

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

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ABSTRACT

*What can or should be done, if anything, to address complaints that corporate executives are overpaid? This article argues that the Securities and Exchange Commission is making progress in the area of disclosure of executive compensation. The SEC will not accomplish any substantial reform regarding compensation as a wider issue, however, because shareholders do not have much of a role in establishing executive compensation packages and have little ability to challenge board decisions after receiving the mandated disclosure. Analyzing the Proposed Regulations and the Delaware Supreme Court decision *In re Walt Disney Co. Derivative Litigation*, this article sheds light on how a gap has arisen in the area of executive compensation regulation. It demonstrates how state law regulates gross negligence, waste and, perhaps, bad faith, while federal law focuses on disclosure of certain compensation packages. The different foci of state and federal regulations creates a gap for behavior that might be adverse to shareholder interests, yet occur beyond the shareholders' ability to effectuate changes. Moreover, compensation decisions have characteristics that distinguish them from routine board decisions since the attributes of arms-length contracting are compromised. Additionally, while disclosure of compensation data is important, it is not the equivalent of merit review and issues of information overload, boilerplate and complexity remain. If the SEC is truly committed to reforming executive compensation, it must address the gap in regulation remaining after *In re Walt Disney Company Derivative Litigation*. The SEC and states could work cooperatively to implement more meaningful corporate governance reform to ensure that shareholders both have the information necessary to make informed investment decisions and the ability to effect changes in company decision-making.*

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I. INTRODUCTION

Why are corporate executives paid so much and what are we doing about it?¹ In the period between 1992 and 2000 alone, the compensation of chief executive officers

¹ The issue of the composition of and approach to executive pay has been the subject of extensive examination. See, e.g., Lucian A. Bebchuk and Jesse M. Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* Chapter 8 (2004) [hereinafter, *Pay without Performance*]; Lucian A. Bebchuk and Jesse M. Fried, *Stealth Compensation via Retirement Benefits*, 1 Berkeley Business Law Journal 291 (2004)(arguing that corporate boards have been able to camouflage compensation through retirement benefits and other payments) [hereinafter *Stealth Compensation*]; Lucian A. Bebchuk and Robert J. Jackson, Jr., *Executive Pensions*, 30 J. CORP. L. 823 (2005) (analysis of the magnitude and composition of executive pension arrangements)[hereinafter *Executive Pensions*]; Mark J. Lowenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 1-2 (2000)(reviewing and evaluating the theories of executive compensation); James McConvill, *Executive Compensation and Corporate Governance: Rising Above the "Pay-for-Performance Principle*, 43 AM. BUS. L.J. 413 (2006)(arguing that pay for performance and agency theories are faulty); William W. Bratton, *The Academic Tournament Over Executive Compensation: Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, 93 CA. L. R. 1557 (2005)(observing that management power matters and evaluating arguments about compensation practice); Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TX. L. R. 1615 (2005)(arguing no reform is needed and that the management power rests with the board solely); Stewart J. Schwab and Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 WASH. LEE L. R. 231 (2006)(examining the characteristics of a large number of executive employment contracts); Randall S. Thomas, *Should Directors Reduce Executive Pay?*, 54 HAST. L. J. 437 (2003)(arguing that gaps between management and worker wages can affect company value).

(CEOs) at S&P 500 companies more than quadrupled, from \$3.5 million to \$14.7 million.² In 1991, the average large company CEO earned about 140 times the wage of the average company employee, but by 2003 it was 500 times.³ In 2005 the average CEO pay rose twenty-seven percent, compared to a rise of thirty-eight percent in 2004, while ordinary workers wages remained stagnant.⁴ Quite often these increases in compensation continue even where the corporation struggles with results.⁵ Other questions persist about whether executive compensation rewards performance of the executive or gains unrelated to the efforts of the executive.⁶ Of course, a high pay package itself does not indicate that the CEO's pay is too much or not competitive.⁷

The debate concerning executive compensation packages has been much in the news and in the Courts.⁸ As to whether these high increases in executive compensation are a

² Pay Without Performance, *supra* note 1, at 1; Patrick McGeehan, *Options in the Mirror, Bigger than they Seem*, New York Times, April 9, 2006, Sec. 3, at 6 (describing how Lehman Brothers has used stock option grants and valuation to obscure compensation to its CEO). Although much of the focus is on the most highly paid CEOs, there are indications that the CEOs of smaller companies have experienced substantial pay gains as well. Amy Cortese, *Smaller Fish are Also Doing Swimmily*, New York Times, April 9, 2006, Sec. 3, at 7.

³ Pay Without Performance, *supra* note 1, at 1. But *see*, Lowenstein, *The Conundrum of Executive Compensation*, *supra* note 1, at 5-6 (arguing that comparisons to rank and file workers are not helpful as CEO payment involves stock options, whereas average worker pay does not).

⁴ Eric Dash, *C.E.O. Pay Keeps Rising and Bigger Rises Faster*, New York Times, April 9, 2006, Sec. 3, at 5 (citing to a Pearl Meyers survey of 200 CEOs included).

⁵ Eric Dash, *C.E.O. Pay Keeps Rising and Bigger Rises Faster*, *supra* note 4, at 5 (boards at auto, retail and telecommunications companies increased CEO compensation in the wake of bad financial results); Eric Dash, *Off to the Races Again, Leaving Many Behind*, New York Times, April 9, 2006, Sec. 3, at 5 detailing the rising compensation practices of ConAgra even during financial difficulties); Tommy McCall, *Pay For Performance? Sometimes, but Not Always*, New York Times, April 9, 2006, Sec. 3, at 6 (outlining where stock prices fell, yet CEOs still paid well). But *see*, Lowenstein, *The Conundrum of Executive Compensation*, *supra* note 1, at 6-7 (arguing that analysis of pay to performance is not helpful because it is difficult to assess what is performance).

⁶ *See, e.g.*, J. Alex Tarquinio, *Pay for Oil Chiefs Spiked Like Prices*, New York Times, April 9, 2006, Sec. 3, at 10 (describing the huge CEO packages for those in the oil industry in 2005, such as Exxon Mobil and Occidental Petroleum CEOs); Tommy McCall, *Pay For Performance? Sometimes, but Not Always*, New York Times, April 9, 2006, Sec. 3, at 6 (CEO pay is often greater than shareholder return by 10 points).

⁷ *See, e.g.*, Lowenstein, *The Conundrum of Executive Compensation*, *supra* note 1, at 1-2; Andrew R. Brownstein & Morris J. Panner, *Who Should Set CEO Pay? The Press? Congress? Shareholders?*, Harv. Bus. Rev., May-June 1992, at 28; Kevin J. Murphy, *Top Executives Are Worth Every Nickel They Get*, Harv. Bus. Rev., Mar.-Apr. 1986, at 125; Robert Thomas, *Is Corporate Executive Compensation Excessive?*, in *The Attack on Corporate America* 276, 278 (M. Bruce Johnson ed., 1978) ("Competition among corporations . . . sets the level of executive compensation."); Nicholas Wolfson, *A Critique of Corporate Law*, 34 U. Miami L. Rev. 959, 975-78 (1980) (market forces will eliminate "excessive" compensation). But *see*, Graef S. Crystal, In Search of Excess: The Overcompensation of American Executives (1991)(arguing that overpayment exists); Rik Kirkland, *The Real CEO Pay Problem*, FORTUNE, June 30, 2006 (80% of Americans think that CEOs are paid too much).

⁸ *See, e.g.*, In re Walt Disney Company Derivative Litigation, ___ A.2d ___, 2006 WL 1562466. *See also*, Disney Investors Seek Reversal of Ovitz Ruling Los Angeles Times, January 26, 2006, C4; Benjamin Pimentel, *HP Sued over Fiorina's \$42 Million in Exit Pay; Shareholders Say Company, Directors Disregarded Own Rules with Golden Parachute*, San Francisco Chronicle, March 8, 2006, at C1 (two institutional investors sued HP over Fiorina severance package allegedly in violation of board policy); Sanders v. Wang, 1999 WL 1044880 (Del. Ch. Nov. 8, 1999)(shareholder challenge to granting of stock plan benefiting executives). *See also, e.g.*, Rik Kirkland, *The Real CEO Pay Problem*, FORTUNE, June 30,

problem, there is much debate. Orin Kramer, the Chairman of the New Jersey State Investment Council, commented:

And if you say, "Well, for senior executives, compensation has risen three and a half times faster than it has for average workers," then you can say, "That makes sense if either (a) there's a declining pool of people who can do these jobs, or (b) the job got something like three and a half times harder, or (c) maybe they're creating three and a half times as much value as executives used to create." If you have problems with those conclusions, the compensation levels are probably a little bit high.⁹

Shareholders, employees and the public in general are often displeased with executive compensation levels. Shareholder litigation brought against the board of the Walt Disney Company after they gave a \$130 million severance package to Michael Ovitz has attracted much publicity and the recent decision by the Delaware Supreme Court will be dissected for some time.¹⁰ Shareholder complaints over former HP CEO, Carly Fiorina's \$42 million severance package has led to new litigation.¹¹ Employees at struggling companies such as ConAgra in Omaha Nebraska have seen their wages not keep pace with the cost of living and their bonuses eliminated at the same time that the former chairman and chief executive, Bruce Rohde, received bonuses, stock options and later retired with a \$20 million package.¹² It is hard to forget the public outrage toward former General Electric CEO Jack Welch when during his divorce proceedings it was discovered that his retirement package included Red Sox tickets, a luxury apartment in New York City, country club memberships and use of a GE corporate jet.¹³

The current system of executive compensation raises a number of important issues. First, investors rely on the availability of accurate disclosure of complete compensation data to assess company prospects and "stealth" or undisclosed compensation is an impediment to shareholder decision-making.¹⁴ Second, the "considerable influence" that

2006 ("the outrage has grown so intense that the country's top CEOs are now vigorously debating the problem in private").

⁹ Orin Kramer, *Pay Without Performance: The Institutional Shareholder Perspective*, 30 J. Corp. L. 773 (2005). In fact, a Watson Wyatt Worldwide survey of directors and institutional investors found that while only sixty-one percent of directors think that executives are overpaid, ninety percent of institutional investors believe executives are overpaid. Watson Wyatt Worldwide, *Corporate Directors Give Executive Pay Model Mixed Reviews, Watson Wyatt Survey Finds*, June 20, 2006, available at <http://www.watsonwyatt.com/news/press.asp?ID=16180> (last visited July 18, 2006).

¹⁰ *In re Walt Disney Company Derivative Litigation*, __ A.2d __, 2006 WL 1562466. See also, *Disney Investors Seek Reversal of Ovitz Ruling* Los Angeles Times, January 26, 2006, at C4..

¹¹ Benjamin Pimentel, *HP Sued over Fiorina's \$42 Million in Exit Pay; Shareholders Say Company, Directors Disregarded Own Rules with Golden Parachute*, SAN FRANCISCO CHRONICLE, March 8, 2006, at C1.

¹² Eric Dash, *Off to the Races Again, Leaving Many Behind*, NEW YORK TIMES, April 9, 2006, at Sec. 3, page 1.

¹³ *Disclosure Won't Tame C.E.O. Pay*, The New York Times, January 14, 2006, at C1.

¹⁴ Chairman Cox speech of January 17, 2006, available at Securities Exchange Commission Website, available at <http://www.sec.gov/news/speech/spch011706cc.htm> (last visited July 6, 2006)[hereinafter "Cox Speech"]. For a discussion of "stealth compensation" via retirement benefits, see *Stealth Compensation*, *supra* note 1, at 293.

executives have over their pay and the “influence” used to obtain it suggests that arms-length contracting may not be present to the detriment of shareholders and employees.¹⁵ Perhaps most importantly, even where shareholders have enhanced disclosure, shareholders do not have a substantial role in establishing executive compensation and little ability to challenge compensation decisions afterwards.¹⁶

During a speech given on January 17, 2006, Securities and Exchange Commission (SEC) Chairman Christopher Cox announced proposed revisions to the SEC’s existing rules (Existing Regulations) governing the disclosure of executive compensation (the Proposed Rules).¹⁷ The SEC subsequently published the Proposed Regulations, including a lengthy “Background and Overview” section detailing the SEC’s assessment of the problem.¹⁸ The SEC has received more than 20,000 public comments to its notice of proposed rulemaking (NPRM) and voted affirmatively to adopt changes to the Existing Rules on July 26, 2006.¹⁹ Characterizing the Existing Regulations as “out of date,” SEC Chairman Cox declared the SEC’s purpose “is to help investors keep an eye on how much of their money is being paid to the top executives who work for them.”²⁰ Commissioner Cox expressed concern that companies are not disclosing compensation information properly.²¹

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

¹⁵ *Stealth Compensation*, *supra* note 1, at 293.

¹⁶ *See infra* Part IV.C.

¹⁷ Cox speech, *supra* note 14. For the current requirements, *see* Executive Compensation Disclosure, Release No. 33–6962, 57 Fed. Reg. 48125 (Oct. 16, 1992) [hereinafter the “1992 Release”]; *See also* Executive Compensation Disclosure; Securityholder Lists and Mailing Requests, Release No. 33–7032, 58 Fed. Reg. 63010, at Section II (Nov. 22, 1993).

¹⁸ Executive Compensation and Related Party Disclosure, 71 Fed. Reg. 6542 (2006) [hereinafter Proposed Regulations].

¹⁹ SEC Press Release of July 26, 2006, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/news/press/2006/2006-123.htm> (last visited August 5, 2006).

²⁰ Cox Speech, *supra* note 13.

²¹ *Id.*

²² Cox Speech, *supra* note 13. *See* Proposed Regulations, 71 Fed. Reg. at 6542. The SEC proposed a transition period for the Proposed Regulations with the earliest portions of the Proposed Regulations having effect sixty days after publication of final rules and the remainder of the rules, such as those related to the summary compensation table that will ultimately require a three year presentation, being phased-in over a longer time period so companies will not be required to restate historical data. 71 Fed. Reg., at 6583.

²³ SEC Press Release, *available at* <http://www.sec.gov/news/press/2006-10.htm> (last visited January 27, 2006); Proposed Regulations, 71 Fed. Reg. at 6543–45, 6551 (summarizing the regulations).

²⁴ SEC Press Release, *available at* <http://www.sec.gov/news/press/2006-10.htm> (last visited January 27, 2006); Proposed Regulations, 71 Fed. Reg. at 6542, 6544, 6571–73. There has been controversy over the

Chairman Cox commented that it is not the government's "job" to determine the appropriate level of executive compensation.²⁵ Rather, it is the role of the shareholders and the board of directors.²⁶ The SEC's primary initiative is aimed at full disclosure of all issues that affect compensation decisions. Although the SEC initially requested comments to be completed by April, 2006, the SEC extended the comment period in this case.²⁷ After closing the comment period, the SEC will consider and respond to material comments²⁸ received before finalizing the Proposed Regulations, such that the revisions will not likely be in force until 2007.

