulate executive compensation, what jurisdiction do states have over executive compensation? To what extent has state authority been exercised? These questions are answered below.

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[45]71 Fed. Reg. at 6598. The SEC cited authority under "Sections 3(b), 6, 7, 10, and 19(a) of the Securities Act, as amended, Sections 10(b), 12, 13, 14, 15(d) and 23(a) of the Exchange Act, as amended, and Sections 8, 20(a), 24(a), 30 and 38 of the Investment Company Act of 1940, as amended." *Id.* The SEC first regulated executive compensation disclosure in 1938. Release No. 34–1823 (Aug. 11, 1938). In one recent enforcement action, the SEC reached a settlement with Tyson Foods and its former CEO, Donald Tyson, with Tyson Foods paying a penalty of $1.5 million and Donald Tyson paying a $700,000 penalty for misleading disclosures of compensation information. U.S. Securities and Exchange Commission, 2005 Performance and Accountability Report, *supra* note 43, at 7.

[46]1992 Release, *supra* note 17.

[47]71 Fed. Reg. at 6545.

[48]1992 Release, *supra* note 17.

[49]71 Fed. Reg. at 6547.

[50]1992 Release, *supra* note 17.

[51]*Id.* sec. II.H. *See also* 71 Fed. Reg. at 53,160, 53,167-68.

B. *Shareholder Rights Under State Law*

Since there is overlapping jurisdiction regarding regulation of compensation matters, this evaluation of the Revised Regulations is considered in the context of state regulation of executive compensation. Practically speaking, the most important, affirmative initiative available under state law to shareholders objecting to executive compensation is to sue the individuals on the board of directors.[52] In general, directors are vested with the authority to manage the corporation, with the business judgment rule protecting their decisions.[53] The Delaware Supreme Court has emphasized, however, that the business judgment rule requires informed decision making.[54] "[A] director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty."[55] For purposes of the business judgment rule, gross negligence is the standard for determining whether decisions were sufficiently informed.[56]

Furthermore, the duty of care inquiry focuses on process only. The Delaware Supreme Court has observed that substantive due care

> is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is *process* due care only.

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[52]*See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006); *see* Randall S. Thomas & Kenneth J. Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 571 (2001) (examining 124 cases where shareholders have brought claims of excessive compensation and concluding that shareholders are more likely to find success against smaller corporations when litigating outside of Delaware).

[53]*See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

[54]*Id.* at 872-73.

[55]*Id.*

[56]*Id.* at 873. While Delaware courts have not precisely defined gross negligence, it is more than simple negligence. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("predicated upon concepts of gross negligence"); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971), *rev'g*, 261 A.2d 911 (Del. Ch. 1969) ("fraud or gross overreaching"); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 887 (Del. 1970), *rev'g*, 255 A.2d 717 (Del. Ch. 1969) ("gross and palpable overreaching"); Warshaw v. Calhoun, 221 A.2d 487, 492-93 (Del. 1966) ("bad faith . . . or a gross abuse of discretion"); Moskowitz v. Bantrell, 190 A.2d 749, 750 (Del. 1963) ("fraud or gross abuse of discretion"); Penn Mart Realty Co. v. Becker, 298 A.2d 349, 351 (Del. Ch. 1972) ("directors may breach their fiduciary duty . . . by being grossly negligent"); Kors v. Carey, 158 A.2d 136, 140 (Del. Ch. 1960) ("fraud, misconduct or abuse of discretion"); Allaun v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929) ("reckless indifference to or a deliberate disregard of the whole body of stockholders"). Additionally, the burden of proof is on the party challenging the board's decision to establish facts rebutting the presumption of informed decision making under the business judgment rule. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

> Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.[57]

Accordingly, shareholder claims against boards of directors often center on satisfaction of the board's procedural duty of care to make informed decisions, though litigation often includes allegations of breach of the duty of loyalty (with good faith) and waste. While state law provides these remedies, *In re Walt Disney* highlights the fact that these state law remedies provide little recourse for shareholder claims of excessive executive compensation.

1. Delaware Developments Regarding the Duty of Care

The Delaware Supreme Court rulings prior to *In re Walt Disney*, which outlined a board's duty of care, have been subjected to extensive commentary. Delaware cases, in particular *Smith v. Van Gorkom*,[58] create a murky picture of a board's responsibility to make informed decisions versus the shareholders' right to challenge board decisions.[59] In *Van Gorkom*, the court refused to allow the business judgment rule to insulate the directors from personal liability for breaching their duty of care in the approval of a merger.[60] This article will not undertake an in-depth review of *Van Gorkom*, as extensive consideration of this case already exists.[61]

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[57]Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).

[58]Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). The shareholders' claim against the board in the case arose in the context of the board's decision for a cash-out merger of Trans Union into a new corporation. *Id.* After little negotiations and a scant two hour meeting, the Trans Union board approved merger with a new company formed by Pritzker for $55 per share. *Id.* at 868-69.

[59]Under Delaware law, the business judgment rule is codified in DEL. CODE ANN. tit. 8, § 141(a) (2001).

[60]*Van Gorkom*, 488 A.2d at 864.

[61]*See, e.g.*, Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 54 (2002); Charles M. Elson & Robert B. Thompson, Van Gorkom*'s Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 NW. U. L. REV. 579, 583 (2002); Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1454-55 (1985); Lawrence A. Hamermesh, *A Kinder, Gentler Critique of* Van Gorkom *and Its Less Celebrated Legacies*, 96 NW. U. L. REV. 595 (2002); Lawrence A. Hamermesh, *Why I Do Not Teach* Van Gorkom, 34 GA. L. REV. 477 (2000); Stephen J. Lubben & Alana J. Darnell, *Delaware's Duty of Care*, 31 DEL. J. CORP. L. 589 (2006); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 1 (1985); *The* Smith v. Van Gorkom *Symposium*, 45 WASHBURN L.J.

To counter the threat of personal liability for directors that resulted from *Van Gorkom*, the Delaware General Assembly acted swiftly to limit its effect by enacting Delaware General Corporation Law section 102(b)(7).[62] Section 102(b)(7) permits corporations to include a provision in their certificate of incorporation to exculpate board members from personal liability for breaching their duty of care, though not for duty of loyalty violations, good faith violations, and certain other violations.[63] Many Delaware corporations, thereafter, adopted exculpatory charter provisions limiting their directors' liability.[64]

Section 102(b)(7) is important for two primary reasons. First, the widespread adoption of section 102(b)(7) exculpatory provisions by shareholders strongly indicates that shareholders will tolerate directors taking a certain amount of risk without creating personal liability.[65] Second, it precludes exculpation of directors who self deal or do not act in good faith; this represents legislative intolerance of directors who breach the basic trust given by the shareholders.[66]

Despite the legislature's apparent intent to put the issue to rest, section 102(b)(7) did not resolve all questions regarding director liability for breaches of the duty of care, even for corporations enacting exculpatory charter provisions. Shareholder claims can involve allegations that directors violated their duties of care or loyalty, acted in bad faith, or committed waste. When shareholders challenge transactions solely alleging a breach of the duty of care, Delaware courts have consistently upheld the effectiveness of section 102(b)(7) provisions and readily dismissed cases once the defense is raised ("pure duty of care cases").[67] In contrast,

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267 (2006).

[62]65 Del. Laws, c. 289 (1986).

[63]DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). The other violations include "intentional misconduct or a knowing violation of law," unlawful payment of dividends under section 174 , and "any transaction from which the director derived an improper personal benefit." *Id.*

[64]Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001); *see* E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681, 693-94 (1998) [hereinafter Veasey, *An Economic Rationale*]; *see also* E. Norman Veasey et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification and Insurance*, 42 BUS. LAW. 399, 401-04 (1987) (examining the enabling aspects of the newly enacted section 102(b)(7)).

[65]Veasey, *An Economic Rationale*, *supra* note 64, at 693-94.

[66]*Id.* at 694.

[67]*See, e.g.*, *Malpiede*, 780 A.2d at 1095; Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001); Zirn v. VLI Corp., 681 A.2d 1050, 1061-62 (Del. 1996); Arnold v. Soc'y for Sav. Bancorp., Inc., 650 A.2d 1270, 1288 (Del. 1994). If the plaintiffs succeed in their allegations that the board acted without due care, then the burden of proof would normally shift to the board to show entire fairness. *Emerald Partners*, 787 A.2d at 92. Where the company has a 102(b)(7) exculpatory provision, the Delaware Supreme Court has explained that no trial under the fairness

when shareholders challenge transactions solely alleging a breach of the duty of loyalty ("pure duty of loyalty cases") or good faith ("pure good faith cases"), section 102(b)(7) itself precludes exculpation. The Delaware Supreme Court has noted, though, that when the factual allegations "describe[] a duty of care violation that could be attributed to the board of directors' divided loyalties" ("hybrid cases"), a section 102(b)(7) charter provision does not automatically insulate directors from liability.[68] The same is true for cases alleging a duty of care violation that includes a lack of good faith allegation.[69] These cases usually survive a motion to dismiss and are allowed to proceed to trial.

Once shareholders show a violation of the pure duty of loyalty, pure good faith, or a hybrid thereof, Delaware law shifts the burden of proof to the board of directors to demonstrate that the transaction was "entirely fair" to the shareholders.[70] Although section 102(b)(7) expressly states that duty of care claims are exculpable, the Delaware Supreme Court has explained that the fairness analysis cannot be avoided in the hybrid cases by a motion to dismiss because "[t]he category of transactions that require judicial review pursuant to the entire fairness standard *ab initio* do so because, by definition, the inherently interested nature of those transactions are inextricably intertwined with issues of loyalty."[71] The hybrid cases and the pure duty of loyalty and pure good faith cases beyond the exculpatory reach of section 102(b)(7) highlight the remaining questions taken up in *In re Walt Disney* regarding board liability when faced with mixed shareholder claims.

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standard is necessary:

> [U]nder those specific circumstances, when the presumption of the business judgment rule has been rebutted in the shareholder complaint solely by successfully alleging a duty of care violation, the director defendants do not have to prove entire fairness to the trier of fact, because of the exculpation afforded to the directors by the Section 102(b)(7) provision inserted by the shareholders into the corporation's charter.

Id. In contrast, if the shareholders allege only claims of duty of loyalty or good faith, the matter proceeds to trial because no section 102(b)(7) exculpation is available.

[68]*Emerald Partners*, 787 A.2d at 92 n.40.

[69]*Id.* at 92 n.41; *see also Malpeide*, 780 A.2d at 1094 n.65 (explaining that if plaintiffs can plead facts supporting good faith violations, the claim would not be barred by the exculpatory charter provision). The Delaware Supreme Court has stated that it is an open issue whether the duty to act in good faith might "serve as an independent basis for imposing liability upon corporate officers and directors." *In re Walt Disney Co.*, 906 A.2d at 67 n.112.

[70]*See, e.g.*, DEL. CODE ANN. tit. 8, § 144 (2001) ("The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders."); *see also Emerald Partners*, 787 A.2d at 92 ("entire fairness"); *Malpiede*, 780 A.2d at 1094 (same).

[71]*Emerald Partners*, 787 A.2d at 93.

