THE PERILS OF SHAREHOLDER VOTING ON EXECUTIVE COMPENSATION

BY MINOR MYERS*

ABSTRACT

Giving shareholders more managerial power over corporate affairs—the goal of many recent corporate reform proposals—comes with costs that commentators have failed to recognize. In general, the more involved shareholders are in a firm's managerial decisions, the more difficult it is for directors to be held accountable for the outcome of those decisions. This can weaken directors' ex ante incentives to act in the interests of shareholders. This Article argues that this phenomenon may undermine the ambitions of the recent high-profile corporate reform requiring each public company to hold periodic, nonbinding shareholder votes on its executive compensation.

Supporters of the reform, known as "say on pay," predict that corporate directors will be fearful of shareholder "no" votes because they will attract embarrassing attention to directors and the firm. In other words, shareholder voting will amplify the "outrage constraint"—the threat of shame or embarrassment in the media that, according to the influential managerial power model of executive compensation, limits directors' ability to award pay packages that are too big and not sensitive enough to performance. To avoid the amplified outrage associated with a "no" vote, directors will be compelled to modify executive pay in ways amenable to shareholders.

Shareholder voting on executive compensation, however, could hurt shareholders in ways supporters of the reform have overlooked. Once shareholders have approved a firm's compensation arrangements, directors will no longer bear complete responsibility for them. If any negative attention—any outrage—is directed at the firm's pay practices in the future, directors can escape a portion of the blame that otherwise would have been theirs alone. This diffusion of responsibility will

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*Assistant Professor of Law, Brooklyn Law School. Thanks to Edward Cheng, Justin Fox, Charles Korsmo, Rebecca Kysar, Arthur Pinto and participants in the Brooklyn Law School Junior Faculty Workshop to for helpful comments, to the 2011 Southeastern Association of Law Schools Conference and the 2010 Federalist Society Works-in-Progress Panel for the opportunity to discuss the ideas in this Article, to Bailey Somers for superb research assistance, and to the Brooklyn Law School Dean's Summer Research Fund for generous support.

partially insulate directors' reputations from future outrage, and because directors will no longer bear all of the future costs of taking risks in the CEO's favor, they may end up taking more of those risks.

By clouding the functioning of the outrage constraint, shareholder approval thus may liberate directors at some firms to offer executive pay packages that are larger and more insensitive to performance than if the board were acting alone. In view of this effect, giving shareholders a say on executive pay may injure as many firms as it helps. To eliminate this overbreadth problem, this Article proposes amending the legislation to allow firms to opt-out of the say on pay regime by shareholder vote. This preserves the benefits of say on pay for those firms where shareholders wish to retain it and allows other firms to exit the regime at little cost.

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I. INTRODUCTION

The object of many recent reform proposals in corporate law is to give shareholders more managerial power over corporate affairs.[1] But these reforms come with costs that commentators fail to recognize. In general, the more involved shareholders are in corporate decisions, the more difficult it is for directors to be held accountable for the outcome of all corporate decisions, thereby weakening directors' incentives to act in the interests of shareholders. This Article argues that this phenomenon may undermine the ambitions of the recent high-profile corporate reform that gives shareholders the power to vote on executive compensation.[2]

After the 2010 Dodd-Frank reform legislation, every public company must now hold periodic, nonbinding shareholder votes on its executive compensation.[3] Supporters of this reform predict that corporate directors will be fearful of shareholder "no" votes because they will attract embarrassing attention to both directors and the firm.[4] In other

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

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

[3]*Id.*

[4]*See Empowering Shareholders on Executive Compensation: H.R. 1257, The*

words, shareholder voting will amplify the "outrage constraint"[5]— the potential for shame and embarrassment in the media, which according to many observers constitutes the operative constraint on directors' ability to offer pay packages that are too high and not sensitive enough to performance.[6] Shareholder voting on executive compensation aims to help direct outrage at directors who deserve it, compelling them to modify executive pay in ways amenable to shareholders.[7]

This reform, known as "say on pay," has plenty of detractors, and the lines of attack are numerous. Criticisms of say on pay include: there is no underlying problem with public company compensation;[8] it will muddle the very useful boundary between board and shareholder authority;[9] it will give unions and other interest groups too much influence;[10] and it will overly homogenize pay practices.[11] But suppose those criticisms are overcome. How will say on pay affect public company compensation? This Article questions the assumption of many supporters that voting on compensation offers a set of discrete benefits to shareholders with no countervailing costs.[12] Instead, it predicts a counterintuitive effect of the reform that calls into question its net

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Shareholder Vote on Executive Compensation Act, Hearing Before the H. Comm. on Fin. Serv., 110th Cong. 110-10 at 14 (2007), [hereinafter *Hearing on H.R. 1257*] (statement of Stephen M. Davis, Fellow, Yale School of Management, the Millstein Center for Corporate Governance and Performance) (discussing how shareholders and directors have more dialogue to make sure they are on the same page regarding compensation).

[5]LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 65 (2004).

[6]*Id.* at 5.

[7]*See* Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. REV. 299, 345 (2009) (discussing how say on pay is simply advisory, but still puts the directors on notice that shareholders can voice their dissatisfaction).

[8]*Hearing on H.R. 1257*, *supra* note 4, at 17 (statement of Steven N. Kaplan, Neubauer Family Professor of Entrepreneurship and Finance, University of Chicago Graduate School of Business) ("[T]he current system is not broken. The bill doesn't have appreciable benefits relative to the current system.").

[9]Stephen M. Bainbridge, *Remarks on Say on Pay: An Unjustified Incursion on Director Authority* 8 (UCLA Sch. L. Law & Economics Research Paper Series, Research Paper No. 08-06, March 4, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1101688.

[10]Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 351 (2009) ("The most active institutional investors have historically been public pension funds and union pension funds, which may have other motives in addition to shareholder-value economic considerations.").

[11]*Id.* at 325 (say on pay will "likely lead to a narrow range of approaches to the inherently difficult problem of executive compensation . . . .").

[12]*Hearing on H.R. 1257*, *supra* note 4, at 18 (statement of Nell Minow, Editor, The Corporate Library) ("The only objection that I have really heard . . . is that the shareholders are too stupid to make good use of the information.").

benefits. Throughout the analysis, this Article assumes the correctness of the managerial power model of executive compensation that finds fault in current pay practices and provides the theoretical foundation for the say on pay reform.[13]

After shareholders have voted to approve a firm's compensation arrangements, directors will no longer bear complete responsibility for those arrangements in the mind of the public. If any negative attention—any "outrage"[14]—is directed at the firm's compensation in the future, directors can share at least a part of the blame with the shareholders. Thus, approval by shareholders can partially protect directors against future risks to their reputations.[15] Directors will have diminished exposure to future outrage and thus will no longer bear all of the costs of taking risks in the CEO's favor. As a consequence, they have less incentive to avoid those risks.[16] By clouding the functioning of the outrage constraint, shareholder approval may liberate directors to offer executive pay packages that are larger and less sensitive to performance than the baseline scenario of the board acting alone. This offers a powerful explanation for why some firms voluntarily adopted shareholder advisory voting plans well before Congress required it.[17]

Directors, of course, can obtain this reputational insulation only by securing shareholder approval, which may mean modifying compensation plans to meet the shareholders' demands.[18] These modifications form the basis of supporters' hopes for the bill.[19] At some firms, the modifications necessary could be large enough to benefit shareholders on balance. But for many firms there are ample reasons to doubt that shareholders will be able to insist on modifications large enough to offset the costs of the insulation. One serious and

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[13]*See infra* Part II.A.2.

[14]BEBCHUK & FRIED, *supra* note 5, at 65.

[15]This "clarity of responsibility" problem is well-documented in political science. *See infra* Part III.C.

[16]*See* Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 238 (1996) (describing moral hazard as a way to deflect the consequences of bad behaviors, which in turn encourages it).

[17]*See* Gordon, *supra* note 10, at 339-40.

[18]*See Hearing on H.R. 1257*, *supra* note 4, at 15 (statement of Stephen M. Davis, Fellow, Yale School of Management, the Millstein Center for Corporate Governance and Performance) (describing how the U.K. boards, which currently have advisory votes on compensation, now need to persuade shareholders instead of other board members in regard to executive compensation).

[19]*See id.*

unrecognized problem is how shareholders are expected to evaluate company pay.[20] Shareholders will vote on the compensation information disclosed in the company's SEC filings, but at the time of disclosure it is not clear which compensation practices are excessive and worthy of outrage. The example of Michael Ovitz illustrates the problem.[21] Ovitz, the deposed heir-apparent at Walt Disney Co., is regularly held out as an example of outrageous compensation. But at the time of his hiring, which was regarded as almost miraculous for Disney, Ovitz's compensation—while notably large—was not regarded as problematic.[22] Shareholders could be asked regularly to vote on—and legitimize—a compensation scheme before they can know whether it is outrageous in relation to the executive's future performance.[23] Additional problems can complicate shareholder voting. First, the presence of competitors not subject to say on pay (private U.S. firms or non-U.S. firms) might prevent shareholders from pressing for concessions too strenuously for fear of harming their own investment. Furthermore, boards might exploit other business developments—a merger, a health event for a current executive, or some threat to the competitive position of the corporation—so that shareholders are asked to approve questionable compensation plans at a time when they are reluctant to create new problems for the company.

Shareholder voting on executive compensation may thus aggravate the problem it was designed to solve. To be sure, say on pay could tighten the relationship between pay and performance at one set of firms, but it could just as easily aggravate that relationship at other firms, where little must be modified to secure shareholder approval. The way to rectify this problem of overbreadth is to amend the legislation in a way that allows firms to opt-out of the say on pay regime by shareholder vote. This preserves the shareholder advisory voting regime for those firms that expect to benefit from it and allows other firms to exit from it at little cost.

Part II outlines the critique of current executive compensation practices and how supporters of say on pay believe it will ameliorate the

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[20] *See* Gordon, *supra* note 10 at 340.

[21] *See In re* The Walt Disney Co. Deriv. Litig, 825 A.2d 275, 279-81 (Del. Ch. 2003) (outlining the decision to hire Ovitz as an executive and the enormous compensation package given to him).

[22] James Bates, *Ovitz's Contract with Disney Gets Him a Cool Million*, L.A. TIMES, Dec. 20, 1995, at D1 (quoting compensation consultant Graef Crystal, who advised Disney on the Ovitz's compensation, that "[b]y Hollywood standards, this is a yawn.").

[23] *See infra* Part III.D.1.

problem identified by a set of commentators. Part III argues that shareholder voting on compensation can function as reputational insulation for directors and develops the implications of that insulation scheme. Part IV explains why shareholders will not be able to eliminate bad pay practices through advisory voting. Finally, Part V argues that the benefits shareholders see from modified executive compensation arrangements may be limited to a discrete set of firms and makes the case for an opt-out alternative.

II. THE PROBLEM OF EXECUTIVE COMPENSATION AND THE PROMISE OF SHAREHOLDER VOTING

This part describes the leading critique of executive compensation as well as the structure and ambition of the shareholder advisory voting regime recently passed by Congress.

A. *The Debate Over Executive Compensation*

A corporation's Board of Directors has the legal authority to set the compensation of the CEO and other executives.[24] The universal corporate practice is for the board to delegate that authority to a standing board compensation committee of independent directors.[25] Thus, executive compensation is the product of negotiations between the executive and the independent directors on the compensation committee.

Because of the deference courts afford to decisions of an independent compensation committee,[26] commentators agree that the

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[24]DEL. CODE ANN. tit. 8, § 122(5) (2006) ("Every corporation created under this chapter shall have the power to . . . [a]ppoint such officers and agents as the business of the corporation requires and to pay or otherwise provide for them suitable compensation."); *see* Wilderman v. Wilderman, 315 A.2d 610, 614 (Del. Ch. 1974) ("The authority to compensate corporate officers is normally vested in the board of directors and the compensating of corporate officers is usually a matter of contract.") (citations omitted).

[25]Valeant Pharm. Int'l. v. Jerney, 921 A.2d 732, 745-46 (Del. Ch. 2007) ("To avoid this high level of judicial scrutiny, an independent compensation committee can be employed to award salaries and bonuses to officers."). Stock exchange rules require that executive compensation be set by independent directors at most companies. NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 303A.05(a) (2005) (amended 2009); NASDAQ MANUAL § 5605(d) (2009) (amended 2010). After Dodd-Frank, all public companies must have fully independent compensation committees. Dodd-Frank § 952.