Response to the SEC's NPRM has been overall positive, but with various refinements suggested by commentators.²⁹ Some in Congress, however, believe that the NPRM does not go far enough and that more comprehensive federal regulation is in order.³⁰ House Bill 4291 calls for more substantial reform that would include shareholder votes on certain compensation packages.³¹ Corporations, corporate counsel and company advocates, already under siege from shareholder complaints about lucrative compensation packages, appear to have taken the NPRM seriously and filed numerous comments seeking to lessen the impact of the Proposed Regulations.³²

effectiveness and meaning of independent directors. *See, e.g.*, Harvey Gelb, *Corporate Governance and the Independence Myth*, 6 WYO. L. REV. 129 (2006).

²⁵ Cox Speech, *supra* note 13.

²⁶ Cox Speech, *supra* note 13. Cox commented: "It is their job [the shareholders and directors], not the government's, to determine how best to align executive compensation with corporation performance, to determine the appropriate levels of executive pay, and to decide on the metrics for determining it."

²⁷ Securities and Exchange Commission Website, *supra* note 15. As of July 6, 2006, the SEC was still receiving comments to the Proposed Regulations.

²⁸ *See generally, e.g.*, *St. James Hosp. v. Heckler*, 760 F.2d 1460, 1470 (7th Cir. 1985); *Home Box Office, Inc. v. FCC*, 567 F.2d 9, 35 (D.C. Cir. 1977).

²⁹ *See, e.g.*, Comment of Lucian Bebchuk, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/lbechuk5984.pdf> (last visited July 6, 2006)(applauding and supporting the SEC's efforts); Comment of Pearl Meyer & Partners, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/jrich7010.pdf> (last visited July 6, 2006)(commending the SEC); Comments of Teachers Insurance and Annuity Association of America, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/s70306-632.pdf> (last visited July 6, 2006)(expressing strong support for the NPRM).

³⁰ *See*, Comment of Rep. Barney Frank, Ranking Member, Committee on Financial Services, U.S. House of Representatives, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/bfrank041006.pdf> (last visited July 6, 2006). *See also*, Protection Against Executive Compensation Abuse Act, H.R. 4291, 109th Cong. (2005)(referred to the Committee on Financial Services)[hereinafter "Protection Against Executive Compensation Abuse Act"].

³¹ *See* Protection Against Executive Compensation Abuse Act, *supra* note 26.

³² *See, e.g.*, Comment of Steve Odland, Business Roundtable, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/sodland041006.pdf> (last visited July 6, 2006); Comment of Christine Richards, Fed Ex Corporation, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/fedex041006.pdf> (last visited July 6, 2006); Comment of W. Wayne Withers, Emerson Electric, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/emerson041006.pdf> (last visited July 6, 2006); Comment of Linda Rappaport and George Spera, Shearman & Sterling, LLP, on behalf of CBS

While the SEC was publishing the NPRM, the Delaware Supreme Court issued its decision in the case *In re Walt Disney Company Derivative Litigation* (In re Walt Disney).³³ The Court upheld the Court of Chancery's decision in favor of the corporate defendants and underscored that existing fiduciary duty, good faith and waste theories apply equally to the executive compensation arena.³⁴ While SEC Chairman Cox has stated that the federal government is not in the business of policing executive compensation decisions, the Delaware Supreme Court seems to have declared its intent to stay out of the business in any meaningful way as well.

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

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

Part II focuses on federal and state jurisdiction for, and regulation of, executive compensation decisions. The SEC maintains that its jurisdiction over executive compensation is limited to information disclosure. The SEC argues that the board and shareholders are vested with actual decision-making authority over such matters, presumably under state corporate law. Even if true, the SEC has failed to highlight the gap existing between where the SEC has asserted authority over executive compensation disclosure and the limited shareholder powers actually existing under state law, as

Corporation, The Walt Disney Company, NBC Universal (a majority-owned subsidiary of General Electric Company), News Corporation, and Viacom Inc., Securities and Exchange Commission Website, available at <http://www.sec.gov/rules/proposed/s70306/shearmansterling041006.pdf> (last visited July 6, 2006).

³³ *In re Walt Disney Company Derivative Litigation*, __ A.2d __, 2006 WL 1562466.

³⁴ *Id.*

evidenced by *In re Walt Disney*. Broad protections exist under state law for board decisions (including those on compensation matters) that will be unaffected by the SEC's Proposed Regulations.

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

II. Jurisdiction for and Regulation of Executive Compensation

A. The SEC and its Rulemaking Authority

The authority of the SEC has traditionally centered on the disclosure requirements of the 1933 Securities Act (1933 Act)³⁵ and the 1934 Securities Exchange Act (Exchange Act).³⁶ Nevertheless, the SEC has on occasion been accused of creativity in construing its own jurisdiction to regulate.³⁷ As far back as the 1960's, the SEC began to take an expanded view of its jurisdiction beyond traditional disclosure by bringing cases aimed at protecting the public against "fraud" generally.³⁸ In general, courts have shown substantial deference to the interpretation by a federal agency of its own statutory authority.³⁹ This deference with respect to the SEC has not been unlimited and the

³⁵ Securities Act of 1933, 15 U.S.C. § 77a (1988). Felix Frankfurter promoted the 1933 Act as able "[t]o build on self discipline by all agencies engaged in marketing securities by compelling full publicity of 'every essentially important element attending the issue of new securities' so that the public may have an opportunity to understand what it buys" Felix Frankfurter, *The Federal Security Act*, FORTUNE, Aug. 1933, at 53. See also, Roberta Karmel, Regulation by Prosecution 40-41 (1982).

³⁶ Securities Exchange Act of 1934, 15 U.S.C. § 78a (1988).

³⁷ See, e.g., Philip Berg, *The Limits of SEC Authority Under Section 14(a) of the Exchange Act: Where Federal Disclosure Ends and State Corporate Governance Begins*, 17 J. Corp. L. 311 (1992); Lacey and George, *Expansion of SEC Authority into Corporate Governance: The Accounting Provisions of the Foreign Corrupt Practices Act (A Twentieth Anniversary Review)*, 7 JTLP 119 (1998).

³⁸ See, *In re Cady Roberts & Co.*, 40 S.E.C. 907 (1961); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

³⁹ See, e.g., *NationsBank of N.C., N.A. v. Variable Annuity Life Ins. Co.*, 115 S. Ct. 810, 813-15 (1995); *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984); see also Thomas W. Merrill, *Judicial Deference to Executive Precedent*, 101 Yale L.J. 969, 980-93 (1992); Mark Seidenfeld, *A Syncopated Chevron: Emphasizing Reasoned Decision-making in Reviewing Agency Interpretations of Statutes*, 73 Tex. L. Rev. 83, 94-103 (1994).

Supreme Court concluded in *Santa Fe v. Green*⁴⁰ that federal securities laws do not "federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."⁴¹

Today, Chairman Cox describes the SEC's mission as follows: "to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation."⁴² Believing that "[a]n educated investing public ultimately provides the best defense against fraud and costly mistakes," the SEC has primarily focused its regulatory reach on requiring companies to disclose extensive information for review by the SEC and the public and on general public education programs.⁴³

The SEC adopted the Existing Regulations in 1992, which focus on disclosure and use a series of formatted tables capturing compensation data over several years.⁴⁴ The SEC has itself criticized the tables as "highly formatted and rigid."⁴⁵ The Existing Regulations include a Performance Graph and Compensation Committee Report relaying in a detailed manner compensation and corporate performance, as reflected by stock price.⁴⁶ The SEC has criticized the Compensation Committee Report as leading to boilerplate discussion and the Performance Graph as "outdated."⁴⁷ The Compensation Committee Report has been furnished to, rather than filed with, the SEC by the compensation committee of a company, such that Exchange Act liability for misstatements does not attach.⁴⁸ The SEC believed that furnishing the data would help spur more open and robust conversation on executive compensation.⁴⁹

The SEC does not venture beyond the current disclosure regulatory approach with the Proposed Regulations. The SEC has some rulemaking authority concerning executive compensation as part of its fraud protection mandate, and, in fact, has regulated disclosure of executive compensation for some time.⁵⁰ The SEC's specific jurisdiction to

⁴⁰ 430 U.S. 462 (1977).

⁴¹ *Id.* at 479. For a discussion of the SEC's attempts to regulate corporate governance matters, see Roberta Karmel, *Realizing the Dream of William O. Douglas-The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 Del. J. Corp. L. 79, at 86-87 (2005)[hereinafter, Karmel, *Realizing the Dream*]. See also, *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990) (SEC rule on voting power exceeded authority under the Exchange Act).

⁴² U.S. Securities and Exchange Commission, 2005 Performance and Accountability Report, at 2, available at <http://www.sec.gov/about/secpar2005.shtml> (last visited July 10, 2006).

⁴³ U.S. Securities and Exchange Commission, 2005 Performance and Accountability Report, at 5, available at <http://www.sec.gov/about/secpar2005.shtml> (last visited July 10, 2006).

⁴⁴ Executive Compensation Disclosure, Release No. 33-6962, 57 Fed. Reg. 48125 (Oct. 16, 1992) (hereinafter the "1992 Release").

⁴⁵ Proposed Regulations, 71 Fed. Reg. at 6545.

⁴⁶ 1992 Release, *supra* note 40.

⁴⁷ Proposed Regulations, 71 Fed. Reg. at 6547.

⁴⁸ 1992 Release, *supra* note 40.

⁴⁹ 1992 Release, *supra* note 40, at Section II.H.

⁵⁰ The SEC first regulated executive compensation disclosure in 1938. Release No. 34-1823 (Aug. 11, 1938). In one recent enforcement action, the SEC reached a settlement with Tyson Foods and its former CEO, Donald Tyson, with Tyson Foods paying a penalty of \$1.5 million and Donald Tyson paying a \$700,000 penalty for misleading disclosures of compensation information. U.S. Securities and Exchange

regulate disclosure of executive compensation generally lies in the 1933 Act and the Exchange Act and the Investment Company Act of 1940, as amended.⁵¹ By continuing the longstanding disclosure approach to executive compensation, the SEC is remaining consistent with its stated mission and tradition.

By failing to go farther with executive compensation, and seeking congressional authority as needed, however, the SEC may be using its regulatory authority over disclosure matters to accomplish very little. If one accepts the SEC's conclusion that it is limited to disclosure in the area of executive compensation, do states have remaining jurisdiction over executive compensation? If so, to what extent has this authority been exercised? These questions are taken up below.

B. Shareholder Rights Under State Law

The Proposed Regulations must be considered in the context of state regulation of executive compensation as well, since there is overlapping jurisdiction regarding regulation of compensation matters. In practice, the most important affirmative initiative available under state law to shareholders objecting to executive compensation is suing the individual members of the board of directors.⁵² In general, the board is vested with the authority to manage the corporation with the business judgment rule protecting decision-making.⁵³ The Delaware Supreme Court has emphasized, though, that the core of a board's protection under the business judgment rule requires informed decision making.⁵⁴ “[A] director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty.”⁵⁵ Gross negligence is the standard for determining whether decision-making was informed for purposes of the business judgment rule.⁵⁶

Commission, 2005 Performance and Accountability Report, at 7, *available at* <http://www.sec.gov/about/secpar2005.shtml> (last visited July 10, 2006).

⁵¹ Executive Compensation and Related Party Disclosure, 71 Fed. Reg. at 6598. The SEC cited authority under “Sections 3(b), 6, 7, 10, and 19(a) of the Securities Act, as amended, Sections 10(b), 12, 13, 14, 15(d) and 23(a) of the Exchange Act, as amended, and Sections 8, 20(a), 24(a), 30 and 38 of the Investment Company Act of 1940, as amended.”

⁵² *See, e.g.*, 2006 WL 1562466. *See*, Randall Thomas and Kenneth Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. at 571 (examining 124 cases where shareholders have brought claims of excessive compensation and concluding that shareholders are more likely to find success against smaller corporations when litigating outside of Delaware).

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

⁵⁴ *Id.* at 872-73.

⁵⁵ *Id.* at 872-73.

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

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

is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decision-making context is *process* due care only. Irrationality is the outer limit of the business judgment rule. Irrationality may be the functional equivalent of the waste test or it may tend to show that the decision is not made in good faith, which is a key ingredient of the business judgment rule.⁵⁷

Accordingly, shareholder claims against the board of directors often center on satisfaction of the board's procedural duty of care in the decision-making process, though litigation often also includes claims of lack of good faith and waste.

1. Delaware Developments Regarding the Duty of Care

Rulings of the Delaware Supreme Court outline a board's duty of care and have been the subject of extensive commentary. Delaware cases, in particular *Smith v. Van Gorkom*,⁵⁸ create a murky picture of a board's responsibility of informed decision-making versus the shareholders right to challenge board decisions.⁵⁹ This article will not undertake an in-depth review of *Smith v. Van Gorkom*, as extensive consideration of this case has been provided by others.⁶⁰

To counter the *Van Gorkom* imposition of personal liability on board members, the Delaware General Assembly acted swiftly to limit its effect on other corporations by enacting Delaware Code § 102(b)(7).⁶¹ Section 102(b)(7) permits corporations to include in the certificate of incorporation a provision to exculpate board members from personal liability for breaches of duty of care, though not for duty of loyalty violations, good faith

establish facts rebutting the presumption of informed decision-making under the business judgment rule. See *Aronson v. Lewis*, 473 A.2d 805, 812 (DE. 1984).

⁵⁷ *Brehm v. Eisner*, 746 A.2d 244 (Del.2000).

⁵⁸ *Smith v. Van Gorkom*, 488 A.2d 858, 898-99 (Del. 1985). The shareholders' claim against the board in the case arose in the context of the board's decision for a cash out merger of Trans Union into a new corporation. After little negotiations and a scant two hour meeting, the Trans Union board approved merger with a new company formed by Pritzker for \$55 per share. *Id.* at 868-69.

⁵⁹ Under Delaware law, the business judgment rule is codified in 8 Del.C. § 141(a).

⁶⁰ See, e.g., *The Smith v. Van Gorkom Symposium*, 45 Washburn L. J. 267 (2006); Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 Ga. L. Rev. 477 (2000) and Lawrence A. Hamermesh, *A Kinder, Gentler Critique of Van Gorkom and Its Less Celebrated Legacies*, 96 Nw. U. L. Rev. 595 (2002); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 Bus. Law. 1, 1 (1985); Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 Bus. Law. 1437, 1455 (1985); Charles M. Elson & Robert B. Thompson, *Van Gorkom's Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives*, 96 Nw. U. L. Rev. 579, 583 (2002); Stephen M. Bainbridge, *Why a Board? Group Decision-making in Corporate Governance*, 55 Vand. L. Rev. 1, 54 (2002).