2. *In re Walt Disney Company Derivative Litigation*

The Delaware Supreme Court did not directly address several unsettled questions regarding the application of the duty of care and its interplay with section 102(b)(7) until more than twenty years after *Van Gorkom*.[72] In June 2006, the Delaware Supreme Court clarified certain aspects of the application of the duty of care, good faith, and waste, when it decided *In re Walt Disney*.[73] *In re Walt Disney* considered the Walt Disney Company's (Disney) board of directors' actions relating to the hiring of Michael Ovitz (Ovitz) as president. The agreement ultimately resulted in the payment to Ovitz of a $130 million severance package when he was dismissed after only fourteen months of service.[74] Michael Eisner (Eisner), was the company's chairman and chief executive officer and also had a social relationship with Ovitz. Eisner, along with Irwin Russell, a director and chairman of the compensation committee, approached Ovitz about joining Disney.[75]

The Ovitz employment agreement (OEA) was modeled after Disney's previously used employment agreements. The OEA contained no fault termination provisions with a significant severance package (NFT) in the event that Ovitz was terminated for anything other than gross negligence or malfeasance.[76] Prior to concluding the OEA, Disney hired Graef Crystal, an executive compensation consultant. Raymond Watson, another member of the compensation committee, worked with Crystal to evaluate the OEA.[77] The Disney compensation committee subsequently met and, after reviewing and discussing the term sheet and presentations by Watson and Russell, approved the terms of the OEA.[78] Later that same day, the full Disney board met, and after discussion and deliberations, elected Ovitz as

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[72]While during this period the Delaware Supreme Court did not decide any cases directly involving a board's duty of care (and none involving compensation issues), it did decide several cases that raised duty of loyalty issues and the overlap with section 102(b)(7). *See, e.g.*, *Emerald Partners*, 787 A.2d at 91; *Malpiede*, 780 A.2d at 1095; *Zirn*, 681 A.2d at 1061-62; *Arnold*, 650 A.2d at 1288. In *Emerald Partners*, the court overturned the court of chancery judgment in favor of the board defendants based on the corporate charter's exculpatory clause. *Emerald Partners*, 787 A.2d at 87. The court characterized the shareholder's claim regarding the merger price as properly pleading an entire fairness claim. *Id.* at 88. The court rejected the board's argument that it was protected from even entire fairness failures under section 102(b)(7). *Id.*

[73]*In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

[74]*Id.* at 35.

[75]*Id.* at 37.

[76]*Id.* at 37-38.

[77]*In re Walt Disney Co.*, 906 A.2d at 38.

[78]*Id.* at 40.

president.[79] Because Ovitz was not as successful as Disney desired, the relationship deteriorated.[80] Ovitz was dismissed without formal board action a mere fourteen months later under the NFT provisions of the OEA, as there was no cause to dismiss.[81] In reaction, the shareholders brought a derivative suit against Ovitz and the board.[82]

In a lengthy opinion, the Delaware Supreme Court tackled unresolved issues between the business judgment rule and section 102(b)(7).[83] The court stressed that the presumption of the business judgment rule "can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith."[84] According to the court, in such cases, "the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders."[85] Because the shareholders did not claim a duty of loyalty breach against the directors, the only way to rebut the business judgment rule was "to show that the Disney defendants had either breached their duty of care or had not acted in good faith."[86] Moreover, building upon its holding in *Emerald Partners v. Berlin*,[87] the court explained that an examination of a board's lack of good faith can be made for purposes of rebutting the business judgment rule, and if the board is found liable, for purposes of exculpation under section 102(b)(7).[88]

This section will more closely examine three specific areas the court grappled with that are likely to impact executive compensation decisions in the future. One area focuses on the reach of *In re Walt Disney*'s concept

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[79] *Id.* at 41.

[80] *Id.* at 42.

[81] *In re Walt Disney Co.*, 906 A.2d at 45.

[82] *Id.* at 46. The suit was brought in January 1997 by several shareholders alleging breaches of fiduciary duty and contract, and waste of assets. *Id.* at 35. The litigation was extended and involved several pretrial motions and an earlier appeal to the Delaware Supreme Court. *Id.* *See* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (allowing the plaintiffs to amend their complaint). The trial lasted thirty-seven days and resulted in a 174 page opinion by the Chancellor concluding that "the director defendants did not breach their fiduciary duties or commit waste." *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 697 (Del. Ch. 2005). The plaintiffs appealed from this judgment, claiming numerous errors. *In re Walt Disney Co.*, 906 A.2d at 46-47.

[83] *In re Walt Disney Co.*, 906 A.2d at 52.

[84] *Id.*

[85] *Id.*

[86] *Id.*

[87] 787 A.2d 85 (Del. 2001).

[88] *In re Walt Disney Co.*, 906 A.2d at 53. The business judgment rule can be rebutted "if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty *or acted in bad faith*." *Id.* (emphasis added).

of the duty of care and how a corporation can insulate itself from shareholder duty of care complaints. A second category involves using good faith to rebut the business judgment rule and, separately, as an element to avoid exculpation under section 102(b)(7). In this category, the key question is whether the board's decision making regarding the executive compensation package involved intentionally bad conduct or a "conscious[ ] and intentional[ ] disregard[ ] [of] responsibilities, adopting a 'we don't care about the risks' attitude."[89] The third category focuses on shareholder complaints of excessive compensation packages, like *In re Walt Disney*, as waste. Where the payments at issue are related to rational business attempts to attract executive talent, there is no waste.

a. *Executive Compensation as a Duty of Care Element After Section 102(b)(7)*

In re Walt Disney raises questions concerning the reach of the due care gross negligence standard in the context of executive compensation. Delaware intended section 102(b)(7) to limit the duty of care analysis primarily to cases where there were also allegations of bad faith. Later cases, like *Emerald Partners*, considered board decisions that also implicated duty of loyalty claims, not exculpable under section 102(b)(7).[90] Neither *Van Gorkom* nor *Emerald Partners* dealt with the issue of shareholder allegations that a board acted without due care and in bad faith in the absence of a duty of loyalty claim. By contrast, the *In re Walt Disney* court struggled with how to apply the duty of care analysis to board and committee decision making in a compensation matter where shareholders alleged bad faith and the corporation had a section 102(b)(7) exculpatory provision.

In *Van Gorkom*, the court imposed liability on board members based on facts that clearly supported a finding of gross negligence. By contrast, the court ruled that the Walt Disney compensation committee and board were not liable based on facts suggesting a much higher level of diligence. These two cases are reflective of factual situations that fall on opposite extremes of the spectrum of conduct involving allegations of breach of fiduciary duty. Where other cases will fall on the continuum and the resulting outcome on the question of liability is yet unknown. Most agree the payment to Ovitz of $130 million was excessive, especially after only fourteen months of service. The *In re Walt Disney* result, however,

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[89] *Id.* at 62-63 (quoting *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003) (emphasis omitted)).

[90] *Emerald Partners*, 787 A.2d at 93.

demonstrates that shareholders may lack a remedy for some excessive compensation packages due to the absence of a substantive inquiry in duty of care cases.

In order to appreciate the broad spectrum of conduct that falls between these extremes, comparison of the facts and circumstances of the two cases is instructive. The general circumstances of *In re Walt Disney* are distinguishable from *Van Gorkom* on a number of grounds. The Trans Union board's decision to enter into a merger agreement, in the *Van Gorkom* case, required board approval under the Delaware statute.[91] The Delaware statute, however, did not require a decision of the full Disney board regarding the OEA. Furthermore, Disney delegated the board's decision-making authority over the OEA to the compensation committee.[92] Moreover, the court in *Van Gorkom* evaluated the action of the Trans Union board as a collective group, whereas the action of the Disney directors was considered individually.[93] The decision of the Trans Union board concerned a merger, one of the most important occurrences in the life of a corporation,[94] whereas *In re Walt Disney* concerned only an executive compensation matter.

Similarly, the specific facts of *In re Walt Disney* are also distinguishable from *Van Gorkom* in terms of the informed decision making of the compensation committee and the board concerning the OEA, and the board's hiring Ovitz as president. Regarding the compensation committee, although they did not have a copy of the OEA when approved, the committee had a "term sheet" describing the NFT provisions, which was attached to the meeting minutes.[95] Furthermore, the committee members were apprised of the potential value of the NFT.[96] The committee reviewed various spreadsheets highlighting the "benchmarking" of the Ovitz options to prior options the compensation committee had approved for other executives, giving the members a fair idea of NFT value.[97] The committee was also well aware of the "downside" protection of $150 to $200 million Ovitz was demanding before leaving his company.[98] Moreover, the court was little concerned with the committee's failure to discuss specifically the gross negligence and malfeasance event triggers of the NFT because "those

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[91] *See* DEL. CODE ANN. tit. 8, § 251(b) (2001).

[92] *In re Walt Disney Co.*, 906 A.2d at 53-54.

[93] *Id.* at 55.

[94] *Van Gorkom*, 488 A.2d at 867.

[95] *In re Walt Disney Co.*, 906 A.2d at 56-57.

[96] *Id.* at 57.

[97] *Id.*

[98] *Id.* at 58.

terms 'were not foreign to the board of directors, as the language was standard, and could be found, for example, in Eisner's, Wells', Katzenberg's and Roth's employment contracts.'"[99] Finally, although the expert consultant was not present at the compensation committee meeting, Crystal had worked on similar Disney agreements before, met with some of the committee members prior to the meeting, and was available by telephone to answer questions.[100] Only after receiving the information and presentations and deliberating on the matter did the compensation committee approve the terms of the OEA.

While the deliberations of the Disney compensation committee fell short of "best practices,"[101] the deliberation process of the Trans Union board stands in sharp contrast. In *Van Gorkom*, the chairman of the board, Van Gorkom, called the meeting on short notice, without advance notice of the agenda, without documentary information for the Trans Union board to consider, and with little in terms of presentations.[102] The management of Trans Union opposed the merger.[103] After board approval of the merger agreement, Van Gorkom revised the agreement inconsistently with the board's authorization.[104] Finally, the Trans Union board did not have expert reports that it could rely on and engaged in little deliberations.[105]

Moreover, the facts surrounding the actions of the full board in the hiring of Ovitz as president are also distinguishable from the facts of *Van Gorkom*. The Disney board spent substantial time over several years debating the hiring of a new president and the potential candidates, including Ovitz.[106] The board was aware the Ovitz hiring would result in him leaving a highly successful company, and the market reacted positively to Disney's announcement that Ovitz would come to work with them.[107] Finally, the board was aware of the compensation committee's approval of the OEA and received presentations regarding its terms.[108]

These distinctions make it easy to conclude that *Van Gorkom* and *In re Walt Disney* are consistent with each other. The Delaware Supreme

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[99] *In re Walt Disney Co.*, 906 A.2d at 59 (citing *In re Walt Disney Co. Derivative Litig.*, 907 A.2d at 702 n.81).

[100] *Id.*

[101] *Id.* at 56. For further discussion of the "best practices," see *infra* notes 198-202 and accompanying text.

[102] *Van Gorkom*, 488 A.2d at 874-75.

[103] *Id.* at 867-68.

[104] *Id.* at 883-84.

[105] *Id.* at 876-78.

[106] *In re Walt Disney Co.*, 906 A.2d at 61.

[107] *Id.*

[108] *Id.*

Court did not specifically rely on these distinctions, however, in writing its opinion, and it failed to cite *Van Gorkom*.[109] The court stressed the requirement that a decision maker become informed of material information reasonably available,[110] which does not necessarily require the decision maker to be privy to all conversations and documents. Further, Delaware General Corporation Law section 141(e) protected the Disney board members' good faith reliance on the professional report prepared by the compensation consultant, Crystal.[111] While the court generally distinguished the type of informed decision making made by the Disney compensation committee and board, it did not specifically rely on any other factual distinctions between the two cases. Moreover, the court seemingly replaced the theme of gross negligence strongly emphasized in *Van Gorkom* with a conclusion that Delaware does not mandate best practices to ensure protections under the business judgment rule.