[26]The decisions of a compensation committee are effectively unreviewable. *See* DEL. CODE ANN. tit. 8 § 144(a)(1); *see also In re* Tyson Foods, Inc. Consol. S'holder Litig., 919 A.2d 563, 591 (Del. Ch. 2007) ("A committee of independent directors enjoys the presumption

operative limits on executive compensation are not legal.[27] The chief dispute in the literature is whether market forces drive compensation decisions or whether the market fails and other forces explain pay decisions.[28]

1. The Arm's-Length View of Current Practice

In the view of some observers, the independence of compensation committees allows them to negotiate at something close to arm's-length with executives,[29] and the market for managerial talent largely sets the terms of negotiation.[30] Proponents of this view argue that the pay of CEOs is, in fact, correlated with performance,[31] and rising pay for CEOs and other executives is simply a function of the growing demand for their services.[32] In this line of analysis, one explanation for any divergence between pay and performance is the potential for anger over high absolute levels of compensation.[33] Kevin Murphy and Michael Jensen hypothesize that political pressure—from both inside and outside firms—can cause directors to avoid pay packages capable of providing large payoffs for extraordinary performance.[34]

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that its actions are *prima facie* protected by the business judgment rule."); Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000) ("[D]irectors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision. . . .").

[27]*E.g.*, Lucian Bebchuk, *The Disney Verdict Shuts Out Investors*, FIN. TIMES, Aug. 12, 2005 ("[I]nvestors cannot look to judicially imposed liability for protection from disastrous compensation decisions and other governance failures.").

[28]*See* Simmons, *supra* note 7, at 304-05.

[29]Steven N. Kaplan, *Are U.S. CEOs Overpaid?*, 22 ACAD. OF MGMT. PERSP., May 2008, at 10 ("[T]he preponderance of the evidence points toward market forces as the driver of high CEO pay.").

[30]Kevin J. Murphy & Ján Zábojník, Managerial Capital and the Market for CEOs 4-5 (April 2007) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984376 (noting that recent CEO pay increases are "consistent with competition" in the market for managerial talent).

[31]Kaplan, *supra* note 29, at 14 ("There can be no doubt that the typical CEO in the United States is paid for performance.").

[32]Murphy & Zábojník, *supra* note 30, at 31.

[33]*Hearing on H.R. 1257*, *supra* note 4, at 4 (remarks of Rep. David Scott (D-GA)) (expressing outrage over the large disparity between the average worker and a CEO).

[34]Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 262 (1990) ("[P]olitical forces . . . limit large payoffs for exceptional performance. Truncating the upper tail of the payoff distribution requires that the lower tail of the distribution also be truncated in order to maintain levels of compensation consistent with equilibrium in the managerial labor market.").

2. The Managerial Power View of Current Practice

In the view of other observers, the system of setting executive compensation is fundamentally broken.[35] The most influential critique has come from Lucian Bebchuk and Jesse Fried, who have developed a model of executive compensation centered on managerial power. They contend that it is naïve to assume that compensation committees bargain at arm's-length with CEOs.[36] The constraint on CEO pay packages is not market forces but the threat of negative attention from the media or shareholders, or "outrage."[37] Understanding this model, particularly the role of outrage in it, is crucial to understanding how shareholder advisory voting on executive compensation is supposed to affect compensation practices at public companies.

At the center of the managerial power model is the claim that CEOs have considerable power over the Board of Directors.[38] Although boards are overwhelmingly populated by independent directors,[39] nominal independence is little match for the numerous sources of influence that CEOs have over board members.[40] CEOs can affect which incumbents are renominated for election to the board,[41] and directors will seek to curry favor with the CEO to retain the substantial compensation, fringe benefits, and prestige associated with the directorship.[42] CEOs can press for higher director compensation or ply directors with benefits like

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[35]*See* BEBCHUK & FRIED, *supra* note 5, at 201 ("The problems of executive compensation arrangements . . . are rooted in boards' failure to bargain at arm's length with executives.").

[36]*Id.* at 61 ("The arm's-length contracting model, we have shown, is insufficient to provide an adequate account of executive compensation.").

[37]*Id.* at 66-67.

[38]CEO power is the basis of both Bebchuk and Fried's critique of the optimal contracting model of CEO pay, and also the basis of their model, which they call the managerial power model. *Id.* at 62.

[39]*See* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1474-75 (2007) (noting that in 2005 approximately 75% of board members were independent).

[40]Bebchuk and Fried note that formal independence is inadequate: "[D]irector independence has in the past been compromised by CEOs' ability to confer significant rewards on directors, and . . . recent reforms diminish but do not eliminate their ability to do so." BEBCHUK & FRIED, *supra* note 5, at 29.

[41]*Id.* at 25-26.

[42]*Id.* at 25-27. The CEO may be on the board's nominating committee, which selects new members, and even if not on the committee the CEO may have "decisive influence" over those who are on it. *Id.* at 26.

travel on corporate aircraft.[43] Additionally, CEOs can influence directors by contracting with them or their businesses to supply the corporation with goods and services or by directing corporate donations to directors' favorite charitable causes.[44] The necessarily limited time that directors devote to board duties also adds to the CEO's power over directors,[45] as does the natural feelings of friendship, loyalty, and collegiality that develop over time.[46]

Directors face few incentives to resist favoring executives. Typical directors have minimal company holdings, so they suffer little financial penalty if the CEO's compensation arrangement does not lead to optimal results for the corporation.[47] In the managerial power model, no market forces discipline the pay-setting process in any serious way.[48] Managerial labor markets, the market for corporate control, and capital and product markets are all inadequate to constrain pay packages;[49] market forces are only a very loose limitation on compensation practices, and the chief constraint on executive pay packages comes from elsewhere.[50]

In view of managerial power, the operative constraint on directors' compensation decisions centers not on market forces but on "outrage," defined as "negative reactions by outsiders" to compensation practices viewed "as unjustified or even abusive or egregious."[51] The particular outsiders that matter in the managerial power model are those whose views matter to directors: "the institutional investor community, the business media, and social and professional groups to which directors and managers belong."[52] Negative reactions from these groups can impose costs on directors; these are termed "outrage costs."[53] As Bebchuk and Fried explain, "[w]hen the potential outrage costs are large enough, they will deter the adoption of arrangements that managers

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[43] *Id.* at 30.

[44] BEBCHUK & FRIED, *supra* note 5, at 27-28.

[45] *Id.* at 36-37.

[46] *Id.* at 31-32.

[47] *Id.* at 34-35.

[48] BEBCHUK & FRIED, *supra* note 5, at 54 ("[M]arket forces . . . are unlikely to impose tight constraints on executive pay.").

[49] *Id.* at 54-58.

[50] *Id.* at 58 (noting that while market forces "may impose some constraints and deter managers from deviating extremely far from arm's-length contracting arrangements, . . . overall they permit substantial departures from that benchmark").

[51] *Id.* at 65.

[52] BEBCHUK & FRIED, *supra* note 5, at 66.

[53] *Id.* at 65.

would otherwise favor."[54] Plans deterred in this way have violated the "outrage constraint."[55]

Even in situations where "economic incentives provided by the markets for corporate control and managerial labor would be insufficient to deter managers from seeking certain outrageous compensation,"[56] Bebchuk and Fried note that the "fear of embarrassment or criticism could discourage managers from doing so."[57] When deciding what kinds of executive pay arrangements to adopt, the directors' calculus turns "not on how costly the arrangements actually are to shareholders, but on how costly the arrangements are *perceived* to be by important outsiders."[58] At bottom, CEOs are essentially setting their own pay, and only public outrage constrains what CEOs are able to allocate to themselves.

To address the problems associated with managerial power, Bebchuk and Fried offer a number of reforms designed to diminish the power that CEOs have over their board and thus bring pay into closer alignment with performance. They propose increasing shareholder power to appoint and replace directors, which would force directors to attend to shareholders' interests instead of managers' interests.[59] In particular, shareholders should be able to nominate directors with comparative ease and have their campaign expenses reimbursed by the corporation.[60] Shareholders also should have the power to initiate certain corporate actions, like reincorporating to a state with more shareholder-friendly corporate law.[61]

B. *Giving Shareholders a Vote on Executive Compensation*

The 2010 Dodd-Frank reform legislation gave shareholders an advisory vote on executive compensation.[62] Proponents argue that the bill was designed, in part, to remedy the problems identified in the

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[54] *Id.*

[55] *Id.*

[56] BEBCHUK & FRIED, *supra* note 5, at 66.

[57] *Id.*

[58] *Id.* at 67.

[59] *Id.* at 207 ("The current system—under which the key to a board seat is pleasing the board members who make nomination decisions—should be replaced. The appointment of directors should substantially depend—in fact and not only in theory—on shareholders.").

[60] BEBCHUK & FRIED, *supra* note 5, at 210-11.

[61] *Id.* at 212-13.

[62] Dodd-Frank § 951(b)-(c).

managerial power model: CEOs exploit their power over the board to increase their pay and decouple it from the company's performance.[63]

Under the implementing rules recently adopted by the SEC, public companies must include in their proxy materials a separate shareholder vote to approve the compensation of executives.[64] Shareholders will pass judgment on the compensation as disclosed in the company's proxy statements under Item 402 of Regulation S-K, and companies must hold the vote not less frequently than once every three years.[65] To aid shareholders in evaluating compensation of the named executive officers, company proxy materials must also include "a clear description of . . . [any] relationship between executive compensation actually paid and the financial performance of the issuer."[66]

The shareholder vote on compensation is purely advisory; directors are free to ignore it.[67] However, each company must disclose whether and how it considered the results of the most recent say on pay vote.[68] Support for shareholder advisory voting is rooted in both major criticisms of current executive compensation: populist anger over the absolute level of compensation and a desire to strengthen the link between executive compensation and firm performance.[69] The political salience of the sheer magnitude of CEO pay explains a lot of the support for say on pay.[70] The House Report on the draft bill exudes worry over

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[63]*E.g.*, Steven M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1818 (2011) ("[S]hareholder activists long have complained that these [executive compensation] schemes provide pay without performance. This was one of the corporate governance flaws Dodd-Frank was intended to address, most notably via say-on-pay.") (citing BEBCHUK & FRIED, *supra* note 5).

[64]17 C.F.R. § 240.14a-21(a) (2011). The say on pay provisions became law as part of the Dodd-Frank financial overhaul legislation. Dodd-Frank § 951.

[65]Dodd-Frank § 951.

[66]Dodd-Frank § 953(a)(i). Companies must also disclose whether executives and directors are permitted to enter hedging arrangements, which protect them from a fall in the price of company stock. Dodd-Frank § 955.

[67]Dodd-Frank § 951(c). This section states:

> The shareholder vote . . . shall not be binding on the issuer or the board of directors of an issuer, and may not be construed—(1) as overruling a decision by such issuer or board of directors; (2) to create or imply any change to the fiduciary duties of such issuer or board of directors; (3) to create or imply any additional fiduciary duties for such issuer or board of directors. . . .

Id.

[68]17 C.F.R. § 229.402(b)(1)(vii) (2011).

[69]As Jeffrey Gordon notes, the pay for performance criticism of executive compensation is "fundamentally inconsistent" with the social justice criticism. Gordon, *supra* note 10, at 328.

[70]*See* Letter from Sen. Carl Levin to Elizabeth M. Murphy, Sec'y of SEC (Nov. 18, 2010) (on file with author), *available at* http://sec.gov/comments/s7-31-10/s73110-54.pdf

the absolute size of executive compensation,[71] and politicians of both parties express strong opinions on the topic.[72] They argue that high levels of executive pay threaten to tear at the fabric of our society.[73] The influence of this sentiment appears in the requirement that proxy materials set forth the ratio of the CEO's annual compensation to the compensation of the median employee.[74] Say on pay, the argument goes, can give shareholders the opportunity to "restore a sense of balance and fairness in compensation levels."[75] Shareholder advisory voting will be one important way for shareholders to register moral disgust with the income inequality at publicly-traded firms.[76] Widely-noted cases of shareholder voting on compensation could also amplify the political salience of executive compensation, which could restrain pay and might also lead to tax changes targeting high earners.[77]

The second source of support for shareholder advisory voting is from those who believe that say on pay can improve the link between pay and performance.[78] This rationale for the legislation is grounded

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("Excessive executive compensation is an ongoing outrage.").

[71]H.R. REP. NO. 110-88, at 3 (2007) (comparing growth in CEO pay to growth of the "average rank-and-file worker's pay").