⁶¹ 65 Del. Laws, c. 289 (1986).

violations and certain other violations.⁶² Many Delaware corporations responded by adopting charter provisions containing such exculpatory language.⁶³

Section 102(b)(7) is important for two primary reasons. First, the widespread approval of Section 102(b)(7) exculpatory provisions by shareholders is a strong indicator that shareholders will tolerate a certain amount of risk taking by directors and believe that it should not create personal liability.⁶⁴ Second, it precludes exculpation of directors who self deal or do not act in good faith, representing legislative intolerance of directors who breach the basic trust given by the shareholders.⁶⁵

Despite apparent legislative intention to put the issue to rest, section 102(b)(7) did not resolve all questions regarding director liability for breaches of the duty of care even for corporations enacting the exculpatory charter provisions. With regard to cases alleging only a duty of care violation, Delaware courts have consistently upheld the effectiveness of section 102(b)(7) provisions when litigated and dismiss cases once the defense is raised.⁶⁶ On the other hand, even in the context of a corporation with a section 102(b)(7) charter provision, shareholders can plead causes of action alleging board breaches of the duty of care that also involve the duty of loyalty or good faith. These cases survive a motion to dismiss and are allowed to proceed to trial.

A duty of loyalty claim would invoke the higher standard of review of fairness.⁶⁷ The Delaware Supreme Court has explained that the fairness analysis cannot be avoided by a motion to dismiss even where a Section 102(b)(7) provision applies because “[t]he category of transactions that require judicial review pursuant to the entire fairness standard *ab initio* do so because, by definition, the inherently interested nature of those transactions are inextricably intertwined with issues of loyalty.”⁶⁸ Where the shareholders allege a duty of loyalty claim, section 102(b)(7) exculpates the board from a finding of liability only if the transaction is found to be unfair and the unfairness was exclusively due to a breach of the duty of care.⁶⁹ The cases that are beyond the exculpatory reach of section 102(b)(7) highlight the remaining questions regarding board liability when faced with shareholder claims involving both the duty of care and the duty of loyalty.

⁶² 8 Del C. § 102(b)(7).

⁶³ *Malpiede v. Townson*, 780 A.2d 1075, 1095 (2001); see E. Norman Veasey, *An Economic Rationale for Judicial Decision-making in Corporate Law*, 53 BUS. LAW. 681, 693-94 (1998); see also E. Norman Veasey et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification and Insurance*, 42 BUS. LAW. 399, 401-04 (1987).

⁶⁴ Veasey, *An Economic Rationale for Judicial Decision-making in Corporate Law*, 53 BUS. LAW. at 693-94.

⁶⁵ *Id.* at 694.

⁶⁶ See, e.g., *Malpiede v. Townson*, Del.Supr., 780 A.2d 1075, 1095 (2001); *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (2001); *Zirn v. VLI Corp.*, Del.Supr., 681 A.2d 1050, 1061-62 (1996); *Arnold v. Soc’y for Sav. Bancorp., Inc.*, Del.Supr., 650 A.2d 1270, 1288 (1994).

⁶⁷ See, e.g., 8 Del. C. § 144 (“The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.”). See also, *Malpiede*, 780 A.2d at 1094 (“entire fairness”).

⁶⁸ *Emerald Partners*, 787 A.2d at 93.

⁶⁹ *Emerald Partners*, 787 S.2d at 98.

2. In re Walt Disney Company Derivative Litigation

The Delaware Supreme Court did not revisit directly the questions left open by Van Gorkom and Section 102(b)(7) until more than twenty years later.⁷⁰ In June 2006, the Court provided some clarification of the application of the duty of care, as well as good faith and waste, when it decided *In re Walt Disney*.⁷¹ *In re Walt Disney Co.* considered the actions of the board of the Walt Disney Company (Disney) in entering into an employment agreement with Michael Ovitz (Ovitz) as President. The agreement resulted in the payment to Ovitz of a \$130 million severance package when he was dismissed after just fourteen months of service.⁷² Michael Eisner (Eisner), was the company's Chairman and Chief Executive Officer and also had a social relationship with Ovitz. Eisner, along with Irwin Russell, a director and the Chairman of the Compensation Committee, approached Ovitz about joining Disney.⁷³

The Ovitz employment agreement (OEA) was modeled after other employment agreements Disney had used previously. The OEA contained no fault termination provisions with a significant severance package (NFT) in the event that Ovitz was terminated for anything other than gross negligence or malfeasance.⁷⁴ Prior to concluding the OEA, Disney hired Graef Crystal, an executive compensation consultant. Raymond Watson, another member of the compensation committee, worked with Crystal to evaluate the OEA.⁷⁵ The Disney compensation committee met at some point later and approved the terms of the OEA, after reviewing the term sheet, presentations by Watson and Russell and discussion.⁷⁶ Later that same day, the full Disney board met, and after discussion and deliberations, elected Ovitz as President.⁷⁷ When Ovitz was not as successful as Disney desired, the relationship deteriorated. Ovitz was dismissed without formal board action a mere fourteen months later under the NFT provisions of the OEA, as there was no cause to dismiss.⁷⁸ In reaction, the shareholders brought a derivative suit against Ovitz and the board.⁷⁹

⁷⁰ While during this period the Delaware Supreme Court did not decide any cases directly involving a board's duty of care (and none involving compensation issues), it did decide several cases that raised duty of loyalty issues and the overlap with section 102(b)(7). *See, e.g.,* *Malpiede v. Townson*, Del.Sup., 780 A.2d 1075, 1095 (2001); *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (2001); *Zirn v. VLI Corp.*, Del.Sup., 681 A.2d 1050, 1061-62 (1996); *Arnold v. Soc'y for Sav. Bancorp., Inc.*, Del.Sup., 650 A.2d 1270, 1288 (1994). In *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (2001), the Court overturned the Chancery Court judgment in favor of the board defendants based on the corporate charter's exculpatory clause. The Court characterized the shareholder's claim regarding the merger price as properly pleading an entire fairness claim. *Id.* at 88. The Court rejected the board's argument that it was protected from even entire fairness failures under section 102(b)(7). *Id.*

⁷¹ ___ A.2d ___, 2006 WL 1562466.

⁷² *Id.* at 1.

⁷³ *Id.* at 3.

⁷⁴ *Id.* at 3.

⁷⁵ *Id.* at 3.

⁷⁶ *Id.* at 5.

⁷⁷ *Id.* at 6.

⁷⁸ *Id.* at 8-9.

⁷⁹ *Id.* at 1. The suit was brought in January 1997 by several shareholders alleging breaches of fiduciary duty and contract and waste of assets. *Id.* The litigation was extended and involved several pretrial

In a lengthy opinion, the Delaware Supreme Court tackled the intersection between the business judgment rule and Section 102(b)(7).⁸⁰ The court stressed that the presumption of the business judgment rule can be rebutted “if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith.”⁸¹ In such cases, according to the Court, “the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders.”⁸² Because no duty of loyalty breach was claimed against the directors, the only way to rebut the business judgment rule, according to the Court, was to “show that the Disney defendants had either breached their duty of care or had not acted in good faith.”⁸³ Moreover, building upon its holding in *Emerald Partners v. Berlin*,⁸⁴ the Court explained that an examination of a board’s lack of good faith can be made: (1) for purposes of rebutting the business judgment rule; and (2) if the board is found liable, for purposes of exculpation under section 102(b)(7).⁸⁵

This section will not review in detail every claim that the shareholders made on appeal. It will look closer at three specific areas that the Court grappled with and that are likely to impact the treatment of executive compensation decisions in the future. One category focuses on the reach of *In re Walt Disney’s* concept of the duty of care and how a corporation can insulate itself from complaints under that basis. A second category involves good faith as an element to avoid exculpation under Section 102(b)(7) and as a grounds to rebut the business judgment rule in general. In this category, the key question is whether the board’s decision-making regarding the executive compensation package involved intentionally bad conduct or a “conscious[] and intentional[] disregard[] [of] responsibilities, adopting a ‘we don’t care about the risks’ attitude,”⁸⁶ which would result in a finding of bad faith, or, alternatively, whether gross negligence, which was found not to be lacking in good faith. The third category focuses on complaints of excessive compensation packages, like *In re Walt Disney*, as waste, where the payments at issue are related to rational business attempts to attract executive talent.

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

The board of Trans Union in *Van Gorkom* made a decision to merge the company at a

motions and an earlier appeal to the Delaware Supreme Court. *Id. See, Brehm v. Eisner*, 746 A.2d 244 (Del.2000)(allowing the plaintiffs to amend their complaint). The trial lasted 37 days and resulted in a 174 page opinion by the Chancellor concluding that “the director defendants did not breach their fiduciary duties or commit waste.” *In re The Walt Disney Company Derivative Litig.*, 2005 WL 20566651, at 1 (Del. Ch. Aug. 9, 2005); --- A.2d ---- (Del.2005). The plaintiffs appealed from this judgment, claiming numerous errors. ___ A.2d ___, 2006 WL 1562466, at 1.

⁸⁰ *Id.* at 15.

⁸¹ *Id.* at 15.

⁸² *Id.* at 15.

⁸³ *Id.* at 15.

⁸⁴ 787 A.2d 85.

⁸⁵ 2006 WL 1562466, at 15. The business judgment rule can be rebutted “if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty *or acted in bad faith.*” *Id.* (italics added).

⁸⁶ 2006 WL 1562466, at 24, 26, quoting 2005 WL 2056651, at 36 (Del. Ch.).

hastily called, brief board meeting with no formal documents or presentations. In doing so, the board in *Van Gorkom* acted short of fulfilling its duty of care to act with informed decision-making.⁸⁷ Section 102(b)(7) was intended to limit the duty of care analysis primarily to cases where there were also allegations of bad faith. Later cases, like *Emerald Partners*, considered board decisions that also implicated duty of loyalty claims, also not exculpable section 102(b)(7).⁸⁸ Neither *Van Gorkom* nor *Emerald Partners* dealt with the issue of shareholder allegations that a board acted without due care and in bad faith in the absence of a duty of loyalty claim. By contrast, the *In re Walt Disney* Court struggled with how to apply the duty of care analysis to board and committee decision-making in a compensation matter where shareholders alleged bad faith and the corporation had a Section 102(b)(7) exculpatory provision.

It is important to note that general circumstances of *In re Walt Disney* are distinguishable from *Van Gorkom* on a number of grounds. The *Trans Union* board's decision to enter into a merger agreement required board approval under Delaware statute.⁸⁹ No decision of the full *Disney* board of the OEA was required by statute. Furthermore, the board's decision-making authority was actually delegated to the compensation committee.⁹⁰ Moreover, the court in *Van Gorkom* evaluated the action of the *Trans Union* board as a collective group, whereas the action of the *Disney* directors was considered individually.⁹¹ The decision of the *Trans Union* board concerned a merger, one of the most important occurrences in the life of a corporation.⁹² *In re Walt Disney* concerned an executive compensation matter.

Similarly the specific facts of *In re Walt Disney* are also distinguishable from *Van Gorkom* in terms of the informed decision-making of: (1) the compensation committee and board concerning the OEA; and (2) the board's hiring *Ovitz* as President. Regarding the compensation committee, although the *Disney* compensation committee did not have a copy of the OEA when approved, the committee had a "term sheet" describing the NFT provisions, which was attached to the meeting minutes.⁹³ Furthermore, the committee members were apprised of the potential value of the NFT.⁹⁴ The committee reviewed various spreadsheets that highlighted the "benchmarking" of the *Ovitz* options to prior options the compensation committee had approved for other executives in order to give the members a fair idea of the value in the event of NFT.⁹⁵ The committee was also well aware of the "downside" protection of \$150 to \$200 million that *Ovitz* was demanding before leaving his company.⁹⁶ Moreover, the committee's failure to specifically discuss the gross negligence and malfeasance event triggers of the NFT was not concerning because "those terms 'were not foreign to the board of directors, as the language was

⁸⁷ 488 A.2d 858.

⁸⁸ 787 A.2d 85, 93.

⁸⁹ See 8 Del. C. § 251(b).

⁹⁰ 2006 WL 1562466, at 16.

⁹¹ *Id.* at 17.

⁹² *Van Gorkom*, 488 A.2d at 867.

⁹³ 2006 WL 1562466, at 18-19.

⁹⁴ *Id.* at 19.

⁹⁵ *Id.* at 19.

⁹⁶ *Id.* at 20.

standard, and could be found, for example, in Eisner's, Wells', Katzenberg's and Roth's employment contracts.”⁹⁷ Finally, although the expert consultant was not present at the compensation committee meeting, Crystal had worked on similar Disney agreements before, met with some of the committee members prior to the meeting and was available by telephone to answer questions.⁹⁸ Only after receiving the information and presentations and deliberating on the matter, did the compensation committee approve the terms of the OEA.

While the deliberations of the Disney compensation committee fell short of “best practices,”⁹⁹ the deliberation process of the Trans Union board stands in sharp contrast. In *Van Gorkom*, the meeting was called on short notice and there was no documentary information for the Trans Union board to consider and little in terms of presentations.¹⁰⁰ The management of Trans Union was opposed to the merger.¹⁰¹ After board approval of the merger agreement, *Van Gorkom* revised the agreement in a manner inconsistent with the board’s authorization.¹⁰² Finally, the Trans Union board did not have expert reports that it could rely on and engaged in little deliberations.

Moreover, the facts surrounding the actions of the full board in the hiring of Ovitz as President are also distinguishable from *Van Gorkom*. The Disney board had spent substantial time over a course of several years debating the hiring of a new President and the potential candidates, including Ovitz.¹⁰³ The board was also aware that hiring Ovitz would result in him leaving a highly successful company and that the market reacted positively to Disney’s announcement that Ovitz would come to work with them.¹⁰⁴ Finally, the board was aware of the compensation committee’s approval of the OEA and received presentations regarding its terms.¹⁰⁵

These distinctions make it possible to conclude that *Van Gorkom* and *In re Walt Disney* are not inconsistent with each other. The Delaware Supreme Court did not rely specifically on these distinctions, however, in writing its opinion and did not even cite *Van Gorkom*.¹⁰⁶ The main theme stressed was the requirement that a decision maker become informed of material information reasonably available, not necessarily being privy to all conversations and documents.¹⁰⁷ Further, the Disney board members were protected under 8 Del. C. § 141(e) for good faith reliance on the professional report prepared by the compensation consultant, Crystal.¹⁰⁸ While the Court generally

⁹⁷ *Id.* at 20 (citing 2005 WL 2056651 at 9 n. 81).

⁹⁸ 2006 WL 1562466, at 21.

⁹⁹ *Id.* at 19-20.

¹⁰⁰ *Van Gorkom*, 488 A.2d at 874-78.

¹⁰¹ *Van Gorkom*, 488 A.2d at 867-68.

¹⁰² *Van Gorkom*, 488 A.2d at 883-84.

¹⁰³ *Id.* at 22.

¹⁰⁴ *Id.* at 21-22.

¹⁰⁵ *Id.* at 23.

¹⁰⁶ While the Supreme Court did not cite *Van Gorkom*, the Delaware Chancery Court decision that the Court affirmed cited *Van Gorkom* more than twenty times and specifically drew upon the distinctions between the cases. *In re Walt Disney Co. Derivative Litigation*, 2005 WL 2056651 (Del. Ch.).

¹⁰⁷ 2006 WL 1562466, at 21-22.