While the court upheld the court of chancery's decision on the due care issue in favor of the board members and Ovitz, the court characterized the actions of the Disney compensation committee as failing to use "best practices" from an informed decision-making standpoint. A simple failure to exercise best practices is insufficient to demonstrate a breach of due care, however, in contrast to the failure of informed decision making present in *Van Gorkom*.[112] The true issue for resolution, according to the court, was whether the compensation committee, when approving the OEA, and the board, when appointing Ovitz as president, "were fully informed of all material facts."[113] Yet the court still retained the general rule that board members are not liable for due care errors in the absence of gross negligence.[114]

In re Walt Disney leaves lingering questions concerning the reach of the gross negligence standard for due care in the executive compensation context. How close to best practices must compensation committees come? If courts define the due care obligation broadly, executive compensation and employment decisions appear to require the same type of information gathering, expert hiring, and other processes used in more complicated transactions, such as mergers. This seems particularly onerous in the

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[109]While the Delaware Supreme Court failed to cite *Van Gorkom*, the Delaware Court of Chancery decision, which the supreme court affirmed, cited *Van Gorkom* more than twenty times and specifically drew upon the distinctions between the cases. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005).

[110]*In re Walt Disney Co.*, 906 A.2d at 64-65.

[111]*Id.* at 59.

[112]*Id.* at 55.

[113]*Id.* at 61.

[114]*In re Walt Disney Co.*, 906 A.2d at 64-65.

differing contexts of a corporate enterprise's life. While in *Van Gorkom*, the board's decision making related to a cash-out merger that would end the life of Trans Union, no similar magnitude of decision making existed in the executive compensation arena of *In re Walt Disney*. Despite the passage of section 102(b)(7), the court's extensive consideration of due care obligations suggests that these obligations are alive and well. So, what is the role of section 102(b)(7)?

b. *The Emergence of the Good Faith Element*

The initial portion of the court's *In re Walt Disney* decision works over the due care analysis in the executive compensation context. Disney, however, had a section 102(b)(7) exculpation clause in its charter documents. Therefore, even if the plaintiffs had prevailed on an informed decision-making claim, it would not be enough to impose liability. To get around the section 102(b)(7) exculpation, the shareholders claimed the compensation committee and board acted in bad faith. Much has been written about the duty of good faith arising under section 102(b)(7) prior to the decision *In re Walt Disney*, but this was truly the court's opportunity to provide some guidance.[115]

The efforts of the court to clarify good faith under section 102(b)(7) are, in the end, probably more confusing than illuminating because the facts did not raise a clear issue of bad faith. Most importantly, the court emphasized that determinations of whether the board met its duty of care

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[115]For articles concerning the Disney litigation, see Robert Baker, In re Walt Disney: *What it Means to the Definition of Good Faith, Exculpatory Clauses, and the Nature of Executive Compensation*, 4 FLA. ST. U. BUS. REV. 261 (2004-2005); Tara L. Dunn, *The Developing Theory of Good Faith in Director Conduct: Are Delaware Courts Ready to Force Corporate Directors to Go Out-Of-Pocket After* Disney IV*?*, 83 DENV. U. L. REV. 531 (2005). For a general discussion of the good faith exception to exculpation, see, e.g., Matthew R. Berry, *Does Delaware's Section 102(b)(7) Protect Reckless Directors from Personal Liability? Only if Delaware Courts Act in Good Faith*, 79 WASH. L. REV. 1125 (2004); Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1 (2006); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005); John L. Reed & Matt Neiderman, *Good Faith and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111 (2004); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491 (2004); Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L.REV. 456 (2004); Filippo Rossi, Making Sense of the Delaware Supreme Court's Triad of Fiduciary Duties (June 22, 2005), *available at* http://ssrn.com/abstract=755784; Christopher M. Bruner, "Good Faith," State of Mind, and the Outer Boundaries of Director Liability in Corporate Law (Boston Univ. Sch. of Law Working Paper No. 05-19, 2005), *available at* http://ssrn.com/abstract=832944; Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism Threatening the Thaumatrope*, 61 BUS. LAW. 1 (2005).

and its duty of good faith were separate inquiries which could not be conflated. Thus, the shareholders' "effort to collapse the duty to act in good faith into the duty to act with due care, is not unlike putting a rabbit into the proverbial hat and then blaming the trial judge for making the insertion."[116] Because the court had already concluded that the plaintiffs could not prevail on their duty of care arguments, treating good faith in the same manner would not have changed the outcome on these facts.[117] The court's analysis could have ended there.

Nevertheless, the court decided to address the plaintiffs' legal claims regarding good faith, in order to provide "*some* conceptual guidance to the corporate community."[118] The court classified corporate behavior as involving three categories of behavior that could be considered in the bad faith analysis.[119] First, "subjective bad faith," where there is an actual intent to harm that is shown to have occurred,[120] would certainly constitute bad faith for purposes of section 102(b)(7). Second, conduct that is simply a lack of due care, i.e., gross negligence,[121] would not, without more, constitute bad faith for purposes of section 102(b)(7).[122] To conclude otherwise would eviscerate the purpose of the statute.[123] The third category of conduct falls between the first two. "[S]uch misconduct is properly treated as a non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith."[124]

The court included in this category of bad faith the conduct described in the Delaware Court of Chancery opinion as a "conscious[ ] and intentional[ ] disregard[ ][of] responsibilities, adopting a 'we don't care about the risks' attitude."[125] Quite naturally, the duty of good faith should

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[116] *In re Walt Disney Co.*, 906 A.2d at 63.

[117] *Id.*

[118] *Id.* at 64 (emphasis added).

[119] *Id.*

[120] *In re Walt Disney Co.*, 906 A.2d at 64.

[121] *Id.* at 64-65.

[122] *Id.*

[123] *Id.* at 65-66. The court also concluded that the Delaware indemnification statute also supported a differentiation between the failures of the duty of care and those of good faith. *Id.* *See* DEL. CODE ANN. tit. 8, § 145 (2001). The statute allows for indemnification in proceedings where the person "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation." *Id.* § 145(a)-(b). Since "a director or officer of a corporation can be indemnified for liability (and litigation expenses) incurred by reason of a violation of the duty of care, but not for a violation of the duty to act in good faith" the two inquiries must be different. *In re Walt Disney Co.*, 906 A.2d at 66.

[124] *In re Walt Disney Co.*, 906 A.2d at 66.

[125] *Id.* at 62-63 (quoting *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003) (emphasis omitted)).

"protect the interests of the corporation and its shareholders" from conduct that "does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence."[126] Furthermore, section 102(b)(7) itself distinguishes misconduct that is intentional from conduct that is not in good faith, though both are nonexculpable.[127]

Questions about good faith remain unaddressed in the wake of the court's decision. The court provides limited guidance about what type of board behavior will lead to a finding of bad faith. For instance, courts could label behavior that may involve the exact type of risk taking expected of the board by shareholders as bad faith. If there is a potential that courts will classify this behavior as bad faith, boards may become risk averse to the detriment of shareholders. Further, the court specifically did not determine the limits of this category of fiduciary conduct. "To engage in an effort to craft . . . 'a definitive and categorical definition of the universe of acts that would constitute bad faith' would be unwise . . . ."[128] Most importantly, the court did not "reach or otherwise address the issue of whether the fiduciary duty to act in good faith is a duty that, like the duties of care and loyalty, can serve as an independent basis for imposing liability upon corporate officers and directors."[129] The court left open the possibility that allegations of bad faith could be a separate claim against boards and committees, such as the compensation committee which approved the OEA.[130] The supreme court will allow the lower courts to struggle with some of these issues regarding the application of the duties of care and good faith. This uncertainty leaves room for a situation where a board may have complied with its procedural decision-making

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[126]*Id.* at 66. The Chancellor described the relation of the types of fiduciary conduct:

> The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

In re Walt Disney Co. Derivative Litig., 907 A.2d at 755-56 (footnotes omitted).

[127]*In re Walt Disney Co.*, 906 A.2d at 67.

[128]*Id.* (quoting *In re Walt Disney Co. Derivative Litig.*, 907 A.2d at 755).

[129]*Id.* at 67 n.112. This question was subsequently answered by the Delaware Supreme Court in *Stone v. Ritter*, where the court held that "the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty." Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

[130]*In re Walt Disney Co.*, 906 A.2d at 67-68.

requirements and acted in good faith, but nevertheless, still approved an excessive executive compensation package. In this case, shareholders lack a remedy.

c. *Executive Compensation as Waste*

The third category of cases where executive compensation packages may be actionable arises where board or committee decision making may not involve a lack of informed decision making, but the payment to the executive nevertheless constitutes waste. The court of chancery dismissed the shareholders' waste claim initially.[131] The Delaware Supreme Court allowed the shareholders to amend the complaint, but emphasized that "waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."[132] In fact, "[i]t is the essence of business judgment for a board to determine if 'a particular individual warrant[s] large amounts of money, whether in the form of current salary or severance provisions.'"[133] The clear conclusion from the court is that it is assuming the board's decision-making authority is broadly protected by the business judgment rule unless there is no "rational business purpose" for the decision.[134] To overcome this inference, a proper challenge to payments to an executive such as Ovitz would be "whether the amounts required to be paid in the event of an NFT were wasteful *ex ante*"; in other words, whether the contract did not require the payment to the executive at all or if the contract was wasteful when entered into by the company.[135]

The facts of *In re Walt Disney* demonstrate that corporate boards have wide discretion in making large executive compensation payments without triggering liability for waste. For instance, at the time the payments were made to Ovitz, Disney was contractually obligated to pay Ovitz the NFT payments under the OEA.[136] Therefore, the board is

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[131] *Brehm*, 746 A.2d at 263.

[132] *Id.* The Delaware Supreme Court has addressed waste in other cases as well. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (acknowledging that the board's power to act comes from its obligations to protect the corporate enterprise); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971); Kerbs v. Cal. E. Airways, Inc., 90 A.2d 652, 656 (Del. 1952) (stating the validity of a stock option plan depends on the existence of circumstances to ensure the contemplated consideration will pass to the corporation).

[133] *Id.* (quoting *In re* Walt Disney Co. Derivative Litig., 731 A.2d 342, 362 (Del. Ch. 1998)).

[134] *In re Walt Disney Co.*, 906 A.2d at 74.

[135] *Id.*

[136] *Id.*

protected from a waste claim unless the OEA itself was wasteful.[137] An example of this kind of agreement would be if the shareholders proved that the OEA itself "incentivized Ovitz to perform poorly in order to obtain payment of the NFT provisions."[138] The compensation committee designed the OEA, however, to financially incentivize Ovitz to leave his prior company and join Disney.[139] There was certainly no evidence that Ovitz had sought to intentionally get himself fired, a claim which the court rejected as "fanciful."[140] At the time Disney exercised the NFT provisions, the board members believed that Disney would be better off without Ovitz, but termination for cause was not an option.[141] Therefore, the shareholders could not prevail on the waste claim involving the OEA.