[72]*See Hearing on H.R. 1257*, *supra* note 4, at 3 (remarks of Rep. Spencer Bachus (R-AL)) (noting a "concern among the American people about the level of executive pay" and a sense that "the average employee is not being taken care of"); *id.* at 4 (remarks of Rep. David Scott (D-GA) (lamenting executives who have "clearly, quite honestly, obscene pay packages of $2-, or $3-, or $400 million, when the average rank-and-file worker in our system is not making a sufficient amount of money to actually provide for his day-to-day care").

[73]*Id.* at 5 (statement of Richard Ferlauto, Director of Pension and Benefit Policy, American Federation of State, County and Municipal Employees); *see also* Jonathan Peterson, *House Votes to Have Shareholders Weigh in on Executive Pay*, L. A. TIMES, April 21, 2007, http://articles.latimes.com/2007/apr/21/business/fi-execpay21 (quoting Damon Silvers, associate general counsel of the AFL-CIO: "By every measure, there is increasing discontent in our country about income inequality generally -- and CEO pay specifically. . . . I think passage of this bill is very significant.").

[74]Dodd-Frank § 953(b)(1).

[75]Gordon, *supra* note 10, at 328 (suggesting reasons why people motivated by "social justice" concerns would support the legislation).

[76]Anne Sheehan, *Give Shareholders Say on Pay*, HARVARD BUSINESS REVIEW BLOG (June 10, 2009, 3:10PM), http://blogs.hbr.org/hbr/how-to-fix-executive-pay/2009/06/give-shareholders-say-on-pay.html (noting that "moral outrage [over income inequality] needs to be acknowledged" and that say on pay can force compensation committees to "demonstrate to shareholders that they understand the sentiment of the country on this issue and they 'get it'").

[77]*See* Gordon, *supra* note 10, at 329.

[78]Nell Minow, for example, says "[i]t's when pay and performance are not linked that we get very upset." *Hearing on H.R. 1257*, *supra* note 4, at 17 (statement of Nell Minow, Editor, The Corporate Library). Indeed, the only serious basis for directing the legislation exclusively at publicly-traded corporations (and not, say, athlete, celebrity, or hedge fund compensation arrangements) is that the publicly-traded corporation presents a unique situation:

largely in the managerial power model developed by Bebchuk and Fried.[79] Giving shareholders a vote on executive compensation, however, is not among the many reforms that Bebchuk and Fried propose to diminish CEO power over directors.[80] In their view, the sources of managerial power over boards are structural, and they do not identify anything that suggests say on pay would improve that structural problem.[81] In recent commentary and Congressional testimony, however, Bebchuk offers some limited support for say on pay while, at the same time, emphasizing its limitations.[82] The ability to vote on compensation plans, he suggests, would "help shareholders influence pay arrangements and would move pay arrangements toward those that best serve shareholder interests."[83] Shareholder advisory voting, in his view, would be a "useful step[],"[84] albeit one that by itself "would do too little to address the problems of executive pay."[85]

In spite of Bebchuk and Fried's ambivalence about the effectiveness of shareholder advisory voting, many of its proponents expect that it will help ameliorate the disjunction between executive compensation and firm performance, drawing inspiration, if not support,

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corporate executives' pay is perceived as being set in the absence of any market constraints. While the redistributive impulse may be responsible for most of the political support for say on pay, this Article generally ignores it and focuses on the pay-performance rationale, which is the only justification for the legislation defended in the academic literature. Jie Cai & Ralph Walkling, *Shareholders' Say on Pay: Does it Create Value?* 46 J. FIN. & QUANT. ANALYSIS. 299, 309 ("[S]hareholders should not be concerned with the level of executive pay but rather with the level of pay that is unjustified by performance and the managerial labor market.").

[79]*E.g.*, Bainbridge, *supra* note 63, at 1818 ("[S]hareholder activists long have complained that these [executive compensation] schemes provide pay without performance. This was one of the corporate governance flaws Dodd-Frank was intended to address, most notably via say-on-pay."). For their part, Bebchuk and Fried are adamant that their sole concern is seeing that pay is tied to performance, not the absolute level of pay. BEBCHUK & FRIED, *supra* note 5, at 8 ("We would accept compensation at current or even higher levels as long as such compensation, through its incentive effects, actually serves shareholders.").

[80]*See id.* at 198.

[81]Bebchuk and Fried suggest that executive compensation "is not an area in which shareholder intervention via voting can completely substitute for the decision making of a board that effectively guards shareholder interests." *Id.* They offer only a limited role for shareholder voting: it "could establish some outer limits to what boards can do without specific shareholder approval," and directors would still need "to make the many and complex choices within these outer limits and to negotiate with executives." *Id.*

[82]*See Hearing on H.R. 1257*, *supra* note 4, at 68-69 (statement of Lucian Bebchuk, Professor of Law, Economics, and Finance, Harvard Law School).

[83]*Id.* at 68.

[84]David Cho & Tomoeh Murakami Tse, *House Backs Greater Authority Over Pay by Shareholders*, WASH. POST, Aug. 1, 2009, at A9.

[85]*Hearing on H.R. 1257*, *supra* note 4, at 73 (statement of Lucian Bebchuk, Professor of Law, Economics, and Finance, Harvard Law School). Bebchuk's preferred solution would be more thorough reforms. Bebchuk, *supra* note 1, at 835.

from the managerial power model.[86] As one commentator observes, "Bebchuk and Fried provide much of the intellectual framework for [say on pay]."[87] The House Report explicitly relies on their work,[88] and the legislation is styled as a remedy for the problem of pay without performance.[89] Thus, the analysis of say on pay here assumes the correctness of the managerial power model and evaluates the consequences of say on pay from within that model.

C. *The Predicted Effect of Shareholder Advisory Voting*

The thinking behind giving shareholders the power to vote on executive compensation is straightforward: shareholders want the company to compensate executives in a way that rewards success and punishes failure. The advisory vote will be an opportunity for shareholders to register their views, and they will vote against pay arrangements that are inadequately sensitive to performance. If shareholders do in fact vote in large proportion against a company's compensation arrangements, that company will attract a great deal of attention, none of it welcome. Fabrizio Ferri and David Maber suggest that "[t]he high responsiveness to say on pay votes may reflect the fact that, unlike shareholder proposals, a say on pay vote directly questions directors' choices and, thus, is more likely to generate reputation concerns—an effective threat."[90] A "no" vote, in other words, will animate precisely those forces that act to constrain pay in the managerial power model to the detriment of directors.[91] They will be anxious to avoid that result, and the board's desire to reward the CEO thus will be checked by the shareholders' self-interest.[92]

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[86] *See* Bainbridge, *supra* note 9, at 2-3.

[87] *Id.* at 3.

[88] H.R. REP. NO. 110-88, at 3-4 (2007).

[89] Dodd-Frank § 953(a) (forcing companies to disclose "the relationship between executive compensation actually paid and the financial performance of the issuer").

[90] Fabrizio Ferri & David Maber, *Say on Pay Votes and CEO Compensation: Evidence from the UK*, 6 (March 14, 2011) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1420394.

[91] *See* BEBCHUK & FRIED, *supra* note 5, at 70 ("[N]egative publicity—or outrage—does impose costs.").

[92] *See Hearing on H.R. 1257*, *supra* note 4, at 68 (statement of Lucian Bebchuk, Professor of Law, Economics and Finance, Harvard Law School) ("I expect that advisory votes on executive pay would similarly induce boards to give greater weight to shareholder views and preferences on this subject.").

The byproduct of that anxiety will be board consultation with major shareholders.[93] To avoid a "no" vote, directors will informally canvass shareholders *before* the vote to ensure that compensation arrangements are structured in ways acceptable to at least a majority of them.[94] One prominent law firm recommends that companies "consider more vigorous shareholder outreach to assure that potential issues are surfaced in advance" because "[e]ven though the Say on Pay vote is non-binding, the consequences of losing such a vote can extend beyond simply receiving negative publicity."[95] It is this process that will push pay and performance into greater alignment.[96] One compensation consultant likened the potential "no" vote to "a vote of 'no confidence'" in the board and the compensation committee, which "would have the potential to significantly influence the executive pay-setting process."[97] Bebchuk predicts that shareholder advisory votes "would discourage practices and decisions that are strongly opposed by shareholders."[98] However, he predicts that the effect would be limited to extreme settings because institutional investors "would commonly display some deference to the board's decisions and would cast a 'no' vote only when they see some good reasons that warrant such a vote."[99]

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[93]H.R. REP. NO. 110-88, at 18 (2007) ("As is the case in other countries, we expect this tool will improve dialogue between management and shareholders on compensation and make compensation a more efficient tool for improving/rewarding management performance.").

[94]*See Hearing on H.R. 1257*, *supra* note 4, at 68 (statement of Lucian Bebchuk, Professor of Law, Economics and Finance, Harvard Law School) ("[T]he fact that the outcome of the vote would be publicly known would apply some pressure on the board to take the shareholders' preferences into account.").

[95]Cleary, Gottlieb, Steen & Hamilton LLP, *Alert Memo: Not Just Financial Reform: Dodd Frank's Executive Compensation and Governance Requirements for All Public Companies* (July 21, 2010), http://www.cgsh.com/files/News/a1d1e9da-9375-4938-9863-e1b261c9a2ea/Presentation/NewsAttachment/a1dd16c0-39a4-43b3-9abe-e91f97e8b837/CGSH%20Alert%20Memo%20-%20Not%20Just%20Financial%20Reform.pdf.

[96]H.R. REP. NO. 108-88, at 18 (2007) ("Knowing that they will be subject to some collective shareholder action will help give boards more pause before approving a questionable compensation plan.").

[97]Mark A. Borges, *Compensia, Inc. Thoughtful Pay Alert: Shareholder Advisory Votes on Executive Compensation—A "Say on Pay" Primer*, 41st Annual Institute on Securities Regulation, 1774 PLI/Corp 23, 26 (June 22, 2009).

[98]*Hearing on H.R. 1257*, *supra* note 4, at 68 (statement of Lucian Bebchuk, Professor of Law, Economics and Finance, Harvard Law School).

[99]*Id.* at 71.

III. THE TROUBLE WITH SHAREHOLDER ADVISORY VOTING ON EXECUTIVE COMPENSATION

This part explains how mandating shareholder advisory votes can injure shareholders in a previously unrecognized way. Directors will wish to mitigate the effect of future negative attention—future outrage—on their reputation, and so they will have an *ex ante* incentive to seek shareholder approval of compensation arrangements. As game theorists and political scientists note in other contexts, such approval can function to insulate directors against future outrage by spreading responsibility across a much larger group of persons, thus diffusing the outrage that would otherwise be directed at directors exclusively.[100] By diminishing directors' exposure to future outrage, directors may be willing to offer CEOs pay packages that are less sensitive to performance than they would be in the baseline scenario of no shareholder approval.

A. *Uncertainty and Future Risks to Directors' Reputations*

For corporate directors, reputation is extremely important.[101] David Skeel notes that corporate directors are "'the most reputationally sensitive people in the world.'"[102] Their standing among "shareholders and, on occasion, the peers and friends of the firm's managers" matters a lot to directors.[103] As Bebchuk and Fried explain, directors wish to be viewed with "approval and esteem," and "are likely to prefer to avoid criticism or ridicule from the social or professional groups whose opinions they value."[104]

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[100]*See infra* notes 120-22 and accompanying text.

[101]JONATHAN MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 52 (2008). Macey states:

> While directors are, of course, intensely concerned about their personal liability for negligence or malfeasance, this is not their only concern. They are also concerned about their reputations as leaders and their standing in the community. In other words, the prevailing norms of director behavior are stricter and less forgiving than the liability rules by which directors are evaluated.

Id. See also Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301, 315 (1983).

[102]David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1812 (2001) (quoting an unpublished interview with Nell Minow, Editor, The Corporate Library).

[103]*Id.* at 1827.

[104]BEBCHUK & FRIED, *supra* note 5, at 66.

A person's ability to serve as a corporate director—a desirable and valuable position—depends heavily on an unimpeachable reputation. Executive compensation decisions carry considerable future risk for directors' reputations. Of course, almost every business decision directors make poses some kind of risk; a new debt issuance may box the company into a financial corner or a merger may fail to live up to its billing. These kinds of failures generally do not do long-term damage to directors' professional reputations. In the United States, cultural attitudes toward business failure are relatively sanguine.[105] The risks associated with executive compensation, however, are different. Poor compensation decisions carry with them a tinge of corruption, calling into question the directors' character and probity—not merely their business judgment—which can be far more destructive to their professional reputations. On the model that animates the say on pay reform, the chief risk tor directors who wish to deliver a CEO compensation package that is large and not sensitive to performance is that they could be the subject of negative media attention and suffer consequent reputational harm.