¹⁰⁸ *Id.* at 21.

distinguished the type of informed board decision-making made by the Disney compensation committee and board, it did not specifically rely on any of the other factual distinctions between the two cases. Moreover, the theme of gross negligence strongly emphasized in *Van Gorkom* was seemingly replaced by one that best practices are not mandated to ensure business judgment rule protections.

In upholding the Court of Chancery's decision on the due care issue in favor of the board members and Ovitz actions concerning the OEA, the Court characterized the actions of the Disney compensation committee as failing "best practices" from an informed decision-making standpoint. A simple failure to exercise best practices is not below the requisite exercise of due care, in contrast to the type of decision-making in *Van Gorkom*.¹⁰⁹ The true issue to be resolved, according to the Court, was whether the compensation committee, when approving the OEA, and board, when appointing Ovitz as President, were "were fully informed of all material facts."¹¹⁰ Yet, the court still retained the general rule that board members should not be liable for due care errors in the absence of gross negligence.¹¹¹

In re Walt Disney Co. raises the question of the reach of the gross negligence standard for due care in the executive compensation context. How close to best practices must compensation committees come? If courts define the due care obligation broadly, executive compensation and employment decisions appear to require the same type of information gathering, expert hiring and other processes used in more complicated transactions, such as mergers. This seems particularly onerous in the differing contexts of the life of a corporate enterprise. While in *Van Gorkom*, the board's decision-making related to a cash out merger that would end the life of Trans Union, no similar magnitude of decision-making exists in the executive compensation arena of *In re Walt Disney*. Despite the passage of section 102(b)(7), the Court's extensive consideration of due care obligations suggests that these obligations are alive and well. So, what is role of section 102(b)(7)?

b. The Emergence of a Good Faith Element

Much of the initial portion of the Court's *In re Walt Disney* decision works over the due care analysis in the executive compensation context. Disney, however, had a Section 102(b)(7) exculpation clause in its charter documents. Therefore, even if the plaintiffs had prevailed on an informed decision-making claim, it would not be enough to impose liability. To get around the section 102(b)(7) exculpation, the shareholders claimed the compensation committee and board acted in bad faith. Much has been written about the duty of good faith requirement arising under section 102(b)(7) prior to the decision *In re Walt Disney*, but this was truly the Court's opportunity to provide some guidance.¹¹²

¹⁰⁹ 2006 WL 1562466, at 18-19.

¹¹⁰ *Id.* at 22-23.

¹¹¹ *Id.* at 17, 22.

¹¹² For articles concerning the Disney litigation, see, e.g., Robert Baker, *In Re Walt Disney: What It Means To The Definition Of Good Faith, Exculpatory Clauses, and the Nature of Executive Compensation*, 4 FLA. ST. U. BUS. REV. 261 (2004-2005); Tara L. Dunn, *The Developing Theory of Good Faith In Director Conduct: Are Delaware Courts Ready To Force Corporate Directors To Go Out-Of-Pocket After Disney*

The efforts of the Court to clarify good faith under section 102(b)(7) are in the end probably more confusing than illuminating without a clear factual application illustrating bad faith. Most importantly, the Court emphasized that the duty of care and duty of good faith were separate. Thus, the shareholders' "effort to collapse the duty to act in good faith into the duty to act with due care, is not unlike putting a rabbit into the proverbial hat and then blaming the trial judge for making the insertion."¹¹³ As the Court had already concluded that the plaintiffs could not prevail on their duty of care arguments, treating good faith in the same manner would not have changed the outcome on these facts.¹¹⁴ The Court's analysis could have ended here.

Nevertheless, the Court decided to address plaintiffs legal claims regarding good faith in order to provide "some conceptual guidance to the corporate community."¹¹⁵ The Court classified corporate behavior as involving three categories of behaviors that could be considered in the bad faith analysis.¹¹⁶ First, "subjective bad faith" where there is an actual intent to harm that is shown to have occurred.¹¹⁷ This conduct would certainly constitute bad faith for purposes of section 102(b)(7). Second, conduct that is simply a lack of due care, gross negligence.¹¹⁸ This conduct, without more, would not constitute bad faith for purposes of section 102(b)(7). To conclude otherwise, would eviscerate the purpose of the statute.¹¹⁹ The third category of conduct is that which falls between the first two. "[S]uch misconduct is properly treated as a non-exculpable, non-indemnifiable

IV?, 83 DENV. U.L.REV. 531 (2005). For a general discussion of the good faith exception to exculpation, see, e.g., Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L.REV. 456 (2004); Matthew R. Berry, *Does Delaware's Section 102(b)(7) Protect Reckless Directors From Personal Liability? Only if Delaware Courts Act in Good Faith*, 79 WASH. L.REV. 1125 (2004); John L. Reed and Matt Neiderman, *Good Faith and the Ability of Directors to Assert § 102(b)(7) of the Delaware Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111 (2004); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491 (2004); Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1 (2005) (Hereinafter "Griffith"); Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 DEL. J. CORP. L. 1 (2005); Filippo Rossi, *Making Sense of the Delaware Supreme Court's Triad of Fiduciary Duties* (June 22, 2005), available at <http://ssrn.com/abstract=755784> (last visited July 18, 2006); Christopher M. Bruner, "Good Faith," State of Mind, and the Outer Boundaries of Director Liability in Corporate Law (Boston Univ. Sch. of Law Working Paper No. 05-19), available at <http://ssrn.com/abstract=832944> (last visited July 19, 2006); Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism Threatening the Thaumatrope*, 61 BUS. LAW, 1 (2005)

¹¹³ 2006 WL 1562466, at 24.

¹¹⁴ *Id.* at 24.

¹¹⁵ *Id.* at 24 (italics supplied).

¹¹⁶ *Id.* at 25.

¹¹⁷ *Id.* at 25.

¹¹⁸ *Id.* at 25.

¹¹⁹ *Id.* at 25-26. The Court also concluded that the Delaware indemnification statute also supported a differentiation between the failures of the duty of care and those of good faith. See 8 Del. C. § 145. The statute allows for indemnification in proceedings where the person "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation . . ." 8 Del. C. §§ 145(a) & (b). Since "a director or officer of a corporation can be indemnified for liability (and litigation expenses) incurred by reason of a violation of the duty of care, but not for a violation of the duty to act in good faith" the two inquiries must be different. 2006 WL 1562466, at 26.

violation of the fiduciary duty to act in good faith.”¹²⁰

The Court included in this category of bad faith the conduct described in the Delaware Chancery Court opinion as a “conscious[] and intentional[] disregard[] [of] responsibilities, adopting a ‘we don't care about the risks' attitude”¹²¹ Quite naturally, the duty of good faith should “protect the interests of the corporation and its shareholders” from conduct that “does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence”¹²² Furthermore, section 102(b)(7) itself distinguishes misconduct that is intentional from conduct that is not in good faith, though both are non-exculpable.¹²³

Questions about good faith remain unaddressed in the wake of the Court's decision. The holding places deliberate bad intent by corporate boards and grossly negligent conduct at the opposite ends of the good faith continuum. On the other hand, the Court gives limited guidance of where on that continuum specific types of board behavior fall. For instance, behavior that may involve the exact type of risk taking expected by shareholders. If there is a potential that courts will classified this behavior as bad faith, boards may become risk averse to the detriment of shareholders. Further, the Court specifically did not determine the limits of the final category of fiduciary conduct. “To engage in an effort to craft . . . ‘a definitive and categorical definition of the universe of acts that would constitute bad faith’ would be unwise”¹²⁴ Most importantly, the Court did not “reach or otherwise address the issue of whether the fiduciary duty to act in good faith is a duty that, like the duties of care and loyalty, can serve as an independent basis for imposing liability upon corporate officers and directors.”¹²⁵ The Court left open that allegations of bad faith could be a separate claim against boards and committees, such as the compensation committee that approved the OEA.¹²⁶ These questions and others that remain unresolved in the wake of *In re Walt Disney*. It has been left to the lower courts to struggle with some of these issues regarding application of the duty of care and good faith analysis.

c. Executive Compensation as Waste

¹²⁰ 2006 WL 1562466, at 26.

¹²¹ 2006 WL 1562466, at 24, 26, quoting 2005 WL 2056651, at 36 (Del. Ch.).

¹²² 2006 WL 1562466, at 26. The Chancellor had described the relation of the types of fiduciary conduct:

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

2005 WL 2056651, at 36 (Del. Ch.)(footnotes deleted).

¹²³ 2006 WL 1562466, at 27.

¹²⁴ 2006 WL 1562466, at 27, *quoting* 2005 WL 2056651, at 36 (Del. Ch.).

¹²⁵ 2006 WL 1562466, at 27 n.112.

¹²⁶ 2006 WL 1562466, at 27 n.112.

The third category of cases where executive compensation packages may be actionable arises where board or committee decision-making may not involve a lack of informed decision-making, but the payment to the executive nevertheless constitutes waste. The Court of Chancery dismissed the shareholders' waste claim initially.¹²⁷ The Delaware Supreme Court allowed the shareholders to amend the complaint, but emphasized that "waste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade."¹²⁸ In fact, "[i]t is the essence of business judgment for a board to determine if 'a particular individual warrant[s] large amounts of money, whether in the form of current salary or severance provisions.'"¹²⁹ The clear conclusion to be drawn from the Court is that it is assuming the board's authority over the decision-making is broadly protected by the business judgment rule unless there is no "rational business purpose" for the decision.¹³⁰ To overcome this inference, a proper challenge to payments to an executive such as Ovitz would be "whether the amounts required to be paid in the event of an NFT were wasteful *ex ante*;" either the payment was not required by contract with the executive at all or was wasteful when entered into by the company.¹³¹

In *re* Walt Disney involves a fact pattern demonstrating that corporate boards have wide discretion in making large executive compensation payments without triggering liability for waste. For instance, at the time the payments were made to Ovitz, Disney was contractually obligated to pay Ovitz the NFT payments under the OEA.¹³² The board, therefore, is protected from a waste claim unless the OEA itself was wasteful.¹³³ An example of this kind of agreement would have been if the shareholders could have proved that the OEA itself "incentivized Ovitz to perform poorly in order to obtain payment of the NFT provisions."¹³⁴ The OEA, however, was designed to financially incentivize Ovitz to leave his prior company and join Disney.¹³⁵ There was certainly no evidence that Ovitz had sought to intentionally get himself fired, a claim the Court rejected as "fanciful."¹³⁶ Finally, at the time Disney exercised the NFT provisions, the board members believed that Disney would be better off without Ovitz, but that termination for cause was not an option.¹³⁷

In *re* Walt Disney solidifies the Court's prior rulings on waste concluding that "[a] claim of waste will arise only in the rare, "unconscionable case where directors irrationally

¹²⁷ Brehm, 746 A.2d at 263.

¹²⁸ Brehm, 746 A.2d at 263. The Delaware Supreme Court has addressed waste in other cases as well. *See*, *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del.1971); *see also Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del.1995); *Kerbs v. California Eastern Airways*, 90 A.2d 652, 656 (Del.1952).

¹²⁹ Brehm, 746 A.2d at 263 (*quoting* *In re The Walt Disney Co. Derivative Litig.*, 731 A.2d at 362 (*quoting* *Grimes v. Donald*, Del.Supr., 673 A.2d 1207, 1215 (1996))).

¹³⁰ 2006 WL 1562466, at 33.

¹³¹ *Id.*, at 33.

¹³² *Id.*, at 33.

¹³³ *Id.*, at 33.

¹³⁴ *Id.*, at 33.

¹³⁵ *Id.*, at 33.

¹³⁶ *Id.*, at 33.

¹³⁷ *Id.*, at 33.

squander or give away corporate assets.”¹³⁸ Because of the wide discretion given to boards in compensation matters, waste is not likely to be a successful claim for shareholders unhappy about a board’s decisions and will not result in much, if any, legal oversight over compensation matters.

III. The Benefits of the SEC’s Disclosure Approach to Executive Compensation

The Proposed Regulations contain extensive provisions designed to improve the SEC's ability to ensure that shareholders have a “more complete picture of the compensation earned by a company’s principal executive officer, principal financial officer and highest paid executive officers and members of its board of directors.”¹³⁹ The Proposed Regulations would not only strengthen the existing disclosure system by expanding the format for and types of executive compensation information covered, but also address more fully “key financial relationships among companies and their executive officers, directors, significant shareholders and their respective immediate family members.”¹⁴⁰ The SEC intends the Proposed Regulations to enhance the strengths of the current reporting system, rather than forging ahead in a different direction.¹⁴¹

Disclosure of executive compensation issues raises complex questions. What should the SEC include in compensation? When was compensation paid to an executive? How was the compensation paid? How and when should compensation be valued? How can the format of disclosure provide meaningful data that the public can use for comparative purposes? The SEC has attempted to address the breadth of these issues in the Proposed Regulations, sometimes with more success and clarity for some items than for others.

A. Compensation Discussion and Analysis Will Explain Compensation Policy

One of the major improvements contained in the Proposed Regulations is the new requirement of a Compensation Discussion and Analysis (CD&A) narrative intended to relay “material factors underlying compensation policies and decisions” related to the information set forth in the required tables.¹⁴² Simplified, the CD&A would give context to the tabular disclosure and explain material elements of the company’s compensation relative to the named executives, including: (1) the objectives of the compensation program; (2) the actions the company rewards through the compensation program; (3) the individual elements included in the compensation program; (4) the rationale supporting particular elements of the compensation program; (5) the reasoning behind the amounts chosen for each element; and (6) how the choices surrounding the elements fit with the

¹³⁸ *Id.*, at 33 (quoting Brehm, 746 A.2d at 263).

¹³⁹ Proposed Regulations, 71 Fed. Reg. at 6542.

¹⁴⁰ Proposed Regulations, 71 Fed. Reg. at 6542.

¹⁴¹ Proposed Regulations, 71 Fed. Reg. at 6543.

¹⁴² Proposed Regulations, 71 Fed. Reg. at 6544-6547. See also, Jeffrey Gordon, *Executive Compensation: If There’s a Problem, What’s the Remedy? The Case for “Compensation Discussion and Analysis,”* 30 J. CORP. L. 675, 702 (2005)(arguing for a CD&A signed by the compensation committee members and submitted to the shareholders for approval).

compensation objectives as a whole.¹⁴³ The SEC intends the CD&A not to be a “boilerplate” discussion.¹⁴⁴ For this reason, compliance with the Proposed Regulations could have a substantial impact on companies by requiring them for the first time to set out compensation policies in a detailed manner.

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

Along with the CD&A, the revisions to the compensation tables are significant in terms of the amount of disclosure that will be made to the public.¹⁴⁵ The compensation tables themselves would include expanded disclosure for: (1) executive compensation for the last fiscal year, including deferred compensation; (2) equity related interests relating to compensation; and (3) retirement and post employment compensation and benefits.¹⁴⁶ The revisions are intended to provide more clarity to the presentation by organizing disclosure around “themes,” while confirming that companies must disclose all elements of executive compensation.¹⁴⁷ For instance, the Summary Compensation Table contemplated by the Proposed Regulations requires companies to disclose compensation of named executive officers for the last three years,¹⁴⁸ including a total compensation

¹⁴³ Proposed Regulations, 71 Fed. Reg. at 6545. For instance, a company would include in its CD&A discussion of the policies underlying decisions to allocate compensation between current and long-term compensation; allocating payments between cash and non-cash compensation, such as stock and stock options; regarding benchmarking of executive compensation packages; and regarding the involvement of executives in the compensation process. *Id.* at 6546.