In re Walt Disney solidifies the court's prior rulings on waste, concluding that "[a] claim of waste will arise only in the rare, 'unconscionable case where directors irrationally squander or give away corporate assets.'"[142] Because of the wide discretion given to boards in compensation matters, waste is not likely to be a successful claim for shareholders unhappy about a board's decisions and will not result in much, if any, legal oversight of compensation matters.

III. THE BENEFITS OF THE SEC'S DISCLOSURE APPROACH TO EXECUTIVE COMPENSATION

The Revised Regulations contain extensive provisions designed to improve the SEC's ability to ensure that shareholders have a "more complete picture of the compensation earned by a company's principal executive officer, principal financial officer and highest paid executive officers and members of its board of directors."[143] The Revised Regulations not only strengthen the existing disclosure system by expanding the format for and types of executive compensation information covered, but they also address "key financial relationships among companies and their executive officers, directors, significant shareholders and their respective immediate family members."[144] The SEC intends the Revised Regulations to enhance

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[137] *Id.*

[138] *In re Walt Disney Co.*, 906 A.2d at 74.

[139] *Id.*

[140] *Id.* at 75.

[141] *Id.* at 74.

[142] *In re Walt Disney Co.*, 906 A.2d at 74 (quoting *Brehm*, 746 A.2d at 263).

[143] 71 Fed. Reg. at 6542.

[144] *Id.*

the strengths of the current reporting system, rather than forging ahead in a different direction.[145]

Disclosure of executive compensation information raises complex questions. What should the SEC include in its definition of "compensation"? When did the company pay the compensation to the executive? How did the company pay the compensation? How and when should the company value compensation payments? How can the format of disclosure provide meaningful data that the public can use for comparative purposes? The SEC has attempted to address the breadth of these issues in the Revised Regulations, with more success and clarity for some items than for others.

A. *Compensation Discussion and Analysis Will Explain Compensation Policy*

One of the major improvements contained in the Revised Regulations is the new requirement of a Compensation Discussion and Analysis (CD&A) narrative intended to relay "material factors underlying compensation policies and decisions" related to the information set forth in the required tables.[146] The CD&A would give context to the tabular disclosure and explain material elements of the company's compensation relative to the named executives, including: (1) the objectives of the compensation program; (2) the actions the company rewards through the compensation program; (3) the individual elements included in the compensation program; (4) the rationale supporting particular elements of the compensation program; (5) the reasoning behind the amounts chosen for each element; and (6) how the choices surrounding the elements fit with the compensation objectives as a whole.[147] The SEC's Revised Regulations clearly intend to prohibit companies from using "boilerplate" discussion in the CD&A.[148] Accordingly, compliance with the Revised Regulations could have a substantial impact on companies by requiring them to set out compensation policies in a detailed manner.

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[145] *Id.*

[146] *Id.* at 6544-6547; 71 Fed. Reg. at 53,161, 53,163-64; *see also* Jeffrey N. Gordon, *Executive Compensation: If There's a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis,"* 30 J. CORP. L. 675, 702 (2005) (arguing for a Compensation Discussion and Analysis signed by the compensation committee members and submitted to the shareholders for approval).

[147] 71 Fed. Reg. at 6545-46. For instance, a company would include in its CD&A a discussion of the policies underlying decisions to allocate compensation between current and long-term compensation; allocate payments between cash and noncash compensation, such as stock and stock options; regard benchmarking of executive compensation packages; and regard the involvement of executives in the compensation process. *Id.* at 6546.

[148] *Id.* at 6546.

B. *Compensation Tables Will Provide Important Disclosure of Perquisites and Retirement Compensation*

Along with the CD&A, revisions to compensation tables are significant in terms of the amount of disclosure that companies will make to the public. The compensation tables themselves will include expanded disclosure for: (1) executive compensation for the last fiscal year, including deferred compensation; (2) equity-related interests relating to compensation; and (3) retirement and post-employment compensation and benefits.[149] The SEC intends that companies provide more clarity to presentation by organizing disclosure around "themes," while confirming that companies must disclose all elements of executive compensation.[150] For instance, the Summary Compensation Table contemplated by the Revised Regulations requires companies to disclose compensation of named executive officers for the last three years,[151] including a total compensation column intended to require disclosure in a single number the aggregate amount of compensation of all types.[152] Moreover, the "all other compensation" column includes a number of important disclosure items, including perquisites and personal benefits,[153] but it does not include disclosure of

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[149]71 Fed. Reg. at 6544, 6547-68. The SEC contemplates three tables that work together: Summary Compensation Table, Grants of Performance-Based Awards Table, and Grants of All Other Equity Awards Table. *Id.* at 6547 n.63.

[150]*Id.* at 6545. It had come to the SEC's attention that some companies believed selected executive compensation figures were not currently required to be disclosed in the tables because they do not precisely fit in the existing tabular format. *Id.* at 6545 n.51 (citing The Corporate Counsel at 6-7 (Sept.-Oct. 2005); The Corporate Counsel at 7 (Sept.-Oct. 2004); Alan L. Beller, Director, Division of Corporation Finance, U.S. Securities and Exchange Commission, Remarks Before Conference of the NASPP, The Corporate Counsel and the Corporate Executive (Oct. 20, 2004) (indicating that the explicit language of the current rules requires disclosure of such items), *available at* www.sec.gov/news/speech/spch102004alb.htm.

[151]71 Fed. Reg. at 6547-48; 71 Fed. Reg. at 53,169-70. A narrative discussion would follow the table to disclose material information needed to understand the presentation in the tables. 71 Fed. Reg. at 6548; 71 Fed. Reg. at 53,169. Additionally, the two supplemental tables would break down and explain information from the summary table, which should provide a better picture of the elements of additional compensation in particular. 71 Fed. Reg. at 6555-57; 71 Fed. Reg. at 53,169-70; *see also* Bebchuk Letter Comment, *supra* note 28, at 4 (explaining that the "all other compensation" figure may be quite large for some companies and that breakdown is necessary for clarity).

[152]71 Fed. Reg. at 6547-48; 71 Fed. Reg. at 53,169-70.

[153]71 Fed. Reg. at 53,175-76. The test for inclusion rests on whether the item is "integrally and directly related" to the executive's job, and would include items "such as use of company-provided aircraft, yachts or other watercraft, commuter transportation services, additional clerical or secretarial services devoted to personal matters, or investment management services." 71 Fed. Reg. at 6553 (detailing numerous examples of perquisites requiring disclosure). This disclosure is on the aggregate incremental cost to the company, rather than the market value of such perquisites. *Id.* at 6554; 71 Fed. Reg. at 53,177. *But see* Frank Letter Comment, *supra*

items that are de minimus (less than $10,000 in the aggregate).[154] This will make progress toward discouraging companies from using perquisites, retirement benefits, lucrative severance packages, and other compensation to avoid public disclosure of compensation, which some have termed "stealth compensation."[155] Finally, the Revised Regulations also tackle the large amounts corporations pay to executives in the form of retirement benefits, or in Ovitz's case, post-employment payments.[156]

C. *Other Disclosures and Modifications Will Help Provide a Clearer Picture of Executive Compensation Practices*

The Revised Regulations add or call for further consideration of new disclosure requirements to strengthen some existing disclosure rules. First, the Revised Regulations have requested additional comment regarding compensation disclosure for the three most highly compensated employees who earn more than the executive officers or directors, but *who are not*

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note 29 (arguing for market valuation approach).

[154]71 Fed. Reg. at 6551; 71 Fed. Reg. at 53,176. First, companies will finally be obliged to report an executive's earnings on nontax qualified deferred compensation in all cases, rather than just if the earnings are above-market or preferential. 71 Fed. Reg. at 6552; 71 Fed. Reg. at 53,175. *But see* Odland Letter Comment, *supra* note 31, at 4 (arguing that this item should not be changed as market rate earnings simply represent what an executive would earn investing the compensation on their own if not deferred). Second, the disclosure of increases in the actuarial value to executives of pension plans may result in disclosure of a significant element of compensation. 71 Fed. Reg. at 6552; 71 Fed. Reg. at 53,175; Bebchuk Letter Comment, *supra* note 28, at 4; Bebchuk & Fried, *Stealth Compensation*, *supra* note 1, at 296; Bebchuk & Jackson, *supra* note 1, at 854-56. Finally, companies would be required to disclose perquisites and personal benefits if they aggregate to $10,000 or more. 71 Fed. Reg. at 6551-54; 71 Fed. Reg. at 53,176-77. This requirement also adds footnote disclosure that specifically identifies the perquisites or personal benefits and requires valuation of those valued at greater than $25,000 or 10% of the perquisites. *Id.* at 6553. *But see* Bebchuk Letter Comment, *supra* note 28, at 5 (suggesting that companies should also be required to disclose post-retirement perks).

[155]*See* Bebchuk Letter Comment, *supra* note 28, at 3; Bebchuk & Fried, *Stealth Compensation*, *supra* note 1, at 323-24; Bebchuk & Jackson, *supra* note 1, at 827-31.

[156]71 Fed. Reg. at 6560-63; 71Fed. Reg. 53,185-89. First, companies will disclose estimated annual retirement payments under defined benefit plans that an executive officer is currently, or will become, entitled to upon retirement. 71 Fed. Reg. at 6560-61; 71 Fed. Reg. at 53,185-86. Second, companies will disclose data regarding nonqualified defined contribution and other deferred compensation plans. 71 Fed. Reg. at 6561; 71 Fed. Reg. at 53,185. Finally, and perhaps most importantly, companies will now be required to disclose in narrative form arrangements with executives for payments in the event of "resignation, severance, retirement or other termination, . . . a change in his or her responsibilities, or a change of control of the company." 71 Fed. Reg. at 6562; 71 Fed. Reg. at 53,185.

themselves executive officers.[157] Second, the SEC believes that a table disclosing director compensation in a format similar to the Summary Compensation Table for executives is also necessary because of the emergence of more complicated director compensation packages, which often include company stock and incentive plans.[158] Finally, the Revised Regulations take the stance that disclosure is warranted because executive compensation involves financial transactions between companies and their directors and significant shareholders.[159]

D. *Filed CD&A and Furnished Compensation Committee Report Will Create Some Liability for Misstatements*

Under the current rules, the Compensation Committee "furnishes" to the SEC a required "Compensation Committee Report and Performance Graph," which does not create potential liability under the 1933 Act or Exchange Act.[160] The Report and Performance Graph are retained under the Revised Regulations.[161] Under the Revised Regulations, the CD&A, tables, and accompanying narrative will be considered "soliciting material" and will be "filed" with the SEC by the company.[162] The effect is that the disclosure of executive compensation information will be a company report

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[157] 71 Fed. Reg. at 6544; 71 Fed. Reg. at 53,158. This requirement has been criticized particularly by those companies in the entertainment industry as onerous, an invasion of entertainers' privacy and unrelated to executive compensation decisions. *See, e.g.*, Letter Comment of Dixie Johnson, Chair, Committee on Federal Regulation of Securities, ABA Section on Business Law, Executive Compensation and Related Party Disclosure (May 15, 2006), *available at* http://www.sec.gov/rules/proposed/s70306/djohnson051506.pdf; Pearl Meyer & Partners Letter Comment , *supra* note 28, at 10; Odland Letter Comment, *supra* note 31, at 2; Linda Rappaport & George Spera, Shearman & Sterling, LLP, on behalf of CBS Corporation, The Walt Disney Company, NBC Universal (a majority-owned subsidiary of General Electric Company), News Corporation, and Viacom Inc., Proposed Amendments to Requirements for Executive Compensation and Related Party Disclosure 1-2 (Apr. 10, 2006), *available at* http://www.sec.gov/rules/proposed/s70306/shearmansterling041006.pdf.