The risk of harm to a director's reputation is different in an important way compared to the risk of legal liability—the other form of potential discipline facing directors. Corporations can purchase insurance policies that can cover directors' legal liabilities, but the threat of reputational harm cannot be offset with insurance.[106]

B. *Shareholder Approval as a Means of Protecting Against Future Outrage*

Proponents of say on pay focus on the consequences that the threat of a "no" vote poses to boards and how that might force boards to make CEO pay more sensitive to performance. But they overlook the countervailing consequences of a "yes" vote. Say on pay offers a potential avenue for directors to protect themselves—at least in part—against the risk that future negative attention poses to their reputations.[107]

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[105]MACEY, *supra* note 101, at 38-39 (noting that "the personal cost of business failure is relatively low," and that the "importance of the lack of social stigma associated with business failure cannot be overestimated").

[106]Skeel, *supra* note 102, at 1833 ("If a court holds that a manager breached her fiduciary duties, insurance may cover the financial liability, but it is not much help against a shaming sanction. A shaming sanction may have serious consequences for a manager's reputation and firms cannot easily insulate their managers against the threat.").

[107]*See* Ferri & Maber, *supra* note 90, at 6.

Currently, directors receive the entirety of outrage directed at a company over compensation decisions.[108] This focused penalty is what makes outrage the operative constraint on compensation practices in the managerial power model.[109] Shareholder approval of a compensation plan, however, can provide some degree of insulation for directors against future negative attention. Say on pay may allow directors to foist responsibility for compensation decisions onto shareholders, and thus outrage will not be directed exclusively at directors but at directors and shareholders together. As a result, the impact of outrage on directors will be diminished relative to the baseline scenario with no shareholder approval. Directors, of course, will not be able to escape all or most outrage, even if they can divert some of it to shareholders. If the benefits of securing shareholder approval of executive compensation were overwhelming, firms would long ago have scrambled to adopt say on pay voluntarily. They did not, although a non-trivial number of firms voluntarily adopted shareholder advisory votes on compensation prior to the passage of Dodd-Frank.[110] Nevertheless, ratification by shareholders can have important consequences for directors.

In other corporate contexts, directors may exploit circumstances that spread responsibility in a way similar to that hypothesized here. As the size of the board increases, for example, measures of excess CEO compensation increase.[111] A larger board means each individual board member faces a smaller share of the negative reactions by outsiders.[112] Further, it may be difficult for outsiders to determine which directors to hold responsible.[113] The same phenomenon is at work in the use of compensation consultants by boards: the use of consultants is associated with higher measures of excess CEO pay.[114] A consultant can provide

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[108] *See* BEBCHUK & FRIED, *supra* note 5, at 65.

[109] *Id.*

[110] *See infra* Part III.D.2.

[111] *See* John E. Core, Robert W. Holthausen & David F. Larcker, *Corporate Governance, Chief Executive Officer Compensation, and Firm Performance*, 51 J. FIN. ECON. 371, 372 (1999).

[112] *See* BEBCHUK & FRIED, *supra* note 5, at 80-81.

[113] *Id.*

[114] Brian D. Cadman, Mary Ellen Carter, & Stephen A. Hillegeist, *The Incentives of Compensation Consultants and CEO Pay*, 49 J. ACCOUNTING & ECON. 263 (2010); Kevin Murphy & Tatiana Sandino, *Executive Pay and "Independent" Compensation Consultants*, 49 J. ACCOUNTING & ECON. 247 (2010); Martin Conyon, Simon Peck, & Graham Sadler, *Compensation Consultants and Executive Pay: Evidence from the United States and United Kingdom*, 23 ACAD. MGMT. PERSPS. 43 (2009).

legitimacy for compensation packages and can offer directors a defense to future charges that they struck a bad deal.[115] The same sort of logic applies to bringing shareholders into compensation decisions. While shareholders cannot be held responsible for initiating the compensation package, their approval can absorb some portion of future criticism. This potential consequence of shareholder voting on executive compensation has gone unnoticed.[116]

C. *Board Incentives with Diminished Exposure to Future Outrage*

Approval by shareholders can at least partially legitimize directors' compensation choices and allow them to escape a portion of the blame that would otherwise be theirs alone. Insulated from outsiders' negative reactions to firm compensation, directors will have diminished incentive to avoid provoking negative reactions in the first place. In other words, shareholder assent shields the board from the very outrage that limits executive compensation, thus attenuating the principal constraint on executive pay in the model that motivates say on pay.

How directors use this increased autonomy depends on assumptions about directors' underlying motivations. If directors want to link pay to performance but refrain from doing so only because the sheer amount of compensation involved might look bad to the outside world—the Jensen and Murphy position—say on pay would shield them from the

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[115]Bebchuk and Fried make use of both findings. BEBCHUK & FRIED, *supra* note 5, at 81 ("Members of large boards are less likely to be constrained in their decisions by the threat of public outrage; the larger the board, the harder it is for outside observers to direct their outrage at any one member."); *id.* at 70 (noting that use of a compensation consultant allows directors to avoid scrutiny because doing so "provides legitimacy" and directors later challenged on pay packages can "justify their compensation decision as being based on the outside expert's recommendation").

[116]The only hint of it came in an exchange between Steven N. Kaplan and Bebchuk at the 2007 hearing before the House Committee on Financial Services. Kaplan, who testified against the bill, suggested that some U.S. CEOs at public companies were underpaid. *Hearing on H.R. 1257*, *supra* note 4, at 15 (statement of Steven N. Kaplan, Neubauer Family Professor of Entrepreneurship and Finance, University of Chicago Booth School of Business). Bebchuk observed that believing CEOs are underpaid is a reason to *support* say on pay. If CEOs were actually underpaid and shareholders agreed, "companies would be able to raise the [compensation] packages, and ignore what the media says, because shareholders would vote for them." *Id.* at 21 (statement of Lucian A. Bebchuk, William J. Friedman and Alicia Townsend Friedman, Professor of Law, Economics, and Finance, Director of Corporate Governance Program, Harvard Law School). In other words, shareholder approval would insulate the directors against negative media attention; it would diminish the impact of outrage on director behavior; and it would diminish at least the outrage from groups besides existing shareholders, who would still only have one target for outrage—directors.

complaints of outsiders and permit them to award extremely high-powered financial incentives.[117] Under the managerial power model, however, this is not what motivates directors. That model is based on the notion that directors on the compensation committee—and on the board generally—are not, in any practical sense, independent from the CEO.[118] The beholden board wishes to reward the CEO and ensure that the CEO's compensation is not linked to performance. Importantly, because the formal powers of shareholders are unchanged by say on pay—the votes would be nonbinding—shareholders will still have the same limited options for penalizing the board for unfaithfulness.[119] Therefore, say on pay will likely slacken the operative constraint on boards' ability to lavish performance-insensitive pay packages on CEOs without creating any new formal constraint in its place. As a consequence, boards may be willing to offer types and levels of pay they might have otherwise been too hesitant to offer.

This insight into the consequences of say on pay is grounded in a substantial and growing political science literature that analyzes how the clarity of politicians' responsibility for policymaking affects voters' decisions.[120] In democratic elections for political office, voters' perceptions of incumbents are crucial. For instance, governmental powers are often divided among various entities and elected leaders, and voters thus may have difficulty assigning credit or blame to incumbents for particular outcomes.[121] This is known as the "clarity-of-responsibility" problem.[122]

Political scientists find that when an incumbent's responsibility over policy outcomes is clearer, voters are more likely to assign blame for policy outcomes to that incumbent.[123] Conversely, the lower the

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[117]*See* Gordon, *supra* note 10, at 329.

[118]*See* BEBCHUK & FRIED, *supra* note 5, at 81-82 (discussing numerous ways a board could be indebted to a CEO).

[119]Under the Bebchuk and Fried model, allowing shareholders access to the corporate proxy may diminish some of the CEO's power and thus get at the root of the problem of pay without performance. *See* Dodd-Frank § 971; *see also* BEBCHUK & FRIED, *supra* note 5, at 207.

[120]*See, e.g.*, CHRISTOPHER ANDERSON, BLAMING THE GOVERNMENT: CITIZENS AND THE ECONOMY IN FIVE DIFFERENT EUROPEAN DEMOCRACIES 6 (1995).

[121]*See id.* (noting that "institutions play a crucial role in structuring the assignment of responsibility").

[122]Jide O. Nzelibe & Matthew C. Stephenson, *Complementary Constraints: Separation of Powers, Rational Voting, and Constitutional Design*, 123 HARV. L. REV. 617, 625 (2010).

[123]*See* Christopher J. Anderson, *Economic Voting and Political Context: A*

clarity-of-responsibility in government, the more insulation incumbents have from electoral penalty for policy failures or deviations from voters' interest.[124] In such situations, incumbents are able to "obscure the weaknesses of their incumbency by blaming them on others who shared power."[125] An incumbent president of one party will attribute policy failures to a Congress controlled by the opposing party and vice versa.[126] For the same reasons, members of Congress may run against their colleagues, regardless of who is in power.[127] The importance of clarity-of-responsibility has informed legal debates over topics such as the structure of executive authority[128] and federalism.[129]

Politicians actively try to alter lines of responsibility to make them less clear to voters.[130] Alberto Alesina and Guido Tabellini argue that

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Comparative Perspective, 19 ELECTORAL STUD. 151, 161 (2000) (finding in a cross-country comparison that, "as countries move from clear to obscure responsibility, the economic effects had less impact" on election results); G. Bingham Powell, Jr. & Guy D. Whitten, *A Cross-National Analysis of Economic Voting: Taking Account of the Political Context*, 37 AM. J. POL. SCI. 391, 398 (1993) ("The greater the perceived unified control of policymaking by the incumbent government, the more likely is the citizen to assign responsibility for economic and political outcomes to the incumbents."); Thomas J. Rudolph, *Institutional Context and the Assignment of Political Responsibility*, 65 J. POL. 190, 209-10 (2003) (examining state variation in power allocation of budgetary power between the governor and the legislature and finding that "[a]s the executive branch's share of institutional power increases, individuals are more likely to attribute responsibility to the governor and less likely to assign it to actors in the state legislature," and thus concluding that "individuals' perceptions of political responsibility [are] sensitive to institutional context").

[124]*See* Anderson, *supra* note 123, at 161 (noting that "countries with low levels of clarity tended to benefit from institutional ambiguity").

[125]Powell & Whitten, *supra* note 123, at 399. Political scientists have long recognized the incentive for politicians to deflect responsibility onto others to avoid the consequences of bad decisions. *See, e.g.*, WOODROW WILSON, CONGRESSIONAL GOVERNMENT 281-82 (2d ed. 1901) ("Each branch of the government is fitted out with a small section of responsibility, whose limited opportunities afford to the conscience of each many escapes. Every suspected culprit may shift the responsibility upon his fellows.").

[126]The dispute between President Clinton and Congressional Republicans over the 1995 government shutdown is an example. *See* Bob Estill, Op-Ed., *Lawmakers are Braced for Next Round of Blame Game*, ST. J. REG., Nov. 27, 1995, (Editorial), at 5.

[127]RICHARD F. FENNO JR., HOME STYLE: HOUSE MEMBERS IN THEIR DISTRICTS 167 (1978).

[128]*See* Christopher R. Berry & Jacob E. Gersen, *The Unbundled Executive*, 74 U. CHI. L. REV. 1385, 1426 (2008) (noting the problems associated with institutional changes that "reduce clarity about which executive is responsible for policy failure, making it harder for voters to sanction the right official with genuine confidence").

[129]*See* MICHAEL S. GREVE, REAL FEDERALISM 57 (1999) (criticizing "cooperative federalism" because it "diffuses responsibility"); Roderick M. Hills, Jr., *The Political Economy of Cooperative Federalism: Why State Autonomy Makes Sense and "Dual Sovereignty" Doesn't*, 96 MICH. L. REV. 813, 818 (1998).

[130]*See* Powell & Whitten, *supra* note 123, at 399 (noting the electoral advantages for incumbents that are able to "maintain symbolic visibility but to diffuse political responsibility"). Politicians also can exploit unclear lines of responsibility for their own

politicians have an incentive to delegate decisions to bureaucrats when those decisions are risky because "the bureaucrat acts as a 'scapegoat' for the politician."[131] This delegation creates a moral hazard because politicians can insulate themselves from the penalties associated with opportunistic behavior; consequently, they have greater incentive to engage in it.