¹⁴⁴ Proposed Regulations, 71 Fed. Reg. at 6546.

¹⁴⁵ Among other things, the Summary Compensation Table contemplated by the Proposed Regulations requires companies to disclose compensation of named executive officers for the last three years. Proposed Regulations, 71 Fed. Reg. at 6547-48. A narrative discussion would follow the table to disclose material information needed to understand the presentation in the tables. *Id.* at 6548. Additionally, the two supplemental tables will break down and explain information from the summary table. *Id.* at 6555-57. See also, Comment of Lucian Bebchuk, at 4, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/lbebchuk5984.pdf> (last visited July 6, 2006)(explaining that the “all other compensation” figure may be quite large for some companies and that breakdown is necessary for clarity).

¹⁴⁶ Proposed Regulations, 71 Fed. Reg. at 6544, 6547-6568. The SEC contemplates three tables that work together: Summary Compensation Table; Grants of Performance-Based Awards Table; and Grants of All Other Equity Awards Table. *Id.* at 6547 n. 63.

¹⁴⁷ Proposed Regulations, 71 Fed. Reg. at 6545. It had come to the SEC’s attention at some companies believed that selected executive compensation figures are not currently required to be disclosed in the tables because they do not precisely fit in the existing tabular format. *Id.* at 6545 n.51 (citing, The Corporate Counsel at 6-7 (Sept.–Oct. 2005); The Corporate Counsel at 7 (Sept.–Oct. 2004); Alan L. Beller, Director, Division of Corporation Finance, U.S. Securities and Exchange Commission, Remarks Before Conference of the NASPP, The Corporate Counsel and the Corporate Executive (October 20, 2004) (indicating that the explicit language of the current rules requires disclosure of such items), *available at* www.sec.gov/news/speech/spch102004alb.htm (last visited July 11, 2006)).

¹⁴⁸ Proposed Regulations, 71 Fed. Reg. at 6547-48. A narrative discussion would follow the table to disclose material information needed to understand the presentation in the tables. *Id.* at 6548. Additionally, the two supplemental tables will break down and explain information from the summary table, which should provide a better picture of the elements of additional compensation in particular. *Id.* at 6555-57. See also, Comment of Lucian Bebchuk, at 4, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/lbebchuk5984.pdf> (last visited July 6,

column intended to require disclosure in a single number of aggregate amounts of compensation of all types.¹⁴⁹ Moreover, the “all other compensation” column includes a number of important disclosure items, including perquisites and personal benefits,¹⁵⁰ but is limited to avoid disclosure of items that are *de minimus* (less than \$10,000 in the aggregate).¹⁵¹ This will discourage companies from using perquisites, retirement benefits, lucrative severance packages and other compensation in a means to avoid public disclosure of compensation, what some have termed “stealth compensation.”¹⁵² Finally, the Proposed Regulations also tackle the large amounts corporations pay to executives in the form of retirement, or like in the case of Ovitz, post employment payments.¹⁵³

2006)(explaining that the “all other compensation” figure may be quite large for some companies and that breakdown is necessary for clarity).

¹⁴⁹ Proposed Regulations, 71 Fed. Reg. at 6547-48.

¹⁵⁰ The test for inclusion rests on whether the item is “integrally and directly” related to the executive’s job, and would include items “such as use of company-provided aircraft, yachts or other watercraft, commuter transportation services, additional clerical or secretarial services devoted to personal matters, or investment management services.” Proposed Regulations, 71 Fed. Reg. at 6553-54 (detailing numerous examples of perquisites requiring disclosure). This disclosure is on the aggregate incremental cost to the company, rather than the market value of such perquisites. Proposed Regulations, 71 Fed. Reg. at 6554. *But see*, Comment of Rep. Barney Frank, Ranking Member, Committee on Financial Services, U.S. House of Representatives, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/bfrank041006.pdf> (last visited July 12, 2006)(arguing for market valuation approach).

¹⁵¹ Proposed Regulations, 71 Fed. Reg. at 6551. First, companies will finally be obliged to report an executives earnings on non-tax qualified deferred compensation in all cases, rather than just if the earnings are above-market or preferential. Proposed Regulations, 71 Fed. Reg. at 6552. *But see*, Comment of Steve Odland, Business Roundtable, at 4, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/sodland041006.pdf> (last visited July 12, 2006)(arguing that this item should not be changed as market rate earnings simply represent what an executive would earn investing the compensation on their own if not deferred). Second, the disclosure of increases in the actuarial value to executives of pension plans may result in disclosure of a significant element of compensation. Proposed Regulations, 71 Fed. Reg. at 6552; Comment of Lucian Bebchuk, at 4, located at Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/lbebchuk5984.pdf> (last visited July 6, 2006); *Stealth Compensation*, 1 BERKELEY BUS. L. J. at 140-41; *Executive Pensions*, 30 J. CORP. L. at 854-56. Finally, companies would be required to disclose perquisites and personal benefits if they aggregate to \$10,000 or more. Proposed Regulations, 71 Fed. Reg. at 6551-54. This requirement also adds footnote disclosure that specifically, rather than generally, identifies the perquisites or personal benefits and requires valuation of those valued at greater than \$25,000 or ten percent of the perquisites. *Id.* at 6553. *But see*, Comment of Lucian Bebchuk, at 5, located at Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/lbebchuk5984.pdf> (last visited July 6, 2006)(suggesting that companies should also be required to disclose post-retirement perks).

¹⁵² *See* Comment of Lucian Bebchuk, at 3, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/lbebchuk5984.pdf> (last visited July 6, 2006); *Stealth Compensation*, 1 BERKELEY BUS. L. J. at 123-124, 128-132; *Executive Pensions*, 30 J. CORP. L. at 827-832.

¹⁵³ Proposed Regulations, 71 Fed. Reg. at 6560-63. First, companies will disclose estimated annual retirement payments that an executive officer is currently entitled to or will become upon eligible for retirement under defined benefit plans. *Id.* at 6560-61. Second, companies will disclose data regarding nonqualified defined contribution and other deferred compensation plans. *Id.* at 6561. Finally, and perhaps most importantly, companies will now be required to disclose in narrative form arrangements with executives for payments in the event of “resignation, severance, retirement or other termination, . . . a change in his or her responsibilities, or a change of control of the company.” *Id.*

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

Further, the Proposed Regulations also add new disclosure requirements and strengthen some existing disclosure. First, the Proposed Regulations contemplate compensation disclosure for the three most highly compensated employees who earn more than the executive officers or directors, but *who are not themselves executive officers*.¹⁵⁴ Second, the SEC believes that a table disclosing director compensation in a format similar to the Summary Compensation Table for executives is also in order because of the emergence of more complicated director compensation packages that often include company stock and incentive plans.¹⁵⁵ Finally, the Proposed Regulations take the stance that executive compensation is also linked to financial transactions between companies and their directors and significant shareholders, warranting disclosure.¹⁵⁶

D. Filing of the Disclosure will Create Liability for Misstatements

Importantly, under the current rules, the Compensation Committee “furnishes” to the SEC a required “Compensation Committee Report and Performance Graph” which does not create potential liability under the 1933 Act or Exchange Act.¹⁵⁷ The Report and Performance Graph are eliminated under the Proposed Regulations.¹⁵⁸ Under the Proposed Regulations, the CD&A, tables and accompanying narrative will be considered “soliciting material” and will be “filed” with the SEC.¹⁵⁹ The effect is that the disclosure

¹⁵⁴ Proposed Regulations, 71 Fed. Reg. at 6544. This requirement has been criticized particularly by those companies in the entertainment industry as onerous, an invasion of privacy of entertainers and unrelated to decisions relative to executive compensation. *See, e.g.*, Linda Rappaport and George Spera, Shearman & Sterling, LLP, on behalf of CBS Corporation, The Walt Disney Company, NBC Universal (a majority-owned subsidiary of General Electric Company), News Corporation, and Viacom Inc., at 1-2, Securities and Exchange Commission Website, *available at*

<http://www.sec.gov/rules/proposed/s70306/shearmansterling041006.pdf> (last visited July 6, 2006); Comment of Pearl Meyer & Partners, at 10, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/jrich7010.pdf> (last visited July 12, 2006); Comment of Steve Odland, Business Roundtable, at 2, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/sodland041006.pdf> (last visited July 12, 2006); Comment of Dixie Johnson, ABA Section on Business Law, at 32, Securities and Exchange Commission Website, *available at* <http://www.sec.gov/rules/proposed/s70306/djohnson051506.pdf> (last visited July 12, 2006).

¹⁵⁵ Proposed Regulations, 71 Fed. Reg. at 6544, 6564-65. *See also, e.g.*, National Association of Corporate Directors and Pearl Meyer & Partners, 2003–2004 Director Compensation Survey (2004); National Association of Corporate Directors, Report of the NACD Blue Ribbon Commission On Director Compensation (2001); Dennis C. Carey, et al. How Should Corporate Directors Be Compensated?, Investment Dealers’ Digest Inc. — Special Issue:Boards and Directors (Jan. 1996).

¹⁵⁶ Proposed Regulations, 71 Fed. Reg., at 6544, 6571-82. The requirements anticipate companies will broadly disclose certain transactions, including indebtedness, with related persons, where the amount exceeds \$120,000. *Id.* at 6572. Furthermore, corporate policies and procedures for related party transactions would also be subject to disclosure. *Id.* at 6576. This disclosure will be consolidated with other existing disclosure items related to corporate governance, such as a narrative about director independence. *Id.* at 6545, 6577-78.

¹⁵⁷ Proposed Regulations, 71 Fed. Reg., at 6544, 6546.

¹⁵⁸ Proposed Regulations, 71 Fed. Reg., at 6544, 6546-47.

¹⁵⁹ Proposed Regulations, 71 Fed. Reg., at 6544, 6546.

of executive compensation information will be a company report certified by the executives, rather than just furnished by the compensation committee of the board.¹⁶⁰ This change would now create liability for misstatements under the Exchange Act for every company that is subject to the rules.

The filing of the information will result in more executive involvement in compensation matters and particularly how they are disclosed.¹⁶¹ There is no reason to believe, though, that executive involvement in this disclosure aspect of compensation matters will affect compensation committee decision-making at the time the compensation is approved. The SEC is convinced that company responsibility over the disclosure of board matters as a filed item in this instance is the means to ensure full disclosure.

With all this information disclosure, what impact will the Proposed Regulations actually have on executive compensation decision-making? Will the shareholders have remedies for excessive executive compensation?

IV. Why the Proposed Regulations Won't Fix Excessive Compensation: Consequences of Dual Regulation

Information disclosure is important and helpful to the investing public. Finalizing the Proposed Regulations alone, though, will not accomplish the task of making corporate decision-makers accountable for compensation decisions. Since its formation, the SEC's mission has been focused on the disclosure of accurate information to the public. The SEC will undoubtedly engage in involved review of information submitted by companies. The SEC will not, and has not been, however, in the business of merit-review of executive compensation. Nevertheless, Chairman Cox is hoping "that when people are forced to undress in public, they'll pay more attention to their figures."¹⁶²

The SEC acts as a repository for financial and other data on executive compensation. Aside from material misstatements contained in filed information, SEC involvement ends after filing. Sifting through the data will be a task for investors, and particularly, institutional investors. While it may be possible for the investing public to rise to this challenge, much depends on whether the public will be motivated and able to curb perceived abuses. SEC disclosure mandates for executive compensation disclosure have been in place since 1938. While in 1940 half of the executives earned fifty-six times the average worker's pay, by 2004 the number increased to one hundred four times the

¹⁶⁰ Proposed Regulations, 71 Fed. Reg., at 6544, 6546.

¹⁶¹ See, e.g., Comment of Steve Odland, Business Roundtable, at 2, Securities and Exchange Commission Website, available at <http://www.sec.gov/rules/proposed/s70306/sodland041006.pdf> (last visited July 12, 2006); Comment of Dixie Johnson, ABA Section on Business Law, at 4-5 Securities and Exchange Commission Website, available at <http://www.sec.gov/rules/proposed/s70306/djohnson051506.pdf> (last visited July 12, 2006); Comment of Pearl Meyer & Partners, Securities and Exchange Commission Website, available at <http://www.sec.gov/rules/proposed/s70306/jrich7010.pdf> (last visited July 12, 2006).

¹⁶² Stephen Labaton, *Spotlight on Pay Could Be a Wild Card*, New York Times, April 9, 2006 at Sec. 3, p. 1.

average worker's pay.¹⁶³ If the past is any guide, improved transparency will not operate as a check on the amount of executive compensation paid.¹⁶⁴

Even if companies fully report and shareholders receive and are able to understand the executive compensation data as more fully disclosed under the Proposed Regulations, shareholders still confront serious obstacles. The SEC only regulates accurate disclosure. The rest is left to state law. Let us assume the Proposed Regulations were in effect when the Disney compensation committee approved the OEA. State law only controls whether compensation decisions are made complying with due care procedures for informed decision-making, in good faith, and are not wasteful. Even with the information that the Proposed Regulations would have required Disney to disclose to the shareholders about the OEA, the Delaware Supreme Court concluded that that the OEA was approved with due care, in good faith and was not wasteful.¹⁶⁵ This leaves a gap between information disclosure and the shareholder's ability to hold decision-makers accountable for compensation packages that the shareholders perceive to be excessive. Unfortunately, the fundamental problem with executive compensation decision-making is not as simple as information disclosure. There are the lingering issues of accountability and shareholders' ability to react to the information. Is the only goal of the Proposed Regulations to provide shareholders information prior to purchasing shares?

The SEC's focus on expanded disclosure of executive compensation information -- excessive or otherwise-- will undoubtedly have consequences for executive compensation.¹⁶⁶ Companies may change policies away from certain compensation elements that must be disclosed to ones that are more useful and link pay to performance.¹⁶⁷ Disclosure will not fully address the issues of executive compensation for a number of reasons. First, compensation decisions raise issues of arms-length dealing and managerial influence over the compensation process. Second, shareholders desiring to respond to the enhanced information disclosure may find they have little recourse beyond selling their shares, which is not always a viable alternative. Third, the ability of shareholders to challenge board decisions on compensation issues directly or by removing directors is limited, suggesting that accountability is lacking. Finally, while disclosure is an important regulatory mechanism, it is not substantive regulation. This section will discuss some of the reasons that collectively impact why the Proposed Regulations are not likely to have significant effect on board decision-making involving executive compensation.

¹⁶³ Eric Dash, *Off to the Races Again, Leaving Many Behind*, New York Times, April 9, 2006, at Sec. 3, p. 1.