[158] 71 Fed. Reg. at 6544, 6564-65; 71 Fed. Reg. at 53,161, 53,191-92; *see also* National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission On Director Compensation (2001) (discussing the large amount of companies that offer equity as a pay boost).

[159] 71 Fed. Reg., at 6544, 6571-82; 71 Fed. Reg. at 53,198. The Commission anticipates that companies will broadly disclose certain transactions—including indebtedness—with related persons, where the amount exceeds $120,000. 71 Fed. Reg. at 6572; 71 Fed. Reg. at 53,198. Furthermore, corporate policies and procedures for related-party transactions would also be subject to disclosure. 71 Fed. Reg. at 6576, 71 Fed. Reg. at 53,202. That disclosure will be consolidated with other existing disclosure items related to corporate governance, such as director independence. 71 Fed. Reg. at 6545, 6577-78; 71 Fed. Reg. at 53,203-04.

[160] 71 Fed. Reg. at 6545-46.

[161] 71 Fed. Reg. at 6546-47; 71 Fed. Reg. at 53,168.

[162] 71 Fed. Reg. at 6546; 71 Fed. Reg. at 53,167-68.

certified by the executives, rather than furnished by the compensation committee of the board.[163] This change would now create Exchange Act liability for misstatements for every company subject to the rules. In contrast, the Revised Regulations also require a Compensation Committee Report which will be "furnished," rather than filed by the company.

The filing of the information will result in more executive involvement in compensation matters, particularly with the means in which they are disclosed.[164] There is no reason to believe, however, that executive involvement in this disclosure aspect of compensation matters will affect compensation committee decision making at the time the compensation is approved. The SEC is convinced that the filing requirement will promote company disclosure of board matters more effectively.

With all this information disclosure, what impact will the Revised Regulations actually have on executive compensation decision making? Will shareholders have remedies for excessive executive compensation discovered in the reports contemplated by the SEC?

IV. WHY THE REVISED REGULATIONS WILL NOT FIX EXCESSIVE COMPENSATION: CONSEQUENCES OF DUAL REGULATION

Information disclosure is important and helpful to the investing public. Finalizing the Revised Regulations, alone, will not accomplish the task of making corporate decision makers accountable for executive compensation decisions. Since its formation, the SEC's mission has been focused on public disclosure of accurate information. The SEC undoubtedly engages in involved review of information submitted by companies to insure accuracy of the filed information. However, the SEC will not, and has not been, in the business of merit-review of executive compensation. Nevertheless, Chairman Cox is hoping "that when people are forced to undress in public, they'll pay more attention to their figures."[165]

The SEC acts as a repository for financial and other data on executive compensation. Aside from when material misstatements are contained in filed information, the SEC's involvement ends after filing. Sifting through the data is a task for investors, particularly for institutional investors. While it may be possible for the investing public to rise to this challenge, much depends on whether investors will be motivated and able

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[163] 71 Fed. Reg., at 6546; 71 Fed. Reg. 53,168.

[164] *See, e.g.*, Johnson Letter Comment, *supra* note 157, at 4-5; Odland Letter Comment, *supra* note 31, at 2; Pearl Meyer & Partners Letter Comment, *supra* note 28, at 1-2.

[165] Stephen Labaton, *Spotlight on Pay Could Be a Wild Card*, N.Y. TIMES, Apr. 9, 2006, sec. 3, at 1.

to curb perceived abuses. SEC mandates concerning executive compensation disclosure have been in place since 1938. In 1940, half of the executives earned fifty-six times the average worker's pay, but by 2004 the number increased to one hundred four times the average worker's pay.[166] If the past is any guide, improved transparency will not provide a check on the amount of executive compensation paid.[167]

Even if shareholders are able to understand the executive compensation data as more fully disclosed under the Revised Regulations, they still confront serious obstacles. The SEC only regulates accurate disclosure. The rest is left to state law. Let us assume the Revised Regulations were applicable when the Disney compensation committee approved the OEA. State law controls only whether compensation decisions are informed, are made in good faith, and are not wasteful. Even with the information the Revised Regulations would have mandated Disney to disclose to the shareholders concerning the OEA, the Delaware Supreme Court concluded that that the OEA was approved with due care, in good faith, and was not wasteful.[168] This leaves a gap between federal mandates of information disclosure and the shareholders' ability to hold decision makers accountable for compensation packages the shareholders perceive as excessive under state law. Unfortunately, the fundamental problem with executive compensation decision making is not as simple as information disclosure. There are lingering issues of accountability and the shareholders' ability to react to the disclosed compensation data. Is the only goal of the Revised Regulations to provide shareholders with information *prior to* purchasing shares?

The SEC's focus on expanded disclosure of executive compensation information, excessive or otherwise, will undoubtedly affect executive compensation.[169] Companies may eliminate certain compensation elements that must be disclosed and adopt ones that are more useful and that link pay to performance.[170] But disclosure will not fully address the issues of executive compensation for a number of reasons. First, compensation decisions raise issues of arm's-length dealing and managerial influence over

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[166]Dash, *supra* note 5, sec. 3, at 1.

[167]In fact, a poll conducted by Watson Wyatt Worldwide evidenced that most American companies did not plan to change their programs. *See* Labaton, *supra* note 165, sec. 3, at 1. In the past, every time that the SEC has mandated additional disclosure, executive pay has actually increased. *Id.* at 10.

[168]*In re Walt Disney Co.*, 906 A.2d at 75.

[169]*See* Labaton, *supra* note 165, sec. 3, at 10 (discussing Bebchuk's prediction that companies may change compensation packages to include more useful elements once public disclosure reaches some of the formerly hidden elements).

[170]*See id.* sec. 3, at 10.

the compensation process. Second, shareholders desiring to respond to the enhanced information disclosure may find they have little recourse beyond selling their shares, which is not always a viable alternative. Third, the ability of shareholders to challenge a board's compensation decisions directly, or to remove directors, is limited, suggesting that accountability is lacking. Finally, while disclosure is an important regulatory mechanism, it is not substantive regulation. This section will discuss some of the reasons why the Revised Regulations are not likely to have a significant effect on executive compensation decision making.

A. *Compensation Decisions May Be Different from Other Board Decisions*

State law vests corporate boards with decision-making power, and the business judgment rule protects a board's decisions, subject to the duties of care and loyalty.[171] Not all decisions that a corporate board makes, however, are treated the same in terms of the extent of judicial review and degree of protection by the business judgment rule. Plenty of examples exist, and they tend to fall into two categories of decisions: (1) where the independence of a board's decision making is questioned ("compromised cases"), and (2) where the impact on the company will fundamentally affect the way in which the company will continue ("impact cases").

With respect to the compromised cases, a number of examples exist under Delaware law. For instance, pre-suit demand on the board by shareholders in derivative actions is excused when "futile" due to doubt about the board's disinterestedness or independence or doubt about whether the business judgment rule affords protection.[172] The rationale is that sometimes the board is "incapable, due to personal interest or domination and control, of objectively evaluating a [shareholder] demand, if made," and thereby unable to exercise the board's decision-making authority objectively for the corporation.[173] Similarly, in a takeover situation, a board must support its decision to institute defensive tactics by a reasonable response to the threat posed since the takeover context presents the

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[171] *See, e.g.*, DEL. CODE ANN. tit. 8, § 141.

[172] *Brehm*, 746 A.2d at 256; Aronson v. Lewis, 473 A.2d 805, 814, 816 (Del. 1984).

[173] *Brehm*, 746 A.2d at 257; *see also* Dennis J. Block et al., *Derivative Litigation: Current Law Versus the American Law Institute*, 48 BUS. LAW. 1443, 1443-44 (1993).

> [C]ourts both in and out of Delaware have ruled with near unanimity . . . that the business judgment rule is the appropriate standard of judicial review in cases where an independent majority of a corporation's board of directors determines that litigation on behalf of the corporation will not serve the best interests of the corporation.

"omnipresent specter" that a board will act in its own best interests, rather than the shareholders' interests.[174] Another example is in the parent-subsidiary context, where the board's independence is questioned because the parent dominates the subsidiary's board.[175] Board decisions are subjected to heightened scrutiny in parent-subsidiary mergers where there is evidence the transaction was not negotiated at arm's length.[176]

In the impact cases, certain decisions cannot be made by the board alone due to the effects they have on the company as an ongoing entity. For instance, under Delaware law, the following decisions require boards to submit the matter to the shareholders after the board votes: (1) approval of mergers;[177] (2) approval of amendments to the certificate of incorporation;[178] and (3) approval of certain business combinations involving interested shareholders.[179] Additionally, shareholders can propose amendments to the company's bylaws by their own initiative.[180]

Compensation decisions share characteristics of both compromised and impact cases. With respect to compromised cases, it is easy to question whether corporate boards bargain at arm's lengths with executives over compensation matters and remain faithful to shareholder interests.[181] Recent empirical work by Professors Randall Martin and Stewart Schwab, examining the contracts of CEOs, concluded that "CEOs have significant bargaining power in their negotiations over the terms of their employment contracts and change-in-control agreements."[182]

A number of questions exist regarding the board's ability to engage in arm's-length contracting with CEOs. First, directors may be motivated to make arrangements favorable to executives out of "collegiality, team spirit, a natural desire to avoid conflict within the board team, and

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[174]*See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

[175]*See* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

[176]*See* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

[177]DEL. CODE ANN. tit. 8, § 251 (2001).

[178]*Id.* § 242(b)(1).

[179]*Id.* § 203(a)(3).

[180]*Id.* § 109(a).

[181]*See, e.g.*, BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 23-44; Karmel, *supra* note 42, at 103 (describing executive compensation decisions as "self-dealing"); Kenneth West, *Pay Without Performance: An Executive's Perspective*, 30 J. CORP. L. 791, 792-93 (2005) (describing board influence by managerial power); *see also* Jennifer Hill & Charles M. Yablon, *Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict*, 25 U. NEW S. WALES L.J. 294, 301 (2002) (executive compensation is a corporate governance problem arising out of managerial conflicts of interest). *But see* Loewenstein, *supra* note 1, at 15-18.

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

sometimes friendship and loyalty."[183] Second, directors might not have enough time, resources, or connections to a company through stock ownership and otherwise to take on the difficult and sometimes unpleasant job of tough compensation negotiations with current or future executives.[184] Third, board members certainly might be motivated by a desire to be reelected.[185] Reelection requires a board member to be nominated to the company slate,[186] and nomination, typically by a nominating committee, is often heavily influenced by the same executives whose compensation the board members approve.[187] Fourth, the ability of the executives to benefit the directors through director compensation packages, charitable giving and other business dealings with companies with which the director is associated suggest a picture of entangled interests.[188] Finally, the "managerial power" approach simply asserts that powerful executives are able to receive higher compensation packages less sensitive to performance from corporate boards.[189]

The connection of executive compensation decision making to the impact cases is present, but seems weaker. Although executive compensation decisions are often "material" to the company, the expenditure does not

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[183]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 4; *see also* Kirkland, *supra* note 6, at 84 (referencing a PricewaterhouseCoopers poll that found that boards are having trouble controlling the size of executive compensation); West, *supra* note 181, at 792-93 (providing an example of a collegially motivated board approving exorbitant compensation to the CEO of First Fleet Boston prior to his retirement and the bank's merger with Bank of America).