Legal scholars and political scientists have recently drawn on this insight—that the incentive to cloud responsibility can perversely encourage malfeasance—in various contexts. For example, in the debate over the separation of war powers, Jide Nzelibe argues that the president has an incentive to seek Congressional approval for foreign wars because doing so diffuses political blame for high-risk armed conflicts.[132] Presidents desire the political cover and electoral insurance that comes with approval by Congress,[133] which minimizes the ability of the opposing party to exploit the conflict for political gain. Nzelibe emphasizes the counterintuitive consequences of Congressional approval; by allowing the president to diffuse responsibility for hostile engagements, the president may be more inclined to enter high-risk military conflict.[134] In the same vein, Nzelibe and Matthew Stephenson apply this logic to executive powers generally, arguing that presidents can seek Congressional approval for various activities as a way of minimizing the political costs of failure.[135] Justin Fox and Matthew Stephenson explain the consequences of judicial review in similar terms.[136] Judicial review, they argue, "may rescue elected officials from

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personal gain, not just electoral benefit. For example, governments tend to have lower levels of corruption when responsibility is clearer. Margit Tavits, *Clarity of Responsibility and Corruption*, 51 AM. J. POL. SCI. 218, 218 (2007) (finding that "governments tend to be less corrupt in countries where responsibility for government decisions and actions is clearer").

[131]Alberto Alesina & Guido Tabellini, *Why Do Politicians Delegate?* 17 (Harvard Inst. of Econ. Research, Discussion Paper No. 2079, 2005) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=764430.

[132]Jide Nzelibe, *Are Congressionally Authorized Wars Perverse?*, 59 STAN. L. REV. 907, 915 (2007).

[133]*Id.* at 920 ("[C]ongressional authorization for high-risk conflicts will likely serve as a political insurance policy.").

[134]*Id.* at 952 ("[B]y fragmenting the political blame for potentially risky military engagements between the President and the political opposition congressional authorization might actually have a perverse effect of unintentionally encouraging the President to engage in more imprudent wars.").

[135]Nzelibe & Stephenson, *supra* note 122, at 640 ("Although presidents sometimes act unilaterally, they frequently seek congressional approval, and when they do, the adverse political fallout from interventions that go bad is lessened.").

[136]Justin Fox & Matthew C. Stephenson, *Judicial Review and Democratic Failure*, 1, 17-20 (Harv. L. Sch. Pub. L. & Legal Theory Working Paper Series, Paper No. 09-47, 2009).

the consequences of ill-advised policies, and this 'bailout effect' tends to increase democratic failure."[137]

Of course, the differences between politics and corporate governance overwhelm the similarities, but the core agency problem is similar enough to allow fruitful comparison of how voting functions as a means for principals to constrain agents. The implications of the political science literature for shareholder advisory voting on executive compensation are clear: in politics, incumbents wish to pursue their own interests but avoid being voted out of office. In the managerial power model of executive compensation, directors wish to overpay executives but avoid facing external outrage.[138] Just as politicians try to obscure their responsibility over policy decisions,[139] corporate directors seek ways to veil their responsibility for compensation decisions. Using compensation consultants and expanding the size of boards are examples of this; shareholder approval of compensation decisions can be another. In the same way that politicians have greater freedom to pursue their own interests once they have obscured their responsibility, directors will be able to offer compensation packages that are higher and less sensitive to performance if they can obtain shareholder approval.

D. *Applications*

The analysis here can provide insight into a variety of issues in executive compensation. Michael Ovitz's compensation package at Disney, perhaps the most notorious example of executive compensation, illustrates how directors might find shareholder approval of compensation decisions useful. The insulation implications of shareholder advisory voting can explain why a number of firms voluntarily adopted a say on pay vote well before Dodd-Frank,[140] and it

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[137] *Id.* at 1. Fox and Stephenson note that judicial review only has a net negative effect on democratic failure if the increase in democratic failure is not outweighed by the correction of bad decisions through judicial review. *Id.* at 31.

[138] Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 786 (2002).

[139] Powell & Whitten, *supra* note 123, at 399 ("[O]pportunities to diffuse responsibility will help insulate incumbents from all the factors that cause them to lose votes").

[140] *See* Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355, 1366 (2010) ("[I]n the last several years (prior to their mandatory imposition as a result of the Dodd-Frank Act), shareholder activists have put forward proposals that would provide for, among other things, 'say-on-pay' bylaw provisions.").

also can explain the findings of empirical studies assessing the United Kingdom system of say on pay.[141]

1. Disney Co., Michael Ovitz, and Reputational Insulation

Walt Disney's hiring of Michael Ovitz in 1995 provides a concrete example of how shareholder approval might work to insulate directors from outrage. That August, Disney hired Hollywood talent agent Ovitz as the heir to then-CEO Michael Eisner. While there was immediate public speculation about whether he and Eisner could work together successfully,[142] industry analysts regarded the hire as a very shrewd and far-sighted move on Disney's part.[143] When details of Ovitz's pay package were disclosed in SEC filings later that year, experts observed that the amount involved—an estimated $110 million in options—was large but "not that surprising."[144] Other press estimates emphasized that if Disney continued to grow at its then-current pace, Ovitz's options could be worth "about three-quarters of a billion dollars."[145] Even in news reports that drew attention to the severance provisions of Ovitz's contract, the tenor of the coverage verged on prosaic.[146] Compensation

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[141]*See* Jeremy Ryan Delman, *Structuring Say-On-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation*, 2010 COLUM. BUS. L. REV. 583, 591 (2010) ("[N]early all empirical work dealing with say-on-pay ha[s] been based on the U.K. experience. . . . As the U.S. moves towards adopting its version of say-on-pay, academics and policymakers have been busy looking at the lessons learned from the U.K. experience.").

[142]Robert W. Welkos & Judy Brennan, *Company Town: Ovitz Joins Disney; Can Two Top Players Work Together?*, L.A.TIMES, Aug. 15, 1995, at D1 ("The question that many in the entertainment industry were asking Monday was whether two strong-willed leaders can work together to shape the expanding Disney conglomerate.").

[143]*See, e.g.*, Adam Pertman, *Disney-Ovitz Deal Seen as 'Recreation of Universe,'* BOS. GLOBE, Aug. 16, 1995, at 46 ("No one seemed to think this was merely another good catch . . . . Rather, it was 'a brilliant strategic move' or 'a sign of Eisner's genius' or, . . . 'not just the beginning of a new era but, in Hollywood terms, something approaching the first stage of the recreation of the universe.'"); Harry Berkowitz, *It's a No. 2 Coup Disney Hires Talent-Whiz Ovitz as 2nd-in-Command*, NEWSDAY, Aug. 15, 1995, at A3 (quoting Merrill Lynch entertainment industry analyst Jessica Reif that the hire was a "huge coup" for Disney).

[144]Bates, *supra* note 22 ("[Pay consultant Graef] Crystal said that the amount is very large by normal executive standards but not a record, and that it is not that surprising considering the rich contracts often awarded in the entertainment industry. . . . 'It is an excessive package by the standards of all the other companies in America, but this is Hollywood. This is what passes for compensation down in La-La Land.'"). Crystal, who advised Disney on the Ovitz's compensation, was obviously not an unbiased voice.

[145]E. Scott Reckard, *Disney Deal Holds Magic for Ovitz*, DAILY NEWS OF L.A., Nov. 15, 1995, at B1.

[146]James Bates, *Ovitz's Contract with Disney Gets Him a Cool Million*, L.A. TIMES,

consultant Graef Crystal, who helped Disney with Ovitz's package, told the *Los Angeles Times*: "[b]y Hollywood standards, this is a yawn."[147]

At this point, the Disney directors likely could have obtained shareholder approval for Ovitz's compensation package with little objection. The package had roughly the same structure as Eisner's package, which although controversial had not been the subject of a shareholder mutiny. Indeed, because the hiring of Ovitz was regarded as a distinct success for Disney, rejecting his pay package would have been contrary to the shareholders' perceived self-interest. Also, as Crystal noted at the time, when Disney negotiated Ovitz's pay package it was forced to consider "'the grim-reaper factor'—the fact that Mr. Eisner had heart surgery recently and Disney was desperate for a strong No. 2."[148] Disney could easily have pressed a similar argument to shareholders. It is hard to imagine that Disney shareholders would have failed to approve the package.

Ovitz's tenure at Disney was a famous failure.[149] After fifteen months on the job, he was fired; Disney exercised the no-fault termination provision in Ovitz's contract, entitling him to a large severance payment. Although news accounts at the time varied,[150] the actual amount of Ovitz's payout was approximately $130 million.[151] Crystal, not long after Ovitz's severance package became known, questioned: "Can you blame Disney's board for what happened? I don't think so. They played by the current rules and, consistent with landing Michael Ovitz, behaved as prudently as they could."[152] Few people agreed with him. A blizzard of outrage over executive compensation directed at the Disney board followed Ovitz's firing. One executive compensation consultant told the *Los Angeles Times*: "I think it is outrageous . . . . It was a bad hiring decision by Disney and a very

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Dec. 20, 1995, at D1.

[147] *Id.*

[148] Hubert B. Herring, *Michael Ovitz: The 5 Million Option Man at Walt Disney*, N.Y. TIMES, Nov. 26, 1995, at C10.

[149] *See In re* Walt Disney Co. Deriv. Litig., 907 A.2d 693, 714 (Del. Ch. 2005).

[150] *See, e.g.*, Martha Groves & Claudia Eller, *Ovitz Severance Leaves Industry Reeling*, L.A. TIMES, Dec. 14, 1996, at A1 ("Ninety million dollars. Enough to buy 2,600 fully equipped Ford Explorers. Enough for half a million or so business dinners at Morton's. Enough to put 750 kids through four years at Stanford."); Douglas Feiden, *A Big-Bucks Bye-Bye Disney Ax Worth $125 Mil to Ovitz*, N.Y. DAILY NEWS, Dec. 14, 1996, at A4 ("Michael Ovitz stands to pocket a whopping $125 million for surrendering the keys to the Magic Kingdom a record payout for a Hollywood executive.").

[151] *See Walt Disney*, 906 A.2d at 57 (Del. 2006) (noting that "the actual payout to Ovitz was approximately $130 million").

[152] Graef Crystal, *Mike Ovitz Got Away With Murder . . . And I Helped Him*, SLATE (Dec. 22. 1996, 3:30 AM), http://www.slate.com/id/2408.

expensive mistake. They made a high-risk decision, and it ended up costing them a lot of money."[153] Syndicated columnist Robert Samuelson called the episode "a public-relations calamity."[154] He lambasted Disney for playing with shareholders' money and said executives never would have been "so cavalier with [their] own cash."[155] At the following annual meeting, various institutional investors withheld votes for five of the sixteen Disney board members.[156] The research director of the Council of Institutional Investors charged that Disney's board "fail[ed] to meet even basic corporate governance standards."[157] One journalist described the board as "a lot of people with little experience in high finance and who seemed beholden to Eisner."[158] The Delaware Supreme Court later described the board's approval of the Ovitz contract as "far less than what best practices would have dictated."[159] In the lower court decision, Chancellor Chandler noted that "[f]or the future, many lessons of what not to do can be learned from defendants' conduct here."[160] In the financial media, Lucian Bebchuk described what happened at Disney as "governance failures."[161]

What might have happened if Disney had secured shareholder approval of Ovitz's package at its shareholder meeting in early 1996? Of course, the fallout for the board could not have been avoided entirely. But surely the board could have deflected some amount of criticism over its arrangement with Ovitz by emphasizing that shareholders had approved his compensation. In this alternative history, the board of directors of Disney could have secured significant protection from outrage over compensation at little or no up-front cost.

Following the Ovitz fiasco, many boards wondered precisely how to avoid such a mess in the future.[162] A prominent New York executive

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[153]Groves & Eller, *supra* note 150.

[154]Robert J. Samuelson, *A Letter to Michael Eisner: How to Fix the Ovitz Problem*, ORLANDO SENTINEL, Dec. 27, 1996, at A17.

[155]*Id.*

[156]*Disney Holders Happy About Rise in Stock, Grumpy About Execs' Pay*, SEATTLE TIMES, Feb. 22, 1997, at C4.

[157]*Id.*

[158]David Lieberman, *Disney Tries to Work Magic with New Board Lineup*, USA TODAY, Mar. 19, 2003, at 1B.

[159]*In re* Walt Disney Co. Deriv. Litig., 906 A.2d 27, 57 (Del. 2006).

[160]*In re* Walt Disney Co. Deriv. Litig., 907 A.2d 693, 760 (Del. Ch. 2005).

[161]Lucian Bebchuk, *The Disney Verdict and the Protection of Investors*, FIN. TIMES, Aug. 12, 2005, at 17.