¹⁶⁴ In fact, one poll of human resources consulting firm Watson Wyatt Worldwide concluded that most American companies did not plan to change their programs. See, Stephen Labaton, *Spotlight on Pay Could Be a Wild Card*, New York Times, April 9, 2006, at Sec. 3, p. 1. In the past, every time that the SEC has mandated additional disclosure, executive pay has actually increased. *Id.* at p. 10.

¹⁶⁵ 2006 WL 1562466.

¹⁶⁶ See, Stephen Labaton, *Spotlight on Pay Could Be a Wild Card*, New York Times, April 9, 2006, at Sec. 3, p. 1 (discussing Lucian Bebchuk's prediction that companies may change compensation packages to more useful elements once public disclosure reaches some of the formerly hidden elements).

¹⁶⁷ See, Stephen Labaton, *Spotlight on Pay Could Be a Wild Card*, New York Times, April 9, 2006, at Sec. 3, p. 10 (discussing Lucian Bebchuk's prediction that companies may change compensation packages to more useful elements once public disclosure reaches some of the formerly hidden elements).

A. Compensation Decisions May Be Different from Other Board Decisions

State law vests the corporate board with decision making for the company, to which the business judgment rule give protections, subject to the duties of care and loyalty.¹⁶⁸ Not all decisions that a corporate board makes, however, are treated the same in terms of the extent of judicial review and degree of protection by the business judgment rule. Plenty of examples exist, though they tend to fall into two categories of decisions: (i) where the board's independent decision-making is questioned and (ii) where the impact on the company will fundamentally affect the way in which the company will continue.

With respect to the first category, in Delaware, for instance, pre-suit demand on the board by shareholders in derivative actions is excused when "futile" due to doubt about the board disinterestedness or independence and doubt about whether the business judgment rule affords protection.¹⁶⁹ The rationale is that sometimes the board is "incapable, due to personal interest or domination and control, of objectively evaluating a shareholder demand, if made," and thereby exercising the board's decision-making authority for the corporation.¹⁷⁰ In a takeover situation, a board's decision to institute defensive tactics must be supported by a reasonable response to the threat posed since the takeover context presents the "omnipresent specter" that a board will act in its own best interests, rather than the shareholders' interests.¹⁷¹ Similarly, in the parent-subsidary context where the board's independence is questioned because the parent dominates the board, board decisions are subjected to a higher standard of scrutiny if there is evidence of self dealing.¹⁷² As another example, board decisions are subjected to heightened scrutiny in parent-subsidary mergers where there is evidence that the transaction was not negotiated at arms-length.¹⁷³

With respect to the second category, there are some decisions which cannot be made by the board alone due to the affect on the company as an ongoing entity. For instance, the following decisions require the board to submit the matter to the shareholders after board vote: (i) approval of mergers;¹⁷⁴ (ii) approval of amendments to the certificate of incorporation;¹⁷⁵ and (iii) approval of certain business combinations involving interested shareholders.¹⁷⁶ Additionally, shareholders can propose amendments to the company's bylaws by their own initiative.¹⁷⁷

¹⁶⁸ See, e.g., 8 Del.C. § 141.

¹⁶⁹ Aronson v. Lewis, 473 A.2d 805, 814, 816 (DE. 1984); Brehm, 746 A.2d at 256.

¹⁷⁰ Brehm, 746 A.2d at 257. See also, Dennis J. Block et al., *Derivative Litigation: Current Law Versus the American Law Institute*, 48 Bus.Law. 1443, 1444 (1993) ("[C]ourts both in and out of Delaware have ruled with near unanimity ... that the business judgment rule is the appropriate standard of judicial review in cases where an independent majority of a corporation's board of directors determines that litigation on behalf of the corporation will not serve the best interests of the corporation.").

¹⁷¹ See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (DE. 1985).

¹⁷² See Sinclair Oil Corp. v. Levien, 280 A.2d 717 (DE. 1971).

¹⁷³ See Weinberger v. UOP, Inc., 457 A.2d 701 (DE. 1983).

¹⁷⁴ See, e.g., 8 Del.C. § 251.

¹⁷⁵ See, e.g., 8 Del.C. § 242.

¹⁷⁶ See e.g., 8 Del.C. § 203.

¹⁷⁷ See 8 Del. C. § 109(b).

Compensation decisions share some of the characteristics of both categories of decision. With respect to the first category where the board's independence might be in doubt, it is easy to question whether corporate boards bargain at arms-lengths with executives over compensation matters and remain faithful to shareholder interests.¹⁷⁸ Recent empirical work by Professors Randall Martin and Stewart Schwab examining the contracts of CEOs concluded that "CEOs have significant bargaining power in their negotiations over the terms of their employment contracts and change-in-control agreements."¹⁷⁹

A number of questions exist regarding the board's ability to engage in arms-length contracting with CEOs. First, directors may be motivated to make arrangements favorable to executives out of "collegiality, team spirit, a natural desire to avoid conflict within the board team, and sometimes friendship and loyalty . . ." ¹⁸⁰ Second, directors might not have enough time, resources or connection to a company themselves through stock ownership and otherwise to take on the difficult and sometimes unpleasant job of tough negotiations with a current or future executive over compensation.¹⁸¹ Third, board members might certainly be motivated by a desire to be reelected to the board.¹⁸² Reelection requires a board member to be nominated to the company slate.¹⁸³ Nomination, typically by a nominating committee, is often heavily influenced by the same executives whose compensation the board members approve.¹⁸⁴ Fourth, the ability of the executives to benefit the directors through director compensation packages, charitable giving and other business dealings with companies with which the director is associated suggest a picture of entangled interests.¹⁸⁵ Finally, the "managerial power" approach asserts simply that powerful executives are able to receive higher compensation packages less sensitive to performance from corporate boards.¹⁸⁶

¹⁷⁸ See, e.g., Pay Without Performance, *supra* note 1, at 23-44; Roberta Karmel, *Realizing the Dream of William O. Douglas-The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 Del. J. Corp. L. 79, at 104 (2005) (describing executive compensation decisions as "self-dealing"); Kenneth West, Pay Without Performance: An Executive's Perspective, 30 J. CORP. L. 791, at 792-93 (2005) (describing board influence by managerial power). See also, Jennifer Hill & Charles M. Yablon, Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict, 25 U. NEW S. WALES L.J. 1 (2002) (executive compensation is a corporate governance problem arising out of managerial conflicts of interest). *But see*, Lowenstein, The Conundrum of Executive Compensation, *supra* note 1, at 15-17.

¹⁷⁹ Stewart Schwab and Randall Martin, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 WASH. LEE L. R. 231, 266 (2006).

¹⁸⁰ Pay Without Performance, *supra* note 1, at 4. See also, Kenneth West, *Pay Without Performance: An Executive's Perspective*, 30 J. CORP. L. at 792-93; Rik Kirkland, *The Real CEO Pay Problem*, FORTUNE, June 30, 2006 (reporting the findings of a PricewaterhouseCoopers poll that boards are having trouble controlling the size of executive compensation).

¹⁸¹ Pay Without Performance, *supra* note 1, at 4.

¹⁸² Pay Without Performance, *supra* note 1 at 24.

¹⁸³ Pay Without Performance, *supra* note 1 at 24.

¹⁸⁴ Pay Without Performance, *supra* note 1, at 25-6; Orin Kramer, *Pay Without Performance: The Institutional Shareholder Perspective*, 30 J. Corp. L. at 773-74 (arguing that directors want to be reelected and that reelection depends on what management and the other directors think, making it uncomfortable to push a CEO).

¹⁸⁵ Pay Without Performance, *supra* note 1, at 27-30.

¹⁸⁶ Pay Without Performance, *supra* note 1, at 5; Lucian Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002) (the "managerial

The connection to the second category of decisions impacting the way in which the company will continue is present, but seems not as strong. Although executive compensation decisions are often “material” ones to the company, the expenditure doesn’t typically amount to a large amount of the companies’ total assets.¹⁸⁷

Nevertheless, companies expect CEOs to have a great impact on the company’s future prospects and measure CEO success in terms of company stock performance, earnings growth, cost reduction, etc. Further, even the decision to hire a particular executive can have substantial effect on the market price for company stock. When Disney hired Ovitz, for instance, the release of the news caused the Disney stock price to jump 4.4% in a single day.¹⁸⁸

These reasons suggest that executive compensation decisions present issues that may distinguish them from other, more routine, board decisions. Whereas we can expect the board to negotiate at arms length in many situations, executive compensation decisions have characteristics of other areas in corporate governance where decision-making is normally subjected to additional processes or higher standards of review. Further, there are indices that even corporate managers and the corporate community have long perceived that compensation decisions are distinguishable from routine decision-making by: (1) New York Stock Exchange (NYSE) listing rules that require companies to have a compensation committee composed of “independent directors” which operate under a written charter describing the responsibilities of the committee;¹⁸⁹ (2) hiring compensation consultants, preparation of spreadsheets and similar documents; and (3)

power approach" explains board deviance from optimal executive compensation packages due to the board’s influence by or sympathy to the executives). For a critical discussion of the managerial power approach used to explain the rise in executive compensation, see Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 1 (2003).); Michael Dorff, *Does One Hand Wash the Other? Testing the Managerial Power and Optimal Contracting Theories of Executive Compensation*, 30 IOWA J. CORP. L. 255 (2005)(concluding that managerial power affects director’s decisions to give higher compensation packages to executives). A Watson Wyatt Worldwide survey of directors and institutional investors found that while only forty-eight percent of directors think that executives heavily influence executive pay decisions, eighty-seven percent of institutional investors believe executives heavily influence the process. Watson Wyatt Worldwide, *Corporate Directors Give Executive Pay Model Mixed Reviews*, *Watson Wyatt Survey Finds*, June 20, 2006, available at <http://www.watsonwyatt.com/news/press.asp?ID=16180> (last visited July 18, 2006).

¹⁸⁷ Brehm, 746 A.2d at 260. See also, Lori B. Marino, Comment, *Executive Compensation and the Misplaced Emphasis on Increasing Shareholder Access to the Proxy*, 147 U.PA.L.REV. 1205, 1235 (1999) (arguing that “[e]xecutive compensation makes up such a small percentage of a firm’s assets that even excessive pay packages will likely not cause a blip in a firm’s stock value.”); cf. *id.* (contrasting executive compensation with decisions by a company’s board regarding takeovers, which have a great effect on a company’s stock price).

¹⁸⁸ 2006 WL 1562466, at 5.

¹⁸⁹ See, New York Stock Exchange, Listed Company Manual, P 303A.05, available at <http://www.nyse.com/Frameset.html?nyseref=&displayPage=/lcm/1078416930957.html?enable=section&number=3&ssnumber=303a.00> (last visited August 7, 2006) [hereinafter NYSE]. See also, National Association of Securities Dealers Automated Quotations, Inc., Marketplace Rules, IM 4350(c), available at http://nasdaq.complinet.com/nasdaq/display/display.html?rbid=1705&element_id=18 (last visited August 7, 2006)(rules require compensation decisions to be approved or recommended to the board by a compensation committee or independent board members)[hereinafter NASDAQ].

spending increasing amounts of board and committee time on executive compensation matters.¹⁹⁰ If board decisions regarding compensation are distinguishable from other routine decisions, the regulatory response might also entail more than business judgment review and disclosure.

While it seems likely that the Proposed Regulations and Existing Regulations would have required disclosure of the OEA, disclosure does not consider the relationships that make executive compensation decisions different from routine board matters. These concerns are summed up by Professor Lucian Bebchuk: “The factors impeding arm’s length contracting are in part a product of legal rules and corporate practices. With the rules and practices that we have had to date, directors have been subject to a myriad of incentives and forces that have prevented them from bargaining at arm’s length with the CEO over pay.”¹⁹¹ The effectiveness of information disclosure hinges on the effect that disclosure will have on decision makers. Adding more disclosure is unlikely to enhance arm’s length dealings here.

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

Another challenge facing the SEC is the gap existing between disclosure and state law regulation of executive compensation decision-making. State law creates accountability for only some executive compensation decisions. Excessive compensation packages are not necessarily the product of a lack of due care, bad faith or waste. An important category of excessive executive compensation packages are those adopted in accordance with state law duties, and perhaps even with “best practices.”¹⁹² The OEA was adopted with due care, in good faith and was not waste, yet some shareholders were outraged enough to litigate the matter for years.¹⁹³

The “best practices” described by the Delaware Supreme Court for executive compensation decision-making might help, but won’t prevent excessive packages.¹⁹⁴ First, the compensation committee members should receive (preferably in advance of the meeting) a spreadsheet or document prepared by a compensation expert disclosing the amounts the executive might receive under various alternatives.¹⁹⁵ Second, the compensation expert or a committee member should explain the spreadsheet or document to the committee with the document being an exhibit to committee minutes.¹⁹⁶ Finally, the committee members would then have deliberations and discussion.¹⁹⁷ The *In re Walt Disney* Court observed that following this “tidy” process will eliminate the basis for litigation.¹⁹⁸

¹⁹⁰ See, e.g., 2006 WL 1562466, at 18 (discussing the “best practices” for compensation matters).

¹⁹¹ Pay Without Performance, *supra* note 1, at 43.

¹⁹² See, e.g., 2006 WL 1562466, at 18 (discussing the “best practices” for compensation matters).

¹⁹³ 2006 WL 1562466.

¹⁹⁴ 2006 WL 1562466, at 18.

¹⁹⁵ 2006 WL 1562455, at 18.

¹⁹⁶ 2006 WL 1562455, at 18.

¹⁹⁷ 2006 WL 1562455, at 18.

¹⁹⁸ 2006 WL 1562455, at 18.

Best practices from Disney are likely to be adopted by companies, but will not prevent excessive compensation packages. The exercise of best practices contemplates a board or committee using procedural safeguards, not substantive ones. If a compensation decision is later challenged by shareholders, state law only considers the procedural due care employed by the board or committee and does not involve a substantive review of compensation decisions.¹⁹⁹ So long as procedural measures are employed, shareholders will have no basis to litigate. A problem that shareholders face, therefore, is that while the Proposed Regulations may aid in the discovery of excessive compensation packages, this limit on state law remedies creates a gap where excessive packages will remain.

C. Shareholders Lack Meaningful Ability to Challenge Board Decisions

Even if the Proposed Regulations operate as intended to trigger additional company disclosure they will not be effective because shareholders do not have much of a role in establishing executive compensation packages and little ability to challenge decisions afterwards.²⁰⁰ We count on corporate boards to make decisions for the company. Accountability, though, is key to policing board decision-making. For instance, shareholders unhappy with board decision-making over executive compensation matters often have little ability to oust directors in a proxy contest or hostile takeover, since such contests are rare.²⁰¹ Furthermore, shareholders cannot rely on state law to eliminate excessive packages because board compliance with the law does not eliminate excessive packages, discussed *supra*.

It might be argued that aggrieved shareholders displeased with compensation policies can simply sell their shares. This would only affect corporate policy if enough shareholders were to sell shares in response to compensation policy. Not all shareholders, for instance ones with indexed investments, can simply readjust investments. Furthermore, to the extent excessive compensation practices are widespread, selling may not operate as a check on the market.²⁰² In fact, few shareholders actually sell in response to unhappiness with compensation policies.²⁰³ For these reasons, the option of selling seems to be a weak check on compensation policy.