[184]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 4.

[185]*Id.* at 25.

[186]*Id.*

[187]*Id.* at 25-6; Kramer, *supra* note 8, at 773-74 (arguing that directors, intent upon being reelected, are uncomfortable to push a CEO).

[188]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 27-30.

[189]*Id.* at 5; Lucian Ayre Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 754 (2002) (opining that the "managerial power approach" explains board deviance from optimal executive compensation packages due to the board's influence by or sympathy to the executives). For a critical discussion of the managerial power approach used to explain the rise in executive compensation, see Michael B. Dorff, *Does One Hand Wash the Other? Testing the Managerial Power and Optimal Contracting Theories of Executive Compensation*, 30 J. CORP. L. 255, 261 (2005) (concluding that managerial power affects director's decisions to give higher compensation packages to executives); Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129, 131 (2003); *see also* WATSON WYATT WORLDWIDE, *supra* note 8, *available at* http://www.watsonwyatt.com/news/press.asp?id=16180 (stating that a survey of directors and institutional investors found that while only 48% of directors think that executives heavily influence executive pay decisions, 87% of institutional investors believe executives heavily influence the process).

typically amount to a large amount of the company's total assets.[190] Nevertheless, companies expect CEOs to have major impacts on their company's future prospects and typically measure CEO success in terms of company stock performance, earnings growth, and cost reduction. Further, even the decision to hire a particular executive can have substantial effects on the market price of a company's stock. For instance, when Disney hired Ovitz, release of the news caused the Disney stock price to jump 4.4% in a single day.[191]

These reasons suggest that executive compensation decisions present issues that may distinguish them from other, more routine, board decisions. Whereas we can expect the board to negotiate at arm's length in many situations, executive compensation decisions have characteristics of the compromised and impact cases in corporate governance, where decision making is normally subjected to additional processes or higher standards of review. Further, there are indications that even corporate managers and the corporate community have long perceived that executive compensation decisions are distinguishable from routine decision making by: (1) enacting New York Stock Exchange (NYSE) listing rules that require companies to have a compensation committee composed of "independent directors" which operates under a written charter describing the responsibilities of the committee;[192] (2) hiring compensation consultants to prepare spreadsheets and similar documents; and (3) spending increasing amounts of board and committee time on executive compensation matters.[193] If board decisions regarding compensation are distinguishable from other routine decisions, the regulatory response might also entail more than disclosure and business judgment review.

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[190] *Brehm*, 746 A.2d at 259-60 n.49 (quoting Lori B. Marino, Comment, *Executive Compensation and the Misplaced Emphasis on Increasing Shareholder Access to the Proxy*, 147 U. PA. L. REV. 1205, 1235 (1999) (arguing that "[e]xecutive compensation makes up such a small percentage of a firm's assets that even excessive pay packages will likely not cause a blip in a firm's stock value")); *cf. id.* ("contrasting executive compensation with decisions by a company's board regarding takeovers, which have a great effect on a company's stock price").

[191] *In re Walt Disney Co.*, 906 A.2d at 40.

[192] *See* New York Stock Exchange, Listed Company Manual, P 303A.05, *available at* http://www.nyse.com/Frameset.html?nyseref=&displayPage=/lcm/1078416930957.html?enable=section&number=3&ssnumber=303a.00 (last visited Feb. 2, 2007) [hereinafter NYSE]; *see also* National Association of Securities Dealers Automated Quotations, Inc., Marketplace Rules, IM 4350(c)(3)(A)(i), (ii), *available at* http://nasdaq.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=18 (last visited Feb. 2, 2007) (rules require compensation decisions to be approved or recommended to the board by a compensation committee or independent board members) [hereinafter NASDAQ].

[193] *See, e.g.*, *In re Walt Disney Co.*, 906 A.2d at 55-58 (discussing the "best practices" for compensation matters).

While it seems likely that the Revised Regulations and Existing Regulations would have required disclosure of the OEA, disclosure does not consider the relationships that make executive compensation decisions different from routine board matters. These concerns are summed up by Professor Lucian Bebchuk:

> The factors impeding arm's-length contracting are in part a product of legal rules and corporate practices. With the rules and practices that we have had to date, directors have been subject to a myriad of incentives and forces that have prevented them from bargaining at arm's length with the CEO over pay.[194]

The effectiveness of information disclosure hinges on the effect that disclosure will have on decision makers. The additional disclosure contemplated by the Revised Regulations, however, is unlikely to enhance arm's-length dealings here.

B. *The Gap: Performance of the Board's Duty of Care and Good Faith Obligations Will Permit Some Excessive Compensation Packages*

Another challenge facing the SEC is the gap between disclosure and state law regulation of executive compensation decision making. State law only creates accountability for some executive compensation decisions. Excessive executive compensation packages are not necessarily the product of a lack of due care, bad faith, or waste. An important category of excessive executive compensation packages are those adopted in accordance with state law duties, and perhaps even with "best practices."[195] The OEA was adopted with due care, in good faith and was not waste, yet some shareholders were outraged enough to litigate the matter for years.[196]

The "best practices" described by the Delaware Supreme Court for executive compensation decision making might help, but will not prevent, excessive packages.[197] To comply with "best practices," the compensation committee members should first receive (preferably in advance of the meeting) a spreadsheet or document prepared by a compensation expert

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[194]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 43.

[195]*See, e.g.*, *In re Walt Disney Co.*, 906 A.2d at 55-58 (discussing the "best practices" for compensation matters).

[196]*In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

[197]*Id.* at 55-58.

disclosing the amounts the executive might receive under various alternatives.[198] Second, the compensation expert, or a committee member, should explain the spreadsheet or document to the committee, with the document itself attached to committee minutes.[199] Finally, the committee members should then have deliberations and discussion.[200] The *In re Walt Disney* court observed that following this "tidy" process will eliminate the shareholders' basis for litigation.[201]

Companies are likely to adopt the "best practices" from *In re Walt Disney*, but adoption will not prevent excessive compensation packages. The exercise of "best practices" contemplates a board or committee using procedural safeguards, not substantive ones. If a compensation decision is later challenged by shareholders, state law only considers the procedural due care employed by the board or committee and does not involve a substantive review of compensation decisions.[202] As long as procedural measures are employed in executive compensation decision making, shareholders have no basis to litigate. A problem that shareholders face, therefore, is that while the Revised Regulations may aid in the discovery of excessive compensation packages, the limit on state law remedies creates a gap where excessive packages may remain.

C. *Shareholders Lack Meaningful Ability to Challenge Board Decisions*

Even if the Revised Regulations operate as intended and trigger additional company disclosure, they will not be effective because shareholders do not have a major role in establishing executive compensation packages and have little ability to challenge decisions afterwards.[203] We count on corporate boards to make these decisions for the company. Accountability, though, is key to policing board decision making. For instance, shareholders unhappy with board decision making over executive compensation often have little ability to oust directors in a proxy contest or hostile takeover because such contests are rare.[204] Furthermore, shareholders cannot rely on state law to eliminate excessive packages because,

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[198] *Id.* at 56-57.

[199] *Id.*

[200] *In re Walt Disney Co.*, 906 A.2d at 56-57.

[201] *Id.* at 56.

[202] Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).

[203] *See* Labaton, *supra* note 165, sec. 3, at 10. For a discussion of the challenges facing shareholders, see Thomas & Martin, *supra* note 52, at 613.

[204] BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 11; Thomas & Martin, *supra* note 52, at 570 (stating that proxy contests of this sort are rare and expensive).

as discussed above, board compliance with the law does not eliminate excessive packages.

It might be argued that aggrieved shareholders, displeased with compensation policies, can simply sell their shares.[205] However, this would only affect corporate policy if enough shareholders were to sell their shares in response to the compensation policy. Not all shareholders, for instance, ones with indexed investments, can simply readjust investments.[206] Furthermore, to the extent excessive compensation practices are widespread, selling may not operate as a check on the market.[207] In fact, few shareholders actually sell in response to unhappiness with compensation policies.[208] Finally, the ability of shareholders to sell shares hardly seems equivalent to the ability to replace directors with whom the shareholders are unhappy. Presuming the share price is depressed because of poor board decisions, the shareholders' remedy would be to sell for the depressed price, rather than being able to obtain the higher price for the shares if the board were performing well. For these reasons, the option of selling shares seems to be a weak check on corporate executive compensation policy.

In practice, affirmative shareholder initiatives objecting to executive compensation packages (generally unsuccessfully) have mostly centered on three areas: (1) suing the board under state law;[209] (2) voting against employee stock option plans;[210] and (3) putting forward shareholder precatory resolutions under Rule 14a-8 of the federal proxy rules.[211] Shareholder derivative suits under state law are constrained by the due care, good faith, and waste analyses.[212] These are procedural inquiries that limit shareholder ability to object to compensation packages that are excessive on a

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[205]Loewenstein, *supra* note 1, at 25.

[206]Thomas & Martin, *supra* note 52, at 570.

[207]Loewenstein, *supra* note 1, at 25-26 (asserting that this could result in shareholders having to leave the market entirely); Thomas & Martin, *supra* note 52, at 570 (commenting that even institutional shareholders may not have the portfolio flexibility in order to simply sell all shares); *see also* Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No,"* 67 U. CIN. L. REV. 999 (1999) (emphasizing that the law governing shareholder decisions on voting and selling should be uniform and should "trust shareholders making voting decisions the same as shareholders making decisions to sell").

[208]Thomas & Martin, *supra* note 52, at 570.

[209]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 45; *see, e.g.*, *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006); Thomas & Martin, *supra* note 52, at 571 (examining 124 cases where shareholders have brought claims of excessive compensation and concluding that shareholders are more likely to find success against smaller corporations when litigating outside of Delaware).

[210]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 45; Thomas & Martin, *supra* note 52, at 570.

[211]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE *supra* note 1, at 45.

[212]*Id.*

substantive level.[213] Furthermore, one must question whether courts are in the best position to evaluate the merits of executive compensation plans even if substantive analysis was adopted as a standard.[214] Shareholder voting on employee stock option plans has not been an effective restraint on executive compensation. Shareholders typically vote on a plan as a whole, not with respect to how the plan rewards a particular executive in the future.[215] Finally, shareholder precatory resolutions on executive compensation matters, even when effectively framed such that widespread support is possible, only have a limited impact on board decision making because they are purely advisory.[216]

The less successful attempts by American shareholders to affect management decision making might be distinguished from that of European company shareholders. In Europe, five or ten shareholders may own a substantial amount of stock in a company. With the ownership more concentrated, these larger shareholders are more successful when taking their complaints directly to management, in terms of getting a response.[217] Even

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[213]*See supra* Part IV.B; *see also* BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 45 (positing that a shareholder suit contesting executive compensation packages solely as breaches of fiduciary duties would not be reviewed on the "substantial merits of the specific compensation arrangement"). Court review is procedural and does not involve "substantive due care" review of the executive compensation package. Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).

[214]Loewenstein, *supra* note 1, at 20-21; Thomas & Martin, *supra* note 52, at 604 (concluding that courts should only have a limited role in policing procedural aspects of compensation practices).

[215]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 48-51; Thomas & Martin, *supra* note 52, at 570 (suggesting that shareholder opposition to these plans does not seem to have had much effect on their use or growth).