[162]*See* Patrick McGeehan, *Quick: What's The Boss Making?*, N.Y. TIMES, Sept. 21,

compensation lawyer noted that publicity surrounding the Ovitz incident and others led "directors to say, 'Wait a minute; I don't want to be made a fool of.'"[163] The *New York Times* reported that the case made board members "more inclined to hire a search firm these days almost as an insurance policy against picking the wrong candidate or as a defense against critical shareholders."[164] One Harvard Business School professor observed that "[b]oards have realized they are vulnerable."[165] Directors can mitigate that vulnerability by seeking shareholder approval of compensation arrangements.

2. Why Did Boards Voluntarily Adopt Say on Pay Before Dodd-Frank?

A substantial number of companies voluntarily adopted shareholder advisory votes on compensation—the same kind of votes Dodd-Frank now requires of all companies. In 2007, the Aflac insurance company was the first publicly traded American company to voluntarily adopt say on pay,[166] attracting positive attention to the firm.[167] Other companies soon followed Aflac's example.[168] This phenomenon has a number of potential explanations. Perhaps these boards were not captured by their CEOs and wanted to signal to the capital markets that they were attentive to the interests of shareholders.[169] Another possibility is that these companies were subject to intense pressure from activist investors and believed the adoption of say on pay would provide a reprieve, if only temporary. Or perhaps these boards concluded that say

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2003, at C1.

[163] *Id.* (quoting Joseph E. Bachelder).

[164] Laura M. Holson, *Investor Suit at Disney Puts Exits in a Spotlight*, N.Y. TIMES, Oct. 18, 2004, at C1.

[165] *Id*; *see also* Simmons, *supra* note 7, at 340 (stating that the episode "sent a warning signal to corporate boardrooms").

[166] Claudia H. Deutsch, *Aflac Investors Get a Say on Executive Pay, A First for a U.S. Company*, N.Y. TIMES, May 6, 2008, at C3.

[167] Rep. David Scott of the House Financial Services Committee said: "Let us commend Aflac for stepping up to the plate, and they not only got a hit, they hit a home run, because they're setting the curve." *Hearing on H.R. 1257*, *supra* note 4, at 5 (statement of Rep. David Scott (D-GA)); *see also, e.g.*, Allan Sloan, *Aflac Looks Smart on Pay*, WASH. POST, May 29, 2007, at D1.

[168] A group of companies, including Verizon Communications, Par Pharmaceutical, Blockbuster and RiskMetrics, and led by pharmaceutical company Pfizer played a prominent role in supporting say on pay. Claudia H. Deutsch, *Say on Pay: A Whisper or a Shout for Shareholders?*, N.Y. TIMES, April 6, 2008, at B9.

[169] Warren Buffett, for one, has suggested that reforming CEO pay is a salient way to demonstrate concern for shareholders. Letter from Warren Buffett, CEO of Berkshire Hathaway, to shareholders for FY 2003, 7 (Dec. 31, 2003) ("In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test.").

on pay was likely to be passed,[170] and they wanted to try a practice run on their own terms.

The foregoing analysis suggests a different motivation for boards to adopt say on pay voluntarily: the insulation benefits which directors can secure by having shareholders ratify compensation. Boards voluntarily adopting shareholder advisory votes may have viewed the modifications necessary for shareholder approval as modest compared to the diminished outrage in the event that the media directed unwanted attention onto their executive compensation practices. In Aflac's case, the company made a very modest change in advance of the first shareholder advisory vote.[171] CEO Daniel Amos explained that Aflac's compensation methodology had not changed for thirteen years, and in anticipation of the shareholder advisory vote the firm "changed the mix a bit," by weighting his compensation more toward restricted stock than options, but "the formula for that top number remains the same."[172] In other words, at Aflac there was no impact on the amount of the CEO's compensation and merely a small change to the form of compensation. Shareholders overwhelmingly approved the compensation package at Aflac; 93 percent of shareholders approved of the package and only 2.5 percent voted against it.[173] This lopsided approval legitimized the board's compensation decisions and partially insulates them from negative scrutiny in the future. Also, by obtaining shareholder approval of its executive compensation practices in the pre-Dodd-Frank era, a firm could potentially capitalize on the inertial effects of that earlier shareholder vote and resist unwelcome new trends that emerge once all firms are subject to say on pay. Thus, for firms with little to modify, seeking shareholder approval in advance of the legislative mandate made sense.

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[170]Borges, *supra* note 97, at 25 (noting that the Obama administration's say on pay proposal "cements the growing belief that such a vote will be required as soon as the 2010 proxy season"). The timing of these firms' adoption is consistent with this explanation: None of the firms, for example, adopted their policies before the House of Representatives approved the say on pay bill for the first time in April 2007.

[171]Deutsch, *supra* note 168.

[172]*Id.*

[173]*Id.*

3. The Say on Pay Experience in the United Kingdom

In 2002, the United Kingdom required companies to hold annual shareholder advisory votes on executive compensation. Ferri and Maber studied how the change affected executive compensation there.[174] Shareholder dissent was rare during the first two years of say on pay in the United Kingdom, but boards swiftly responded to dissent.[175] Ferri and Maber found "a marked increase in the sensitivity of CEO pay to poor performance after the introduction of say on pay."[176] They thus conclude that say on pay was a success in the United Kingdom.[177]

Many see the United Kingdom's experience as encouraging for the United States.[178] While the United States's experience could mirror that in the United Kingdom, there are ample reasons to believe that the United Kingdom experience may reveal little about how say on pay will work in the United States. As Jeffrey Gordon notes, "a 'transplant' of 'say on pay' alone would operate differently in the United States," because the United Kingdom advisory votes are "bundled with an overall corporate governance system that gives shareholders considerably more power than in the United States."[179] Crucially, shareholders in the United Kingdom have much more potent ways of punishing boards for ignoring shareholder wishes.[180] Under United Kingdom law, a shareholder can call a special meeting, place director candidates on the corporate ballot,

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[174]Ferri & Maber, *supra* note 90, at 9-10.

[175]All six firms with over 50% dissent in 2003 decreased their levels to below 50% in 2004. The average dissent at those three firms in 2003 was 63.1%; in 2004 it dropped to 19.4%. *Id.* at 42. To appease shareholders, boards altered provisions associated with "rewards for failure" (shortening severance payment periods, toughening performance targets in equity plans, etc.); hired new compensation consultants; and shifted compensation from stock options to restricted stock. *Id.* at 21.

[176]*Id.*

[177]*Id.*

[178]Press Release, U.S. Department of the Treasury, Administration's Regulatory Reform Agenda Moves Forward: Say-On-Pay (July 16, 2009), http://www.treasury.gov/press-center/press-releases/pages/tg219.aspx (noting that in the U.K. "[t]he awareness of a potential 'no' vote and the subsequent change in practices has led to an empirically-verified tightening of the link between pay and performance"); *Hearing on H.R. 1257*, *supra* note 4, at 15 (statement of Stephen M. Davis, Fellow, Yale School of Management) (noting that the say on pay in the UK had "one principal effect, and that is that pay is tied much more strictly to performance, to real performance from the company").

[179]Gordon, *supra* note 10, at 348.

[180]*Id.* at 349. (noting that the U.K. has a "legal regime that empowers shareholders to a much greater extent than in the United States"); *see Hearing on H.R. 1257*, *supra* note 4, at 69 (statement of Lucian Bebchuk, Professor of Law, Economics, and Finance, Harvard Law School) ("[S]hareholder rights in the U.S. are weaker than they are in the U.K.").

amend the articles of incorporation, and remove directors during their term.[181] Shareholders generally have none of these powers in the United States.[182] Further, in the United Kingdom, unlike the United States, boards may not engage in defensive tactics against a takeover.[183] Thus, in the United Kingdom an expression of shareholder discontent in a say on pay vote could foretell more serious shareholder action to come; in the United States, shareholders have no mechanism to reprimand directors who ignore negative say on pay votes. To Bebchuk, these differences in power suggest that say on pay is all the more necessary in the United States.[184] However, for the same reasons they also suggest that say on pay may not be as effective in the United States.

E. *Stepping Back from the Managerial Power Model*

The argument thus far has assumed the correctness of Bebchuk and Fried's model of how executive compensation in the United States is set. The reason for this is straightforward: proponents of shareholder advisory voting assume the correctness of that model. But what are the potential effects of say on pay if the managerial power model is wrong and its critics are correct?[185]

If there is no pervasive problem with executive compensation, what will shareholder advisory voting do? Suppose that the constraint on pay is not outrage generated by shareholders' anger at the disjunction between executive compensation and firm performance, but instead outrage generated by the absolute amount of compensation. If this account of executive compensation is correct, say on pay could still have the same consequences of dissipating outrage, irrespective of what generates it, and it will give boards greater freedom to do more of whatever they wish. If, as Bebchuk and Fried argue, boards prefer giving large payouts to executives uncorrelated to firm performance, say on pay can lead to more of that. If, as Kaplan and others argue, boards

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[181] Bebchuk, *supra* note 1, at 848-49.

[182] *Id.* at 844. ("The basic and longstanding principle of U.S. corporate law is that the power to manage the corporation is conferred on the board of directors.").

[183] *See id.* at 849.

[184] *Hearing on H.R. 1257*, *supra* note 4, at 69 (statement of Lucian Bebchuk, Professor of Law, Economics, and Finance, Harvard Law School) ("Given how much shareholders' hands are tied by U.S. rules [compared to the U.K.], providing some means of influencing firm policy is especially needed.").

[185] *See supra* notes 29-34 and accompanying text.

would prefer to give more performance-sensitive compensation packages but are reluctant to do so because of the potential political fallout—the consequences of which they would otherwise bear themselves—then say on pay could provide cover for the board and allow it to give larger pay packages.[186]

This cover for the Board will present a fundamental challenge in designing empirical tests of shareholder advisory voting in the United States. Suppose empirical studies find that the relationship between executive pay and firm performance tightened at U.S. public companies following say on pay. This finding by itself will do little to settle debates about executive compensation in the United States. Say on pay might force directors to override their natural tendency to favor executives and act instead in the interests of shareholders, consistent with Bebchuk and Fried's model. Or it might liberate directors to ignore critics in the media and act in the interests of shareholders by giving executives higher-powered incentives. Separating these causes of the tightening of pay and performance will be a threshold challenge to drawing any broader conclusions from the experience of say on pay in the United States.

IV. SHAREHOLDERS' INABILITY TO ELIMINATE BAD COMPENSATION PRACTICES THROUGH VOTING

The insulation effect of shareholder advisory voting applies only if shareholders approve the proposed compensation. To obtain shareholder approval, boards may be forced to modify compensation arrangements in ways shareholders find beneficial. These two consequences of say on pay are sides of the same coin, one coming only at the expense of the other. The critical question in weighing which of these effects will predominate is to what extent boards will be forced to eliminate bad pay practices in order to secure the "yes" vote from shareholders. If shareholders can secure modifications to compensation practices with benefits that outweigh the costs of diffusing directors' responsibility, the net benefits of the legislation will be positive. However, there are ample reasons to doubt that shareholder voting will have that strong of an impact on compensation.

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[186]Bebchuk emphasized this in his testimony to Congress on say on pay. *See supra* note 116.

A. *Ex Ante Voting*

The say on pay vote will come at a particular stage in the compensation process: after the firm has settled its pay package with the CEO but before the CEO has completed—or even started—her performance under that package. As Andrew Lund argues, voting on compensation after it has been settled inevitably mixes the vote's signals—censure of the board's compensation decision or of the executive's performance.[187] Even if shareholders set aside worries about how their vote will affect the CEO personally,[188] it is not obvious that they, or anyone, can determine what constitutes "good compensation" before the CEO has completed her term of service. It may be that in many circumstances compensation can be deemed appropriate (or at least not outrageous) only *ex post*. In their book, Bebchuk and Fried focus not only on components of pay that can be evaluated *ex ante*, but also on some that can only be assessed *ex post*.[189] For example, contractual retirement benefits can be judged *ex ante*. So too can equity-based compensation that filters out equity gains independent of the executives' performance as well as equity packages that prevent executives from unwinding their exposure.[190] But some of their objections to current compensation practices are based on *ex post* analysis. Gratuitous awards made to departing executives, for example, is an issue that cannot be identified before they happen.[191] Similarly, compensation components like sign-on bonuses and executive loans can only be recognized as problematic after the fact.[192]

Most importantly, it is impossible to know *ex ante* whether a new executive's performance will be so inadequate relative to her contractual entitlements that the payout upon her departure from the firm will later appear outrageous. The question of how shareholders will evaluate pay

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[187]Andrew C.W. Lund, *Say on Pay's Bundling Problems*, 99 KY. L.J. 119, 122 (2011) ("[S]hareholders who are upset with a firm's pay practices may nevertheless accede to objectionable compensation for fear of offending a CEO they believe to be prospectively valuable."). For this reason, Lund advocates having shareholders vote on a compensation plan that the firm will use prospectively. *Id.* at 161.