¹⁹⁹ Brehm, 746 A.2d 244.

²⁰⁰ See, Stephen Labaton, *Spotlight on Pay Could Be a Wild Card*, New York Times, April 9, 2006, at Sec. 3, p. 10. For a discussion of the challenges facing shareholders, see, Randall Thomas and Kenneth Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 613 (2001).

²⁰¹ Pay Without Performance, *supra* note 1, at 11; Randall Thomas and Kenneth Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 570 (2001)(proxy contests of this sort are rare and expensive).

²⁰² Lowenstein, *The Conundrum of Executive Compensation*, *supra* note 1, at 25-26 (this could result in a shareholder having to leave the market entirely); Randall Thomas and Kenneth Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 570 (even institutional shareholders may not have the portfolio flexibility in order to simply sell all shares). See also, See Robert B. Thompson, Shareholders as Grown-Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No," 67 U. Cin. L. Rev. 999 (1999).

²⁰³ Randall Thomas and Kenneth Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. at 570.

In practice, affirmative shareholder initiatives objecting to executive compensation (mostly unsuccessful) have mostly centered on three areas: (i) suing the board under state law;²⁰⁴ (ii) voting against employee stock option plans;²⁰⁵ and (iii) putting forward shareholder precatory resolutions under Rule 14a-8 of the federal proxy rules.²⁰⁶

Derivative suits are constrained by the due care, good faith and waste analyses, which are procedural inquiries that limit shareholder ability to object compensation packages that are excessive on a substantive level.²⁰⁷ Furthermore, one must question whether courts are in the best situation to evaluate the merits of executive compensation plans.²⁰⁸

Shareholder voting on employee stock option plans has not been an effective restraint on executive compensation. Shareholders typically vote on a plan as a whole, not with respect to how the plan rewards a particular executive in the future.²⁰⁹ Finally, shareholder precatory resolutions on executive compensation matters, even when effectively framed such that widespread support is possible, only have a limited impact on board decision-making because they are purely advisory.²¹⁰

The less successful experience of American shareholders attempts to affect management decision-making might be distinguished from that of European company shareholders. In many European companies, five or ten shareholders own substantial stakes in many companies. With the ownership more concentrated, these larger shareholders are more

²⁰⁴ See, e.g., 2006 WL 1562466. See, Randall Thomas and Kenneth Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. at 571 (examining 124 cases where shareholders have brought claims of excessive compensation and concluding that shareholders are more likely to find success against smaller corporations when litigating outside of Delaware).

²⁰⁵ Pay Without Performance, *supra* note 1, at 45; Randall Thomas and Kenneth Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 570 (2001).

²⁰⁶ Pay Without Performance, *supra* note 1, at 45.

²⁰⁷ See *supra* Part IV.B. See also, Pay Without Performance, *supra* note 1, at 45. Court review is procedural and does not involve “substantive due care” review of the executive compensation package. *Brehm v. Eisner*, 746 A.2d 244.

²⁰⁸ Lowenstein, *The Conundrum of Executive Compensation*, *supra* note 1, at 20-21; Randall Thomas and Kenneth Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. at 604 (2001) (concluding that courts should only have a limited role in policing procedural aspects of compensation practices).

²⁰⁹ Pay Without Performance, *supra* note 1, at 48-51; Randall Thomas and Kenneth Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 570 (2001) (shareholder opposition to these plans does not seem to have had much effect on their use or growth).

²¹⁰ Pay Without Performance, *supra* note 1, at 51-52; Lowenstein, *The Conundrum of Executive Compensation*, *supra* note 1, at 26 (noting the limited effect shareholders can have with precatory resolutions); Randall Thomas and Kenneth Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. 569, 570 (2001) (these proposals typically get less than ten percent of the vote); Brownstein and Kirman, *Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions*, 60 BUS. LAW. 23 (2004) (concluding that boards can resist the adoption of shareholder proposals, but should take them seriously). In the case of HP, shareholders mounted and succeeded in an effort to get the company to adopt a policy requiring a shareholder vote for any severance package exceeding 2.99 times the executive’s base salary plus bonus. See, Benjamin Pimentel, *HP Sued over Fiorina’s \$42 Million in Exit Pay; Shareholders Say Company, Directors Disregarded Own Rules with Golden Parachute*, San Francisco Chronicle, March 8, 2006, at C1 (two institutional investors sued HP over Fiorina severance package allegedly in violation of this board policy).

able to take their complaints to management and get a response.²¹¹ Even for smaller stakeholders, strong European initiatives aimed at disclosure to shareholders in advance of board meetings, coupled with shareholder rights to challenge resolutions not properly disclosed, offer protections.²¹² It might be observed, though, that the ability of larger shareholders in European companies to impact management decisions might also adversely affecting the rights of minority shareholders in the same company.²¹³

The SEC has identified a strategy for dealing with excessive compensation: “to help investors keep an eye on how much of their money is being paid to the top executives who work for them.”²¹⁴ Given the obstacles to challenging compensation decisions, American shareholders, who often do not have substantial stakes in any individual corporation, find it difficult to achieve changes in corporate policy. The Proposed Regulations will provide the shareholders information, but reacting to it will be troublesome. Although this approach is laudable, it does not suggest or entail accountability. Chairman Cox has explained “the SEC lacks statutory authority to impose salary caps on corporate executives and we’d be out of bounds to attempt that through indirection.”²¹⁵ Without holding corporate decision makers accountable to the shareholders, however, the Proposed Regulations will be not change much in the world of executive compensation.

D. Disclosure of Compensation Information in a Transparent Format is Critical but is Not Enough

Yet another problem facing the SEC is that disclosure is not the equivalent of merit

²¹¹ See, Rafael LaPorta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999)(presents empirical evidence illustrating the different corporate ownership patterns). See also, e.g., High Level Group of Co. Law Experts, Report of the High Level Group of Company Law Experts on A Modern Regulatory Framework for Company Law in Europe 59-60 (2002), available at http://ec.europa.eu/internal_market/company/docs/modern/consult_en.pdf (last visited ???); Felicia Kung, *The Regulation of Corporate Bond Offerings: A Comparative Analysis* 26 U. PA. J. INT’L ECON. L. 409, 436 (2005) (investors have less need to sue issuers because they have more power vis-à-vis the company); Luca Enriques, *EC Company Law Directives and Regulations: How Trivial Are They?*, 27 U. PA. J. INT’L ECON. L. 1, 29 (2006)(how company ownership concentration affects preemptive rights); John Huber and Alexander Cohen, *Foreign Issuers and The Regulatory Agenda: Deregistration and IFRS Transition*, 1544 PLI/Corp 9 (May 2006)(arguing that concentrated ownership in European companies affects new deregistration rules).

²¹² But see Dirk A. Zetzsche, *Explicit and Implicit System of Corporate Control - A Convergence Theory of Shareholder Rights* 53-58 (Ctr. for Bus. & Corp. Law Research Paper Series, Paper No. 0001, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=600722 (last visited July 18, 2006)(arguing the relevance of shareholder approval of certain decisions in countries where the law protects minority shareholders by imposing a broad duty to disclose information prior to a meeting and by granting individual shareholders the right to challenge the validity of shareholder meetings resolutions taken without due disclosure).

²¹³ Jennifer Hill, *Regulatory Responses to Global Corporate Scandals*, 23 WIS. INT’L L.J. 367, 387 (2005). See also, e.g., High Level Group of Co. Law Experts, Report of the High Level Group of Company Law Experts on A Modern Regulatory Framework for Company Law in Europe 14-15 (2002), available at http://ec.europa.eu/internal_market/company/docs/modern/consult_en.pdf (last visited ???) (independent monitoring on behalf of minority shareholders is needed).

²¹⁴ Cox Speech, *supra* note 13.

²¹⁵ Cox Speech, *supra* note 13.

review or substantive regulation of conduct. Some believe, for instance, that the increased disclosure requirements anticipated by the Proposed Regulations will actually result in new increases in executive compensation levels.²¹⁶ New surveys indicate that most companies will not change compensation policies in response to the Proposed Regulations.²¹⁷

The benefit to the public of having full access in a fully transparent way to executive compensation policies, practices and data cannot be understated.²¹⁸ Brandeis' oft-quoted statement "[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman" is appropriate here.²¹⁹ Transparency, if achieved, certainly will have an effect on the ability of executives to receive executive compensation packages that are less coupled to performance.²²⁰ Disclosure makes sure that all investors have access to compensation information prior to making an investment.²²¹ It is widely believed that access to understandable financial data even by the market professionals alone would result in the data being reflected in the pricing of the stock.²²² Reflection of information in stock prices and opening access to information prior to investment, though, is not the same as providing accountability for decision-making or changing compensation policies or processes to protect an investment once made.²²³ Should we employ a regulatory approach for executive compensation that is predominately dependent on investor choice at the purchase stage? What about information overload, overconfidence in one's ability to decipher information, optimism and other barriers to disclosure based regulation?²²⁴

²¹⁶ Stephen Labaton, *Spotlight on Pay Could Be a Wild Card*, New York Times, April 9, 2006, Sec. 3, at 1 (noting that every time disclosure increases, pay increases also); Floyd Norris, New York Times, June 2, 2006, Sec. C., at 1 (same).

²¹⁷ Stephen Labaton, *Spotlight on Pay Could Be a Wild Card*, New York Times, April 9, 2006, Sec. 3, at 1 (describing a poll by WatsonWyatt Worldwide, a human resources firm, which found that only 1 in 10 would make changes in compensation programs). *See also*, Watson Wyatt Worldwide, *Corporate Directors Give Executive Pay Model Mixed Reviews, Watson Wyatt Survey Finds*, June 20, 2006, available at <http://www.watsonwyatt.com/news/press.asp?ID=16180> (last visited July 18, 2006) ("While most directors believe the executive pay system needs further reform, they are unlikely to make dramatic changes to their programs.").

²¹⁸ Pay Without Performance, *supra* note 1, at 11, 192; David A. Westbrook, *Telling All: The Sarbanes-Oxley Act and the Ideal of Transparency*, 2004 MICH. ST. L. REV. 441, 453 (2004)(disclosure regulations "increase transparency and thereby increase informational efficiency of markets"). Claudia Deutsch, *Behind Big Dollars, Worrisome Boards*, New York Times, April 9, 2006, Sec. 3, at 7..

²¹⁹ Louis D. Brandeis, *Other People's Money and How the Bankers Use It*, 92 (1914).

²²⁰ Pay Without Performance, *supra* note 1, at 11.

²²¹ *See*, H.R. Rep. No. 73-1383, at 11 (1934) reprinted in 5 Legislative History of the Securities Act of 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973) ("No investor...can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells."); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. R. at 152-54.

²²² Pay Without Performance, *supra* note 1, at 192; Claudia Deutsch, *Behind Big Dollars, Worrisome Boards*, New York Times, April 9, 2006, Sec. 3, at 7.

²²³ Pay Without Performance, *supra* note 1, at 192; Claudia Deutsch, *Behind Big Dollars, Worrisome Boards*, New York Times, April 9, 2006, Sec. 3, at 7; Lowenstein, *The Conundrum of Executive Compensation*, *supra* note 1, at 24 ("it is clear that disclosure should not be regarded as an effective limitation on compensation").

²²⁴ *See, e.g.*, Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. R. at 160-72 (2006).

The SEC has often turned its focus to disclosure based regulations,²²⁵ rather than merit review or substantive regulation, under the belief that the market assumes that investors make informed decisions with full disclosure.²²⁶ As an example, the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) contains substantive prohibitions against certain corporate behavior. Yet, Sarbanes-Oxley is intended "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws"²²⁷ The advantage of disclosure as a regulatory approach is that it serves as a less invasive government intrusion into companies and allows investors to make their own personal choices about investments.²²⁸ This theory fails to appreciate, first, that investors don't always make rational decisions in making an initial investment, and, second, that investors need options other than selling in response to disclosure of information about excessive compensation to executives. That is, not all investor behavior can fall neatly into buy and sell decisions in response to information. Investors are vulnerable to corporate misdealing not only from lack of information about executive compensation, but limits on their decisions.²²⁹ Regulating conduct, rather than disclosure surely is more complicated.²³⁰

Traditional SEC disclosure-focused programs can produce results in other areas, such as making sure that the prospectus in an initial public offering that contains misstatements creates liability for the issuer.²³¹ Using the same approach for executive compensation matters is not likely to yield the same meaningful results. For instance, information overload is a problem with disclosure-based regulatory systems generally,²³² but will

²²⁵ Louis Loss & Joel Seligman, *Securities Regulation*, 29 (3d ed. rev. 1998); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. R. 139, 145-46 (2006)(questioning the continuation of the disclosure approach).

²²⁶ See Thomas Lee Hazen, *The Law of Securities Regulation*, 22 (5th ed. 2005); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963). The House Report on the Securities Exchange Act of 1934 commented: "No investor...can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells....[T]he hiding and secreting of important information obstructs the operation of the markets as indices of real value." H.R. Rep. No. 73-1383, at 11 (1934), reprinted in 5Legislative History of the Securities Act of 1934 (J.S. Ellenberger & Ellen P. Mahar eds., 1973).

²²⁷ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in various sections of 15 U.S.C.) (preamble) (emphasis added).

²²⁸ Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. R. at 149-55 (2006).

²²⁹ Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. R. at 148 (2006).

²³⁰ Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. R. at 148-49 (2006).

²³¹ But see, Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. R. at 185-87 (2006) (arguing the weaknesses of the SEC's disclosure approach).

²³² See generally, Alison Grey Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L.J. 311, 325 (1974); Jay T. Brandi, *Securities Practitioners and Blue Sky Laws: A Survey of Comments and a Ranking of States by Stringency of Regulation*, 10 J. CORP. L. 689, 692 (1985)(even sophisticated analysts can have difficulty with complex regulatory disclosure); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. R. at 185 (2006); Ray J. Groves, Here's the Annual Report. *Got a Few*

particularly be a hurdle to investors understanding executive compensation disclosure. The Proposed Regulations contemplate no less than eight complex graphs and extensive narrative discussion.²³³ Additionally, the SEC is attempting to avoid “boilerplate” disclosure of compensation information with the Proposed Regulations.²³⁴ Because lawyers draft much of documents filed with the SEC,²³⁵ boilerplate will be almost impossible to eliminate with the Proposed Regulations. Further, most of the disclosure contemplated by the Proposed Regulations will be received after executive compensation decisions are made, which does not provide existing shareholders with meaningful options other than selling their shares.