[216]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 51-52; Andrew R. Brownstein & Igor Kirman, *Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 BUS. LAW. 23, 74-77 (2004) (concluding that boards can resist the adoption of shareholder proposals, but should take them seriously); Loewenstein, *supra* note 1, at 26 (noting the limited effect shareholders can have with precatory resolutions); Thomas & Martin, *supra* note 52, at 570 (stating that these proposals typically get less than 10% of the vote). In the case of Hewlett-Packard, shareholders mounted, and succeeded in, an effort to get the company to abide by a "policy requiring a shareholder vote for any severance package exceeding 2.99 times the sum of the executive's base salary plus bonus." Pimentel, *supra* note 7, at C1 (reporting that two institutional investors sued HP over Fiorina severance package allegedly in violation of this board policy).

[217]*See* Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999) (presenting empirical evidence illustrating the different corporate ownership patterns); *see also*, Luca Enriques, *EC Company Law Directives and Regulations: How Trivial Are They?*, 27 U. PA. J. INT'L ECON. L. 1, 29 (2006) (discussing how company ownership concentration affects preemptive rights); John J. Huber & Alexander Cohen, *Foreign Issuers and the Regulatory Agenda: Deregistration and IFRS Transition*, 1544 PLI/Corp 9 (May 2006) (arguing that concentrated ownership in European companies affects new deregistration rules); Felicia H. Kung, *The Regulation of Corporate Bond Offerings: A Comparative Analysis*, 26 U. PA. J. INT'L ECON.

for smaller stakeholders, strong European initiatives aimed at disclosure to shareholders in advance of board meetings, coupled with shareholder rights to challenge resolutions not properly disclosed, offer protections.[218] However, it might be observed that the ability of larger shareholders in European companies to impact management decisions might also adversely affect the rights of minority shareholders.[219]

The SEC has an identified strategy for dealing with excessive executive compensation: "to help investors keep an eye on how much of their money is being paid to the top executives who work for them."[220] Given the obstacles to challenging compensation decisions, American shareholders, who often do not have substantial stakes in any individual corporation, find it difficult to achieve changes in corporate policy. The Revised Regulations will provide the shareholders with information, but reacting to it will continue to be troublesome. Although the SEC's approach is laudable, it does not suggest or entail accountability. Chairman Cox has explained, "[T]he SEC lacks statutory authority to impose salary caps on corporate executives and we'd be out of bounds to attempt that through indirection."[221] Without holding corporate decision makers accountable to the shareholders, however, the Revised Regulations will not change much in the world of executive compensation.

L. 409, 436 (2005) (suggesting that investors in EU corporations have less need to sue issuers because they have more power vis-à-vis the company); High Level Group of Co. Law Experts, Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe 59-60 (2002), *available at* http://ec.europa.eu/internal_market/company/docs/modern/consult_en.pdf (last visited Feb. 3, 2007) (providing European Commission "with recommendations for a modern regulatory company law framework").

[218]*But see* Dirk Zetzsche, Explicit and Implicit System of Corporate Control—A Convergence Theory of Shareholder Rights 53-58 (Ctr. for Bus. & Corp. Law Research Paper Series, Paper No. 0001, 2004), *available at* http:// papers.ssrn.com/sol3/papers.cfm?abstract_id=600722 (last visited Feb. 3, 2007) (arguing the relevance of shareholder approval of certain decisions in countries where the law protects minority shareholders by imposing a broad duty to disclose information prior to a meeting and by granting individual shareholders the right to challenge the validity of shareholder meetings resolutions taken without due disclosure).

[219]Jennifer G. Hill, *Regulatory Responses to Global Corporate Scandals*, 23 WIS. INT'L L.J. 367, 387 (2005); *see also* High Level Group of Co. Law Experts, *supra* note 217, at 14-15 (suggesting that independent monitoring on behalf of minority shareholders is needed).

[220]Cox Speech, *supra* note 13.

[221]*Id.*

D. *Disclosure of Compensation Information in a Transparent Format is Critical but Insufficient*

Yet another problem facing the SEC is that disclosure of executive compensation data is not the equivalent of merit review or substantive regulation of corporate conduct. Accordingly, investors and the SEC cannot be assured that the Revised Regulations will affect corporate conduct in a meaningful way. In fact, some believe the Revised Regulations will actually result in increases in executive compensation levels.[222] Moreover, new surveys indicate that most companies will not change compensation policies in response to the Revised Regulations.[223] The effectiveness of the Revised Regulations hinges on two elements: (1) getting information to investors, and (2) investors' being able to use the information and act.[224]

The benefit to the investing public of having full access, in a more transparent way, to executive compensation policies, practices and data cannot be understated.[225] Brandeis' oft-quoted statement, "[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman," is appropriate here.[226] Transparency, if achieved, certainly will have an effect on the ability of executives to receive executive compensation packages that are less linked to performance.[227] Disclosure also ensures that investors have access to compensation information prior to making an

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[222]Labaton, *supra* note 165, sec. 3, at 10 (noting that every time disclosure increases, so does pay); Floyd Norris, *Which Bosses Really Care if Shares Rise?*, N.Y. TIMES, June 2, 2006, sec. C., at 1 (same).

[223]Labaton, *supra* note 165, at sec. 3, at 1 (describing a poll by WatsonWyatt Worldwide, a human resources firm, which found that only one in ten would make changes in compensation programs); *see also* WATSON WYATT WORLDWIDE, *supra* note 8, at 2 ("While most directors believe the executive pay system needs further reform, they are unlikely to make dramatic changes to their programs.").

[224]*See* Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 418 (2003) (arguing that the ability to use information effectively is often overlooked).

[225]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 11, 192; David A. Westbrook, *Telling All: The Sarbanes-Oxley Act and the Ideal of Transparency*, 2004 MICH. ST. L. REV. 441, 453 (2004) (noting that disclosure regulations "increase transparency and thereby increase informational efficiency of markets"). *But see* Claudia H. Deutsch, *Behind Big Dollars, Worrisome Boards*, N.Y. TIMES, Apr. 9, 2006, sec. 3, at 7 (suggesting that greater transparency is only treating a symptom of excessive executive compensation policies, and at the very least, "it can help [the shareholders] decide whether to re-elect the directors").

[226]LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914).

[227]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 11.

investment.[228] It is widely believed that access to understandable financial data, even by the market professionals alone, results in the data being reflected in the pricing of the stock.[229] Examining compensation policies in stock prices and giving shareholders access to this information prior to investment is meaningful. However, it is not the same as providing shareholders with a means to hold decision makers accountable or to change compensation policies or processes to protect investments once made.[230] Should we employ a regulatory approach for executive compensation that is predominately dependent on investor choice at the purchase stage? What about information overload, overconfidence in one's ability to decipher information, optimism and other barriers to disclosure-based regulation?[231]

The SEC has often turned its focus to disclosure-based regulations,[232] rather than merit review or substantive regulation. "[T]here is the recurrent theme throughout [the federal securities laws] of disclosure, again disclosure, and still more disclosure."[233] The SEC believes that the market assumes investors make informed decisions with full disclosure.[234] The advantage of disclosure as a regulatory approach is that it serves as a less

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[228]H.R. REP. NO. 73-1383, at 11 (1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973) ("No investor . . . can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells."); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 152-54 (2006).

[229]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 192; Deutsch, *supra* note 225, sec. 3, at 7.

[230]BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at 192; Deutsch, *supra* note 225, sec. 3, at 7; Loewenstein, *supra* note 1, at 24 ("[I]t is clear that disclosure should not be regarded as an effective limitation on compensation.").

[231]*See, e.g.*, Ripken, *supra* note 228, at 160-72.

[232]LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 29 (3d ed. rev. 1998); Ripken, *supra* note 228, at 145-49 (questioning the continuation of the disclosure approach).

[233]LOSS & SELIGMAN, *supra* note 232, at 29; *see also* ANNE M. KHADEMIAN, THE SEC AND CAPITAL MARKET REGULATION: THE POLITICS OF EXPERTISE 83 (1992) (identifying "disclosure-enforcement" as the foundation of securities regulation); Elaine A. Welle, *Freedom of Contract and the Securities Laws: Opting Out of Securities Regulation by Private Agreement*, 56 WASH. & LEE L. REV. 519, 534 (1999) ("From the beginning, the central focus of the federal regulatory structure has been disclosure.").

[234]*See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 22 (5th ed. 2005); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963). The Report on the Securities Exchange Act of 1934, the House commented: "No investor . . . can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells . . . . [T]he hiding and secreting of important information obstructs the operation of the markets as indices of real value." H.R. REP. NO. 73-1383, at 11 (1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973).

invasive government intrusion into companies and allows investors to make personal choices about investments.[235] The disclosure focus is certainly evident in the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), which is intended "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws."[236] Traditional SEC disclosure-focused programs can produce results in some areas, such as making sure a prospectus in an initial public offering that contains misstatements creates liability for the issuer.[237]

The second factor, concerning investors' ability to use disclosed information and act, cannot be understated. In light of the continuing issues surrounding corporate governance, over-reliance on disclosure as a regulatory approach may be out-of-step with the current regulatory needs. First, investors do not always make rational decisions when making an initial investment. Second, investors need options other than selling to respond to disclosure of information about excessive compensation to executives. Third, the complexity of modern corporate enterprises makes clear that accurate disclosure that is understandable to shareholders is a daunting task for corporate officers. Not all investor behavior is simple buy and sell decisions in response to readily understandable disclosed information. Investors are vulnerable to corporate misdealing from the lack of information about executive compensation. Investors are also vulnerable from limits on their ability to respond to the information they have.[238]

Using the same disclosure approach for executive compensation matters is not likely to yield the same meaningful results. The SEC-mandated disclosure to shareholders of executive compensation data lacks value if the shareholders cannot process and effectively use the information. For instance, information overload is a problem with disclosure-based regulatory systems generally,[239] but it will particularly be a hurdle to

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[235]Ripken, *supra* note 228, at 149-56.

[236]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in various sections of 15 U.S.C.) (preamble).

[237]*But see* Ripken, *supra* note 228, at 185-87 (arguing the weaknesses of the SEC's disclosure approach).

[238]*Id.* at 148.

[239]*See generally* Alison Grey Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L.J. 311, 325 (1974); Jay T. Brandi, *Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation*, 10 J. CORP. L. 689, 691-92 (1985) (suggesting that even sophisticated analysts can have difficulty with complex regulatory disclosure); Ripken, *supra* note 228, at 185; Ray J. Groves, *Here's the Annual Report. Got a Few Hours?*, WALL ST. J., Aug. 4, 1994, at A12; Kimberly A. Strassell, *The Weekend Interview with Christopher Cox: Full Disclosure*, WALL ST. J., May 20, 2006, at A8 (noting that "today's disclosure system is impenetrable to all but whiz kid financial analysts").

investors in understanding executive compensation disclosure. The Revised Regulations contemplate no less than eight complex graphs and extensive narrative discussion.[240] Additionally, the SEC is attempting to avoid "boilerplate" disclosure of compensation information with the Revised Regulations.[241] Because lawyers draft many of the documents filed with the SEC,[242] boilerplate language will be almost impossible to eliminate with the Revised Regulations. Further, most of the disclosure contemplated by the Revised Regulations will be received after executive compensation decisions are made. Therefore, existing shareholders have no meaningful options to change compensation policies after the fact, short of selling their shares. As discussed above, selling shares is a weak check on corporate decision makers.