[188]Lund suggests that negative say on pay votes may have the collateral consequence of offending the CEO, and for that reason shareholders fond of the CEO will be reluctant to vote "no" even if they dislike the board's pay decisions. *Id.* at 146-47.

[189]BEBCHUK & FRIED, *supra* note 5, at 166.

[190]*Id.* at 174-79, 183-185.

[191]*Id.* at 87.

[192]*Id.* at 112, 117.

arrangements is thus intensely important because it will affect directors' incentives. Perhaps shareholders will have one eye on the past and one on the future, but the criteria for evaluating company compensation is currently unknown and will be of great consequence. Shareholders may be reluctant to vote against compensation where there is merely the possibility that payouts to an executive could be outrageous, and this can inhibit the concessions they insist upon before approving compensation.

B. *Nonbinding Voting*

The shareholder vote is nonbinding. Boards are legally free to ignore the results, which limits the influence of the vote.[193] To be sure, an advisory vote by itself can be extremely influential.[194] Cai, Garner, and Walkling find that executive compensation declines abnormally after directors on compensation committees receive fewer votes in annual director elections.[195] But as noted previously, the consequence of a "no" vote for the board is purely reputational. As important as reputation is, there will nevertheless be some limit to the concessions shareholders can demand due to their limited ability to back up their threats.[196]

C. *Stickiness of Prior Shareholder Approval*

Once shareholders approve a firm's compensation, the opportunities for concessions may have passed. The board has obtained its insulation benefit and the shareholders their modifications.[197] But of course the game will be iterated; companies must hold an advisory vote periodically, and not less frequently than once every three years.[198] Will shareholders be able to undo the insulation effect of a Year-Zero shareholder ratification by forcing additional modifications in Year One? Or will the inertia from the Year-Zero approval make shareholders reluctant to change their votes so long as the underlying compensation

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[193]*See, e.g.*, Cai & Walkling, *supra* note 78, at 301 ("The Say-on-Pay Bill does not limit executive compensation but requires a non-binding shareholder vote on it.").

[194]*See id.* at 306 (elaborating on some of the possible positive and negative effects of an advisory vote).

[195]Jie Cai, Jacqueline L. Garner, & Ralph A. Walkling, *Electing Directors*, 64 J. FIN. 2387, 2389 (2009).

[196]Cai & Walkling, *supra* note 78, at 334 (noting that the advisory legislation is "unlikely to affect deeply entrenched managers").

[197]*See supra* Part III.D.2.

[198]*See* Dodd-Frank § 951(a)(1).

package has not changed materially? If influential outrage emerges only *ex post*, shareholders may be unable to change their mind on unchanged compensation without compromising their quality as a signal of problematic compensation. Shareholders and those who advise them might be able to make compelling arguments that years of experience have shown certain, previously-acceptable pay practices to be problematic and grounds for a no vote. But behavioral research suggests that shareholders may be reluctant to go against their earlier approval,[199] even when they could alter their vote without losing any credibility.

Consider the Ovitz example. The outrage over his pay package emerged only after he had been fired.[200] If Disney shareholders had approved Ovitz's arrangement in early 1996, it might have been difficult—though, of course, not impossible—to explain subsequent shifts in shareholder voting while maintaining that the shareholders are a credible arbiter of good and bad compensation.[201] For this reason, there may be a powerful inertia effect in compensation decisions under say on pay.

D. *Pressure from Modifications or Shareholder Approval at other Firms*

The decisions of shareholders and boards of other companies will bear on what shareholders and directors at any particular company do. In other words, some market-clearing package of modifications will arise. Boards of directors may feel compelled to match those modifications, and shareholders may be hesitant to press for more. It is not clear at this point where this will push pay practices under say on pay. Perhaps public firms will set compensation levels with the help of shareholder advisory votes, and private and foreign firms will match those prices. It could also be that the compensation decisions of private and foreign firms will constrain how far public firms are able to press executives. At some point shareholders of a firm would be unable to press for more

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[199] *See* Barry M. Staw, *The Escalation of Commitment to a Course of Action*, 6 ACAD. OF MGMT. REV. 577, 584 (1981) (arguing that there is a human tendency "to escalate commitment above and beyond what would be warranted by the 'objective facts' of a situation" for the sake of mere consistency).

[200] *See supra* notes 153-61 and accompanying text.

[201] *See supra* Part III.D.1.

concessions without injuring the standing of the market for executive talent.[202]

E. *Information Asymmetry*

Shareholders face an information disadvantage in voting on the firm's compensation.[203] The board will know more about the firm's competitive position, its willingness to offer alternative compensation arrangements, and the willingness of the CEO to accept those alternatives. The board—or the CEO—may also know more about the future performance of the company and which of the many possible payouts contemplated by an employment agreement are most likely. To be sure, there are a variety of ways for shareholders to minimize the board's information advantage—mandatory disclosure, proxy advisors, and the media. In spite of them, the board will be able to exploit its information asymmetry to its benefit.

1. Disclosure

Mandatory disclosure rules are designed to reduce the information asymmetry between the board and shareholders.[204] In 2006, the SEC enhanced the executive compensation disclosure requirements for public companies.[205] Designed to increase transparency in compensation,[206] the

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[202]*See* Kaplan, *supra* note 29, at 6 ("Many public company executives chose to go work for private equity-funded companies or for private equity firms themselves [during the 2005-07 period]. These were market-based decisions.").

[203]*See* Paul M. Healy & Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Emperical Disclosure Literature*, 31 J. ACCOUNTING. & ECON. 405, 420 (2001) ("Disclosure studies assume that, even in an efficient capital market, managers have superior information to outside investors on their firms' expected future performance.").

[204]*See* Simmons, *supra* note 7, at 343 ("Without question, enhanced disclosure requirements act as a constraint on managers and improve the monitoring capabilities of corporate constituents."); *Hearing on H.R. 1257*, *supra* note 4, at 9 (statement of Lucian Bebchuk, Professor of Law, Economics, and Finance, Harvard Law School) (nothing that disclosures under new rules "provide a lot of information to the marketplace"); Jeannemarie O'Brien et al., *Drafting and Negotiating Public Company Executive Employment Agreements: A Practitioner's Guide*, 1709 PLI/CORP 11, 33 (2009) (noting that Wachtell, Lipton, Rosen & Katz advise that the new regulations "have resulted in more complete disclosure of employment agreements," and companies should "make sure that they understand how the disclosure will appear in the company's proxy statement, and should be mindful of potential disclosure in crafting new arrangements.").

[205]Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53158, 53158 (Sept. 8, 2006) (to be codified at 17 C.F.R. pts. 228, 229).

revised regulations require that a company's disclosures provide "one number for total annual compensation for each named executive officer," and a discussion of the company's compensation principles.[207] In a new "Compensation Discussion and Analysis" section, the company must explain the objectives of its compensation program and what the compensation is designed to reward.[208] It must also describe each element of its compensation program, why it chooses to include each element, and how it determines the amount or formula to pay for each element.[209] In view of the comprehensive nature of the new rules, shareholders are in a stronger position relative to the old disclosure baseline. The additional disclosure requirements that the SEC promulgates under Dodd-Frank may help even more.[210] But of course they cannot eliminate the asymmetry.[211] Shareholders cannot know, for example, whether the board could have pressed for alternative pay arrangements that might have been better for shareholders and also acceptable to the CEO. The board will be able to continue to exploit the residual asymmetry in seeking shareholder approval.[212]

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[206] *Id.* (noting that the rules intended to provide investors with "a clearer and more complete picture of the compensation earned by" executive officers).

[207] Press Release, U.S. Securities and Exchange Commission, SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters (July 26, 2006), *available at* http://www.sec.gov/news/press/2006/2006-123.htm (quoting John W. White, Director of the SEC's Division of Corporation Finance).

[208] *Id.*

[209] *See* 17 C.F.R. § 229.402 (2006), Instructions to Item 402(a)(3).

[210] Dodd-Frank § 951(b)(1).

[211] *See, e.g.*, Nina Baranchuk et al., *Renegotiation-Proof Contracting, Disclosure, and Incentives for Efficient Investment*, 145 J. ECON. THEORY 1805, 1806 (2010) ("[T]he impact of disclosure is subtle because . . . disclosure about compensation are endogenous and their information content depends on equilibrium incentives.").

[212] *See* David I. Walker, *The Manager's Share*, 47 WM. & MARY L. REV. 587, 657 (2005) ("Managers have an interest in concealing compensation and will respond to new disclosure requirements by inventing new, opaque compensation elements. Thus, adequate disclosure will be a continuing race between regulators, on the one hand, and corporate executives and their compensation consultants, on the other."); *see also Hearing on H.R. 1257*, *supra* note 4, at 8 (statement of Lucian Bebchuk, Professor of Law, Economics, and Finance, Harvard Law School) ("[A]lthough the recent disclosure reform is going to make compensation more transparent in the future, past efforts by companies to camouflage pay do raise significant concerns about how companies have been setting pay arrangements.").

2. Proxy Advisors

Proxy advisors are another potential force for minimizing the information asymmetry between shareholders and directors.[213] Many institutional investors currently rely on proxy advisors for guidance on voting for directors, equity plans, and other shareholder issues. Proxy advisors, however, may have the same difficulties that shareholders have in evaluating compensation numbers and philosophy *ex ante*.[214] To the extent that proxy advisors evaluate a firm's compensation based on its governance, there may be strong reasons to doubt proxy advisors' ability to discriminate between good and bad pay arrangements.[215] Jeffrey Gordon predicts that proxy advisors may become especially formulaic in reviewing compensation,[216] leading to "a narrow range of compensation 'best practices' that will be adopted throughout the economy."[217] Thus, while proxy advisors may play a large role in say on pay voting, there is no reason to think their recommendations will improve the position of shareholders significantly.

The early returns from the first season of advisory voting on executive compensation suggests that the influence of proxy advisors may be limited. The prominent advisory firm ISS recommended negative votes at 276 companies, and at only 36 of those firms did shareholders actually vote down executive compensation.[218] Indeed, of 2225 firms that

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[213]*See* Ferri & Maber, *supra* note 90, at 9-10 (noting various information problems but suggesting that "information intermediaries (such as proxy advisory services) may reduce these problems"). Some evidence suggests that proxy advisors have less influence than commonly thought, in part because shareholders are already paying attention to the information important to the proxy advisors in formulating their recommendations. Stephen J. Choi, Jill E. Fisch & Marcel Kahan, *Director Elections and the Influence of Proxy Advisors* 50-51 (NYU L. & Econ. Research Paper Series, Working Paper No. 08-22, 2008), *available at* http://papers.ssrn.com/ sol3/papers.cfm?abstract_id=1127282 (estimating that the marginal impact of an ISS recommendation to withhold a vote has a 6-9% marginal impact on voting outcomes).

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

[215]*See* Robert M. Daines, Ian D. Gow & David F. Larcker, *Rating the Ratings: How Good Are Commercial Governance Ratings?* 1-6, 45-47 (Rock Ctr. for Corp. Governance at Stanford Univ., Working Paper Series No. 1, 2009), *available at* http://ssrn.com/abstract =1152093 (2010 revision) (finding that proxy advisors do not provide shareholders with useful information).

[216]Gordon, *supra* note 10, at 352.

[217]*Id.* at 367.

[218]Michael R. Littenberg, *The Votes Are In—Deconstructing the 2011 Say on Pay Vote*, HARVARD CORPORATE GOVERNANCE BLOG (July 29, 2011, 9:09 AM), http://blogs.law.harvard.edu/corpgov/2011/07/29/the-votes-are-in-%E2%80%94-deconstructing-the-2011-say-on-pay-vote/.

held votes through June 17, 2011, shareholders approved the compensation at 2189 of them, or 98.4%.[219] The initial influence of proxy advisors thus seems much more limited than conventional wisdom had anticipated.

3. The Media

The media could be a powerful force for helping shareholders to minimize the natural information advantages of directors. There is a limited amount of research examining how media coverage influences executive compensation,[220] and it leads to mixed conclusions. Core, Guay, and Larcker find that absolute levels of compensation, not any measure of "excess compensation," drives whether the media focuses on a firm's compensation.[221] They also find that "excess compensation" is associated with *negative* media coverage.[222] This somewhat encouraging result is in tension with their finding that the media is drawn to large option exercises in its negative coverage, leading them to conclude that the motivation behind media coverage of executive compensation "appears to be sensationalism" instead of providing information valuable to shareholders.[223] The media, in other words, may lead shareholders astray in identifying problematic pay packages and may not equalize the information available to shareholders.

4. Strategic Behavior by Boards

While some forces can minimize the informational asymmetry, the board still has an incentive to aggravate it in other ways. The greater the anxiety and uncertainty among shareholders about future firm performance, the more deference shareholders may be willing to show to the board. Thus, the board might try to take advantage of situations where shareholders are more apt to defer to the board's inherent

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[219] *Id.*

[220] John E. Core, Wayne Guay & David F. Larcker, *The Power of the Pen and Executive Compensation*, draft of May 23, 2007, at 1 ("[T]here is little empirical evidence on the role of the popular and business press as a potential monitor of executive pay . . . ."); Alexander Dyck, Natalya Volchkova & Luigi Zingales, *The Corporate Governance Role of the Media: Evidence from Russia*, 63 J. FIN. 1093, 1098 (2008).

[221] Core et al., *supra* note 220, at 24.

[222] *Id.* at 25.

[223] *Id.* at 29.

informational advantage—a health event for a current executive, a recent change in the company's strategy, or alterations in the competitive landscape. Consider the Ovitz example. If shareholders worried *ex ante* about the Ovitz package, the board could emphasize recent events: that Disney had just merged with Capital Cities/ABC[224] and that Eisner had recently been hospitalized for a heart bypass procedure.[225] If the board had said to shareholders that Ovitz was necessary to sustain the company's success and Ovitz said he would accept nothing less than the pay package on the table, it would be difficult to imagine Disney shareholders voting against his compensation.

V. THE COSTS AND BENEFITS OF SHAREHOLDER VOTING AND THE CASE FOR AN OPT-OUT REGIME

A. *Which Firms Can Benefit from Say on Pay*

Shareholders will not be able to eliminate bad pay practices through advisory voting, and thus the net effect of say on pay is unclear. Suppose firms are arrayed on a spectrum of compensation practices, from terrible to comparatively great. At firms with bad compensation practices, shareholders may see net benefits as a result of say on pay because the modification effect may outweigh the insulation effect.[226] At the other end of the spectrum, shareholders in firms with already good compensation may see net costs.[227] These may be the sorts of firms that adopted shareholder advisory voting voluntarily before the Congressional mandate. For those firms, the benefits of reputational insulation for the firms' directors are likely to be greater than the trivial expense of obtaining shareholder approval. Compensation at those firms could suffer as a result.

For firms on neither end of the spectrum, the results are decidedly unclear. Improved disclosure can provide shareholders with a more comprehensive picture of compensation practices and a potentially stronger bargaining position.[228] But in view of all of the forces involved

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[224]Adam Pertman, *Disney-Ovitz Deal Seen as "Recreation of Universe,"* BOS. GLOBE, Aug. 16, 1995, at 46.

[225]Herring, *supra* note 148.

[226]Gordon, *supra* note 10, at 352. ("It is clear that legislated 'say on pay' in the United States is one way to catch and stop misbehaving outliers . . . .").

[227]*See id.* at 325 (providing some of the anticipated costs).

[228]*See id.* at 346 (implying that shareholder knowledge of compensation contributed to shareholder empowerment).

it is difficult to predict how the equilibrium under say on pay would change relative to the existing baseline.[229] One certainty is that say on pay will fail to meet the problem identified by the managerial power model, in which most publicly-held companies suffer from pay-performance problems.[230]

Empirical work suggests that say on pay may have a positive effect only in a limited subset of firms. Examining market reactions to the surprisingly lopsided 2007 House approval of an earlier version of the legislation,[231] Cai and Walkling found significant and positive market reactions to the passage of say on pay—approximately 0.5 percent—for firms with overpaid executives and executives whose pay is less sensitive to performance.[232] The market reactions Cai and Walkling find come from an interesting set of firms—firms with bad governance, but not the worst. On various measures of governance, such as board size, percentage of outside directors appointed by the CEO, and boards whose directors hold many directorships, firms in the third quartile—not the fourth—show the strongest positive market reaction.[233] This suggests that market participants expect say on pay to be most effective in firms with governance that is bad enough to permit the board to overpay the CEO, but not so bad that the board can afford to ignore the advisory vote.[234] As Cai and Walkling conclude, say on pay "will create value for firms with overpaid CEOs and firms more likely to respond to shareholder votes."[235] In other words, for these firms, the modification costs will outweigh the insulation costs, and forcing these firms to go through with a shareholder advisory vote (and thus modify their pay packages) will provide net benefits to shareholders.

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[229]Jeffrey Gordon predicts there will be no dramatic change in compensation: "there would be no 'big bang' in the United States." *Id.* at 353.

[230]BEBCHUK & FRIED, *supra* note 5, at 23 (noting that "significant deviations from arm's-length contracting have been common in widely held public companies" and that such deviations are currently "substantial and widespread").

[231]Cai & Walkling, *supra* note 78, at 301 ("The passage of the Say-on-Pay Bill might not be surprising to the market, since Democrats were in control of the House. However, its 2-1 margin (269 positive votes vs. 134 negative votes) was a surprise, as well as the fact that 55 Republican Congressmen also supported the Bill.").

[232]*Id.* at 312, 314. "Overpaid" in this context means compensation that is statistically high relative to other firms of similar characteristics like size, industry, leverage, and so forth.

[233]*Id.* at 315-18 and Table 4.

[234]*See id.* at 318

[235]Cai & Walkling, *supra* note 78, at 332.

At firms where managers are entrenched or pay is not abnormally high, there is almost no evidence for benefits from the legislation in the Cai and Walking results. Looking at market reactions by abnormal CEO pay, firms in all but the highest quartile had statistically insignificant market reactions to the House vote,[236] and the market reaction for firms in the lowest quartile of abnormal CEO pay was negative.[237] Looking at firm reactions by various measures of corporate governance—board size, outside holdings, indices like the G-Index and E-Index—firms in the top two quartiles and in the bottom quartiles experienced non-statistically significant reactions across all measures of governance.[238] These results were generally positive, but not uniformly so.[239] In sum, the evidence is consistent with the analysis in this Article: Only at a discrete set of firms will the benefits of modifications to executive compensation outweigh the insulation directors can obtain from shareholders' ratification of pay packages.

Empirical evidence also suggests that for certain firms the net effect of say on pay could be negative. Before Dodd-Frank, shareholders of a public company could sponsor a proposal that the company adopt say on pay voting. Cai and Walkling examined these shareholder-sponsored say on pay proposals at 113 firms between 2006 and 2008.[240] These proposals received tepid endorsement from shareholders: Average support for say on pay proposals was less than 30 percent.[241] The market reactions to shareholder-sponsored say on pay proposals are similarly telling: When say on pay proposals were defeated by shareholders, the average abnormal market return was positive 0.4 percent, and when proposals were approved by shareholders, the market reaction was negative 1.9 percent.[242] The market reacted favorably when shareholders rejected say on pay proposals, and negatively when shareholders adopted them. Cai and Walkling interpret these results to show that "in general company specific say-on-pay proposals target firms that are unlikely to benefit from compensation related changes," and that consequently "the market reaction is negative when proposals targeting these firms receive

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[236] *Id.* at Table 3.

[237] *Id.*

[238] *Id.* at Table 4.

[239] Firms in the lowest quartile of "busy directors" had a CAR of -0.075%. Cai & Walkling, *supra* note 78, at Table 4B.

[240] *Id.* at 302-03.

[241] *Id.* at 330.

[242] *Id.* at 331, and Table 10. The 2.3 percent difference is statistically significant at the 5% level.

higher levels of support" from shareholders.[243] This suggests that some firms may see net costs from a say on pay vote.[244] Cai and Walking conclude that those who agitated for shareholder-sponsored say on pay proposals did "not target the 'right' firms."[245] This of course implies that there are firms for which say on pay is wrong. At these firms, the costs of insulation may outweigh the possibly trivial benefits shareholders can obtain through modifications to compensation arrangements. As Cai and Walkling emphasize, say on pay "does not . . . benefit all firms."[246]

B. *The Attractiveness of an Opt-out System*

The shortcomings of the legislation as currently drafted grow out of its overbreadth: it forces all firms—not just those where shareholders believe say on pay would be beneficial—to hold advisory votes on compensation. Amending the legislation to allow companies to opt-out of the say on pay regime by shareholder vote would improve the legislation considerably. Firms where shareholders expect to see benefits from advisory voting can continue to hold them, even over the objections of directors, but firms where shareholders will see no benefits from say on pay could select to not hold advisory votes.

Others have proposed making say on pay an opt-in regime.[247] At first glance, an opt-in approach is attractive because it would allow shareholders to adopt advisory voting irrespective of the board's wishes.[248] At the same time, it would not require any firm to hold shareholder votes.[249] At firms where shareholders' benefits from modifying compensation plans outweigh the costs of insulating directors against future outrage, shareholders could choose to vote on compensation.[250] In such a regime, shareholders would not initiate say on pay at firms where they would suffer by insulating directors more than they would gain from modifying compensation.

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[243]Cai & Walkling, *supra* note 78, at 331.

[244]*See id.* at 334-35.

[245]*Id.* at 327. Only firm size—not abnormal compensation or raw compensation—explained which firms were targeted by shareholders. Id.

[246]Cai & Walkling, *supra* note 78, at 335.

[247]Jeffrey Gordon argues for an opt-in say on pay regime. Gordon, *supra* note 10, at 326, 356-60.

[248]*Id.* at 358.

[249]*See id.* at 326.

[250]*See id.* at 356.

The fatal problem with the opt-in system, however, is that boards would still be free to adopt say on pay on their own initiative. A board that anticipates insulation benefits greater than the costs of modifications necessary to obtain shareholder approval would institute shareholder advisory voting by its action alone, even though shareholders at these firms would not need the modifications and would not want to give directors the cover. As more and more boards voluntarily adopted say on pay—and were thus able to deliver more CEO-friendly pay packages—other boards would be compelled to follow in order to have the insulation necessary to deliver competitive CEO pay packages. This adverse selection problem would push boards to adopt say on pay even if it offers no benefits to shareholders. On balance, the opt-in approach offers no substantial benefits over a mandatory system so long as boards retain the freedom to elect shareholder advisory voting on their own.

The solution is to apply the say on pay requirement to all companies but allow individual companies to opt-out by shareholder vote. The amendment to the legislation and regulations would be straightforward: Currently, companies must hold votes on how frequently to hold say on pay votes, and shareholders may decide to vote every 1, 2, or 3 years.[251] They must hold these frequency votes at least every six years.[252] The amendment could simply add the option of no voting on compensation to the menu in the frequency vote. Thus, shareholders would vote every six years whether to hold shareholder advisory votes on compensation every 1, 2, or 3 years or not at all. This would allow those firms whose shareholders believe say on pay to be beneficial to protect their ability to vote and extract modifications, regardless of the wishes of the board. At those firms where shareholders gain little or nothing from modifications and will suffer from diffusing responsibility for compensation decisions may opt out. To ensure that a board does not pass advisory voting against the wishes of shareholders, the rule should be construed to make the frequency vote the only method by which a company could put an advisory compensation vote to shareholders. This approach retains the benefits of say on pay for the discrete set of firms that can make use of it and allows other firms to avoid the costs associated with shareholder voting.

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[251] Dodd-Frank § 951(a)(2).
[252] *Id.*

VI. CONCLUSION

Shareholder advisory voting on executive compensation can benefit a discrete set of firms by forcing the board to modify pay practices in ways they otherwise might not. But the regime also comes with costs overlooked by commentators. Shareholder approval has the potential to insulate directors from criticism for compensation decisions, which may perversely lead directors at some firms to offer pay packages that are higher and less sensitive to performance than the current baseline. Once this effect is taken into account, the reform, on balance, will not necessarily help shareholders at all firms and, in fact, may injure shareholders at some subset of firms. More generally, shareholder participation in firm governance can have unintended consequences: when shareholders share in responsibility for firm decisions, it can be more difficult to hold directors accountable for the outcomes of those decisions.

The overbreadth of the say on pay regime could be ameliorated by allowing firms to opt out of it by shareholder vote. This would preserve the benefits of shareholder advisory voting on compensation for the set of firms that can make best use of it and allow other firms to exit the regime at little cost.