Although the Revised Regulations create some liability for misstatements, this does not mean the SEC is undertaking merit review of executive compensation decisions. In fact, Chairman Cox specifically said the SEC is not in the business of setting compensation or evaluating compensation decisions.[243] Nevertheless, Chairman Cox is clearly hoping that better disclosure will result in changes to executive compensation policies and programs.[244] Unfortunately, Chairman Cox's intention may not be attainable in light of the following realities: (1) most companies do not plan to change their practices;[245] (2) most directors do not believe that the current executive compensation approach is flawed;[246] (3) the board's role as an independent, arm's-length decision maker is compromised;[247] (4) the gap between state and federal regulation allows some excessive compensation packages to exist;[248] and (5) shareholders lack the ability under state law to

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[240]71 Fed. Reg. at 6548, 6556, 6559-62, 6565 (contemplating the following tables: Summary Compensation, Grants of Performance-Based Awards, Grants of All Other Equity Awards, Outstanding Equity Awards At Fiscal Year End, Option Exercises and Stock Vested, Retirement Plan Potential Annual Payments and Benefits, Nonqualified Defined Contribution and Other Deferred Compensation Plans, and Director Compensation).

[241]*Id.* at 6546.

[242]Alan B. Levenson, *The Role of the SEC as a Consumer Protection Agency*, 27 BUS. LAW. 61, 68 (1971); *see also* Paredes, *supra* note 224, at 429 n.58 ("[C]ompanies often disclose information not to better inform investors, but to reduce the risk of liability for omitting a material fact or disclosing a 'half truth.'").

[243]Cox speech, *supra* note 13; Labaton, *supra* note 165, sec. 3, at 1 ("[G]overnment should stay out of the business of setting executive compensation.").

[244]Labaton, *supra* note 165, sec. 3, at 1 (Cox is hoping that compensation decision makers will "pay more attention to their figures").

[245]*See supra* notes 189, 241.

[246]*See supra* notes 9 & 21 & *infra* note 265.

[247]*See supra* Part IV.A.

[248]*See supra* Part IV.B.

attack compensation plans they perceive as excessive.[249] As a result, the Revised Regulations may not have the major impact that the SEC and the public wants or expects.

Substantive regulation of conduct, rather than disclosure, is surely a more complicated regulatory approach.[250] Substantive regulation of conduct operates to prohibit specified conduct even if a company makes disclosure to the shareholders.[251] Substantive regulation of conduct requires closer scrutiny of corporate behavior to determine what conduct cannot be tolerated. One common example of the Exchange Act's use of substantive regulation is section 16(b). Section 16(b) requires disgorgement of "short-swing" profits received by directors, officers, and shareholders who hold more than 10% of the corporation's shares if they buy and sell the corporation's securities within a six-month time period.[252] Forming substantive rules requires in-depth discussion of the merits of specified corporate behavior and the costs and benefits of the prohibited conduct. The limited effectiveness of disclosure in some areas suggests that this discussion should occur more often.

Executive compensation presents a difficult situation for regulators. The Revised Regulations would require companies to disclose substantial amounts of compensation data, but to what result? Many directors believe that disclosure of increased compensation information is a positive change, mainly because it will demonstrate that the *existing* pay system works.[253] Sometimes direct conduct regulation is more effective to deter fraud or bad practices.[254] Professor Charles Elson sums it up: "Disclosure is like an aspirin; it can make you feel a little better, but it can't even cure the common cold . . . . The fact is, a board that overpays the C.E.O. is in all

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[249]*See supra* Part IV.C.

[250]Ripken, *supra* note 228, at 148-49.

[251]*Id.* at 190.

[252]Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (2000).

[253]*See* WATSON WYATT WORLDWIDE, *supra* note 8 (finding that only 41% of directors think that the current model of executive pay is poor).

[254]*See* Anderson, *supra* note 239, at 343 ("[D]irect regulation of conduct may be the best means of deterring fraud and undesirable practices."); John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1115 (1977) ("Disinfectants are not, after all, a universal panacea; sometimes surgery is required."); William O. Douglas, *Protecting the Investor*, 23 YALE REV. 521, 528 (1934) (suggesting that substantive regulation is sometimes more effective). *But see* A.A. Sommer, Jr., *Random Thoughts on Disclosure as "Consumer" Protection*, 27 BUS. LAW. 85, 88 (1971) (discussing the disclosure approach to securities regulation); Paula Walter, *The Doctrine of Informed Consent: To Inform or Not to Inform?*, 71 ST. JOHN'S L. REV. 543, 545-46 (1997) ("[S]elf-determination, which assures that man is master of his destiny, is deeply rooted in our legal system and is the legal mirror of the Western values system, which exalts the individual.").

probability not minding the store on other issues, either."[255] For these reasons, more stringent disclosure requirements are unlikely to have widespread impact on compensation policies.

To date, the SEC has not been fully candid about the limitations of solely continuing an information disclosure regulatory approach. As Representative Barney Frank commented:

> [T]he proposed rule is an excellent first step, and I hope we can work together to ensure that shareholders have the tools needed to address executive compensation and corporate governance *as they see fit*. For a market to work, however, participants require information; *and* choice. This proposed rule would give shareholders valuable information relating to executive compensation, but does not give them much hope for doing anything about it. Short of shaming boards into holding executives accountable, the proposed rule does not ensure that shareholders can effectively change compensation practices.[256]

Even if the SEC does not pursue additional regulations now, corporations have no assurance that this policy would continue. The SEC, particularly in the event of a Congressional mandate or in the wake of another corporate scandal, could easily change its mind at a later date.[257] The SEC's assertion of only informational jurisdiction over executive compensation as part of its core mission leaves much undone with the gap existing between the SEC's information disclosure and the *In re Walt Disney* expression of shareholder recourse for excessive compensation. Without more marked changes, the Revised Regulations are not likely to have significant impact on compensation decisions or practices.

V. FILLING THE GAP BETWEEN *IN RE WALT DISNEY* AND DISCLOSURE

Some changes to executive compensation practices are needed to address the lack of shareholder remedies remaining after the disclosure contemplated by the Revised Regulations and the procedural review

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[255]Deutsch, *supra* note 225, sec. 3, at 7.

[256]Frank Letter Comment, *supra* note 29, at 3; *see also* Lucian Bebchuk, *The SEC: Beyond Disclosure*, FORBES, Jan. 19, 2006 (stating that SEC rules will not fix problems of executive compensation).

[257]*See* Cary Coglianese et al., *Seeking Truth for Power: Informational Strategy and Regulatory Policymaking*, 89 MINN. L. REV. 277, 279 (2004) (arguing that government collects information and then may use it to support the need to regulate at a later date).

contemplated by *In re Walt Disney*. This could be fulfilled by three different approaches: (1) federal regulation, including amending the Exchange Act or Sarbanes-Oxley to alter the corporate governance framework; (2) state regulation, including altering the duty of care analysis for shareholder challenges to executive compensation packages; or (3) corporate self-regulation, specifically enhancing listing requirements by SROs. These alternatives each raise issues about the appropriate role of regulators balanced against the preference for a freely operating market. The following section will examine some of the potential solutions available within each of these approaches and evaluate their relative strengths and weaknesses.

A. *Federal Regulation of Executive Compensation*

1. Federalizing Corporate Governance

The Revised Regulations ask corporations to disclose executive compensation information to the public. If that information is disclosed appropriately, the SEC's involvement ends. The lack of further SEC involvement in executive compensation is not unusual given its nature as a corporate governance matter. Corporate governance is traditionally a matter of state law. Nevertheless, the SEC has been increasing its role in corporate governance beyond disclosure-based regulations and is currently more than a minor regulator in the area. The federal government could address remaining problems with executive compensation by enacting substantive regulation and vesting the SEC with greater authority over these areas.

For instance, the Foreign Corrupt Practices Act (FCPA) takes a substantive-based regulatory approach to curb specific corporate conduct.[258] Congress, in the post-Watergate period when concern over corruption was high, amended the securities laws to involve the SEC in corporate governance.[259] Congress acted after the SEC's sensitive payments program discovered corporate payments to "foreign government officials to keep or

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[258]Exchange Act §§ 13(b)(2), 30A, 32 (codified as amended at 15 U.S.C. §§ 78m(b)(2), 78dd-1-2, 78ff (1977)); *see also* Karmel, *supra* note 42, at 87 (discussing the SEC's increasing attempts to regulate corporate governance); Lacey & George, *supra* note 38 (alerting the business community to the SEC's increased use of the Foreign Corrupt Practices Act to regulate corporate governance).

[259]*See* 15 U.S.C. §§ 78m(b)(2), 78dd-1-2, 78ff.

obtain business abroad."[260] The FCPA prohibits corporations from bribing or making certain other payments to foreign officials and imposes record-keeping requirements.[261] The prohibitions apply not only to the actions of U.S.-based corporate enterprises, but also to foreign subsidiary businesses.[262]

More recently, the federal government demonstrated its willingness to pass substantive regulation over corporate governance in response to scandal. Sarbanes-Oxley contains both direct regulation of corporate conduct and disclosure requirements. For example, Sarbanes-Oxley grants the SEC authority with respect to matters of board composition and committee structure.[263] The SEC can also prohibit executives from serving as corporate officers through administrative, rather than court, proceedings.[264] Sarbanes-Oxley forbids certain types of executive compensation by prohibiting most types of loans to company executives.[265] Additionally, the CEO and CFO must return bonuses, incentives, and equity based compensation, and certain profits from the sale of securities if the corporation has to file an accounting restatement due to misconduct.[266] Sarbanes-Oxley also prohibits issuers' directors and executive officers from trading in any equity securities of their companies during any employee fund blackout period.[267]

The SEC can also regulate the substance of corporate governance indirectly through its oversight of SRO rules. The Exchange Act grants the SEC wide authority over SRO rules, including the power to approve or

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[260]Karmel, *supra* note 42, at 87; *see* SEC. & EXCH. COMM'N, 94TH CONG., Report on Questionable and Illegal Corporate Payments and Practices (Comm. Print 1976); *see also* John F. Berry & William H. Jones, *Boxes of Boxes of SEC Documents Reveal Secret Dealings*, WASH. POST, May 18, 1977, at A1 (outlining specific questionable conduct by large corporations).

[261]15 U.S.C. §§ 78m(b)(2), 78dd-1-2, 78ff; *see* Karmel, *supra* note 42, at 87.

[262]*See, e.g.*, John P. Giraudo, *Charitable Contributions and the FCPA: Schering-Plough and the Increasing Scope of SEC Enforcement*, 61 BUS. LAW. 135 (2005); Martin T. Weinstein & Robert J. Meyer, *SEC Finds Donations to Bona Fide Charity to be in Violation of the FCPA*, *in* 146 CORP. & SEC. LAW UPDATE 565, 579 (New York Practice Skills Course Handbook Series) (Daniel D. Rubino et al. eds., Practicing Law Institute 2004).

[263]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15 18, 28 and 29 U.S.C.); *see also* Sarbanes-Oxley, § 301, 15 U.S.C. § 78j-1 (2002) (audit committees requirements). For a general discussion of the new role of the federal government in governance matters, see Karmel, *supra* note 42.

[264]Sarbanes-Oxley § 1105(f),15 U.S.C.§ 78u-3(f) (2002).

[265]*Id.* § 402(k), 15 U.S.C. § 78m(k).

[266]*Id.* § 304, 15 U.S.C. § 7243. The SEC can freeze corporate assets to prevent payments of bonuses to executives in cases involving financial fraud. *Id.* § 1103, 15 U.S.C. § 78u-3.

[267]*Id.* § 306, 15 U.S.C. § 7244.