Moreover, although the Proposed Regulations create liability for misstatements, this does not mean that the SEC is undertaking merit review of executive compensation decisions. In fact, Chairman Cox specifically said that the SEC is not in the business of setting compensation or evaluating compensation decisions.²³⁶ Nevertheless, Chairman Cox is clearly hoping that fuller disclosure will result in changes to executive compensation policies and programs.²³⁷ Unfortunately, Chairman Cox’ intention may not be realizable in light of the following realities: (1) most companies don’t plan to change their practices;²³⁸ (2) most directors don’t believe that the current executive compensation approach is flawed;²³⁹ (3) the board’s role as an independent decision maker is compromised;²⁴⁰ (4) the gap between state and federal regulation of state law results allows some excessive compensation packages to exist;²⁴¹ and (5) shareholders lack the ability to attack compensation plans they perceive as excessive.²⁴² As a result, the Proposed Regulations may not have the level of impact that the SEC and the public want.

Hours?, Wall St. J., Aug. 4, 1994, at A12; Kimberly Strassell, *The Weekend Interview with Christopher Cox: Full Disclosure*, THE WALL STREET JOURNAL, May 20, 2006, at A8 (“today’s disclosure system is impenetrable to all but whiz kid financial analysts”).

²³³ Proposed Regulations, 71 Fed. Reg. at 6548, 6556, 6559-62, 6565 (The following tables are contemplated: Summary Compensation, Grants of Performance-Based Awards, Grants of All Other Equity Awards, Outstanding Equity Awards At Fiscal Year End, Option Exercises and Stock Vested, Retirement Plan Potential Annual Payments and Benefits, Nonqualified Defined Contribution and Other Deferred Compensation Plans, Director Compensation)

²³⁴ Proposed Regulations, 71 Fed. Reg. at 6546.

²³⁵ Alan B. Levenson, *The Role of the SEC as a Consumer Protection Agency*, 27 BUS. LAW. 61, 68 (1971); see also Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 429 n.58 (2003) 429 n.58 (“companies often disclose information not to better inform investors, but to reduce the risk of liability for omitting a material fact or disclosing a ‘half truth’”).

²³⁶ Cox speech, *supra* note 13; Stephen Labaton, *Spotlight on Pay Could Be a Wild Card*, New York Times, at Sec. 3, p. 1 (April 9, 2006) (“government should stay out of business of setting executive compensation”).

²³⁷ Stephen Labaton, *Spotlight on Pay Could Be a Wild Card*, New York Times, April 9, 2006, at Sec. 3, p. 1 (Cox is hoping that compensation decision makers will “pay more attention to their figures”); but see Comment of Steve Odland, Business Roundtable, at 2-3, Securities and Exchange Commission Website, available at <http://www.sec.gov/rules/proposed/s70306/sodland041006.pdf> (last visited July 6, 2006) (“The rules should be designed to elicit information on the corporate governance context in which compensation decisions are made without unduly or inappropriately affecting that context.”).

²³⁸ See *supra* notes 185 and 234.

²³⁹ See *supra* notes 10, 205, 258.

²⁴⁰ See *supra* Part IV.A.

²⁴¹ See *supra* Part IV.B.

²⁴² See *supra* Part IV.C.

Executive compensation presents a difficult situation for regulators. The Proposed Regulations would require companies to disclose substantial amounts of compensation data, but to what result? Many directors believe that disclosure of increased compensation information is a positive change because it will demonstrate that the *existing* pay system works.²⁴³ Sometimes direct regulation of conduct is more effective to deter fraud or bad practices.²⁴⁴ Professor Charles Elson sums it up: “[d]isclosure is like an aspirin; it can make you feel a little better, but it can’t even cure the common cold The fact is, a board that overpays the C.E.O. is in all probability not minding the store on other issues either.”²⁴⁵ For these reasons, disclosure regulatory programs are unlikely to enjoy widespread impact on compensation policies with more stringent regulation.

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

[T]he proposed rule is an excellent first step, and I hope we can work together to ensure that shareholders have the tools needed to address executive compensation and corporate governance *as they see fit*. For a market to work, however, participants require information; *and* choice. This proposed rule would give shareholders valuable information relating to executive compensation, but does not give them much hope for doing anything about it. Short of shaming boards into holding executives accountable, the proposed rule does not ensure that shareholders can effectively change compensation practices.²⁴⁶

Of course, even if the SEC does not pursue additional regulation now, corporations have no assurances that this policy would continue. The SEC, particularly in the event of a

²⁴³ See Watson Wyatt Worldwide, *Corporate Directors Give Executive Pay Model Mixed Reviews*, *Watson Wyatt Survey Finds*, June 20, 2006, available at <http://www.watsonwyatt.com/news/press.asp?ID=16180> (last visited July 18, 2006)(only 41% of directors think that the current model of executive pay is poor).

²⁴⁴ See Anderson, *supra* note 243, at 343 (“direct regulation of conduct may be the best means of deterring fraud and undesirable practices”); John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099, 1115 (1977)(“[d]isinfectants are not, after all, a universal panacea, sometimes surgery is required.”); William O. Douglas, *Protecting the Investor*, 23 YALE REV. 521, 528 (1934)(substantive regulation is sometimes more effective). *But see*, A.A. Sommer, Jr., *Random Thoughts on Disclosure as “Consumer” Protection*, 27 BUS. LAW. 85, 88 (1971)(discussing the disclosure approach to securities regulation); Paula Walter, *The Doctrine of Informed Consent: To Inform or Not to Inform?*, 71 ST. JOHN’S L. REV. 543, 545-46 (1997) (“self-determination, which assures that man is master of his destiny, is deeply rooted in our legal system and is the legal mirror of the Western values system, which exalts the individual”).

²⁴⁵ Claudia Deutsch, *Behind Big Dollars, Worrisome Boards*, *New York Times*, April 9, 2006 at Sec. 3, p. 7 (interview with Elson).

²⁴⁶ Comment of Rep. Barney Frank, Ranking Member, Committee on Financial Services, U.S. House of Representatives, Securities and Exchange Commission Website, available at <http://www.sec.gov/rules/proposed/s70306/bfrank041006.pdf> (last visited July 6, 2006). *See also*, Lucian Bebchuk, *Beyond Disclosure*, *Forbes*, January 19, 2006 (SEC rules will not fix problems of executive compensation).

mandate by Congress or in the wake of another corporate scandal, could easily change its mind at a later date.²⁴⁷ The SEC's assertion of only informational jurisdiction over executive compensation as part of its core mission leaves much undone with the gap existing between the SEC's information disclosure and the *In re Walt Disney* expression of shareholder recourse for excessive compensation. Without more marked changes, the Proposed Regulations aren't likely to have significant impact on compensation decisions or practices.

V. Filling the Gap between *In Re Walt Disney* and Disclosure

The gap between the disclosure required by the Proposed Regulations and the procedural review contemplated by *In re Walt Disney* could be filled with three different approaches: (1) federal legislation, including amending the Exchange Act or Sarbanes-Oxley to alter the corporate governance framework; (2) state legislation, including enhancements of shareholder control over approval of executive compensation packages; or (3) corporate self-regulation, such as enhanced listing requirements by SROs. These alternatives each raise issues with the appropriate role of regulators balanced against the preference for the market to operate freely. This section will examine some of the possible solutions in each of these approaches and evaluate their relative strengths and weaknesses.

A. Federal Interest in Regulation of Executive Compensation

The Proposed Regulations ask corporations to disclose executive compensation information to the public; if disclosed appropriately, that is the end of the SEC's involvement. Nevertheless, the federal government has demonstrated that it can make greater intrusions in the traditionally state realm of corporate governance beyond disclosure. For instance, the Foreign Corrupt Practices Act (FCPA), represents federal involvement, through the SEC, in corporate governance through the FCPA's prohibitions on bribery of and other certain payments to foreign officials by corporations and recordkeeping requirements.²⁴⁸

More recently, the federal government again demonstrated that it will enter corporate governance in response to scandal. Sarbanes-Oxley regulates corporate conduct, in addition to containing disclosure requirements. For example, Sarbanes-Oxley grants to the SEC of authority with respect to matters of board composition and committee structure.²⁴⁹ The SEC can also prohibit through administrative, rather than court,

²⁴⁷ See, Cary Coglianese, Richard Zeckhauser & Edward Parson, *Seeking Truth for Power: Informational Strategy and Regulatory Policymaking*, 89 MN. L. R. 277, 279 (2004)(arguing that government collects information and then may use it to support the need to regulate at a later date).

²⁴⁸ Exchange Act, §§ 13(b)(2), 30A, 32; 15 U.S.C. §§ 78m(b)(2), 78dd-1-2, 78ff, added by Public L. No. 95-213, 91 Stat. 1494 (Dec. 19, 1977).). Roberta S. Karmel, *Realizing the Dream*, *supra* note X.

²⁴⁸ Sarbanes-Oxley, § 402(k), 15 U.S.C. § 78m(k) (2002).

²⁴⁸ Exchange Act, § 19(b)-(c), 15 U.S.C. § 78s(b)-(c) (2001).

²⁴⁹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15 18, 28 and 29 U.S.C.). See also, Sarbanes-Oxley, § 301, 15 U.S.C. § 78j-1 (2002) (audit committees requirements). For a general discussion of the new role of the federal government in

proceedings, executives from serving as corporate officers.²⁵⁰ Importantly, Sarbanes-Oxley takes a shot at executive compensation by prohibiting most types of loans to company executives.²⁵¹ Additionally, the CEO and CFO must return bonuses, incentives and equity based compensation and certain profits from the sale of securities if the corporation has to file an accounting restatement due to misconduct.²⁵² Sarbanes-Oxley also prohibits directors and executive officers of issuers from trading in any equity securities of the issuer during any employee fund blackout period.²⁵³

The Exchange Act grants to the SEC wide authority over Self-Regulated Organization ("SRO") rules, including the power to approve or disapprove rule changes and to unilaterally change SRO rules,²⁵⁴ so long as the SEC is acting "in furtherance of the purposes of the Exchange Act."²⁵⁵ Because Sarbanes-Oxley greatly expanded the SEC's authority over corporate governance matters under the Exchange Act, the SEC may find that it has increased ability to use listing rules to regulate corporate governance matters generally and executive compensation specifically.²⁵⁶

One issue yet to be mentioned is whether there is any potential for further federal involvement in executive compensation regulation.²⁵⁷ To remedy remaining abuses, the SEC could attempt to use its Sarbanes-Oxley authority to regulate compensation committees or shareholder involvement in compensation decisions, perhaps using its authority over SRO listing rules.²⁵⁸ As Professor Roberta Karmel has observed: "the SEC is an agency with a very long institutional memory that has always acquired more power in response to crisis and scandal, and the future use it may make of the additional power it has acquired pursuant to Sarbanes-Oxley is unknown."²⁵⁹ Thus far, however, the SEC has been discouraged by the business community (and the CEOs in particular) from attempting more substantial reforms in the corporate governance area.²⁶⁰

governance matters, see Roberta Karmel, *Realizing the Dream of William O. Douglas-The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 Del. J. Corp. L. 79 (2005).

²⁵⁰ Sarbanes-Oxley § 1105(f), 15 U.S.C. § 78u-3(f) (2002).

²⁵¹ Sarbanes-Oxley, § 402(k), 15 U.S.C. § 78m(k) (2002).

²⁵² Sarbanes-Oxley, § 304, 15 U.S.C. § 7243 (2002). The SEC can freeze corporate assets to prevent payments of bonuses to executives in cases involving financial fraud.

Sarbanes-Oxley, § 1103, 15 U.S.C. § 78u-3 (2002).

²⁵³ Sarbanes-Oxley, § 306, 15 U.S.C. § 7244 (2002).

²⁵⁴ Exchange Act, § 19(b)-(c), 15 U.S.C. § 78s(b)-(c) (2001).

²⁵⁵ *Business Roundtable v. SEC*, 905 F.2d 406, 409-17 (D.C. Cir. 1990).

²⁵⁶ The SEC most recently amended SRO rules regarding internet publication of SRO rules. 69 Fed. Reg. 60287 (Oct. 8, 2004).

²⁵⁷ See *supra* Part IV.

²⁵⁸ In 2003, the SEC proposed rules concerning corporate governance that would allow nominations of directors by certain shareholders in a limited amount of circumstances where the nomination would be part of the company's proxy materials. Security Holder Director Nominations, Exchange Act Release No. 48,626, 68 Fed. Reg. 60,784 (Oct. 23, 2003). No final action has occurred on this proposed rule.

²⁵⁹ Roberta Karmel, *Realizing the Dream*, *supra* note X, at 143.

²⁶⁰ The Business Roundtable prepared a lengthy opposition to the SEC's proposed rules on "Security Holder Direct Nominations", 68 Fed. Reg. 60784 (Oct. 23, 2003), that would have increased shareholder access to the nomination process. See, Letter from Henry A. McKinnell, Chairman, The Business Roundtable, to Jonathan Katz, Secretary, Securities and Exchange Commission (December 22, 2003), available at <http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf> (last visited July 24, 2006).

If outrage over executive compensation persists and the SEC is unable to react, however, new federal law could result. In fact, the Protection Against Executive Compensation Abuse Act, H.R. 4291, (H.R. 4291)²⁶¹ was introduced in 2005. H.R. 4291 would amend the Exchange Act to require specific disclosures of compensation figures that are subject to shareholder votes approving compensation and golden parachute plans.²⁶² H.R. 4291 would mandate executives to return to companies any compensation received: (1) that was not approved by the shareholders; (2) where the executive does not meet the stated job performance measures; (3) that is incentive compensation or bonuses received by the executive “within 18 months before any negative material restatement by the issuer;” or (4) that is “related to fraud or misrepresentation” by the executive.²⁶³

The main advantage of federal regulation of executive compensation is uniformity of regulation across state lines, most likely under the Exchange Act. The SEC is already involved in monitoring and reporting of many matters under the Exchange Act and certainly could monitor compliance with new regulation in the area of executive compensation. In fact, the SEC already has some involvement in executive compensation through the existing loan prohibitions and other provisions of Sarbanes-Oxley. Moreover, the SEC already has an enforcement apparatus available to sanction corporations that do not comply fully.

Corporate governance has historically been a matter of state, not federal law, however. For this reason, existing federal involvement in corporate governance is only sporadic, not comprehensive. Nevertheless, the federal government clearly could regulate executive compensation matters. One must question, though, whether expanding the federal role is the optimal response. Because corporate governance in general is a matter left to state law, the federal government does not seem to be the first line of defense for reforming the specific area of corporate governance concerning compensation matters. Reformation of executive compensation is better done in the context of the existing corporate governance structure covering a variety of matters, which is set by state, not federal, law. Federal government regulation of compensation seems to be a measure of last resort. Of course, the SEC could work with state governments on this issue.

B. State Interest in Regulating Executive Compensation

The Supreme Court has observed that “[c]orporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.”²⁶⁴ For this reason, state courts and legislatures have a strong interest in regulating executive compensation and are the most logical actors here. Quite simply, it is important that

²⁶¹ See, Protection Against Executive Compensation Abuse Act, H.R. 4291, 109th Cong. (2005)(referred to the Committee on Financial Services and in committee as of this writing).

²⁶² *Id.*

²⁶³ *Id.*

²⁶⁴ *Cort v. Ash*, 422 U.S. 66, 84 (1975).

shareholders have tools to evaluate and respond to inefficient or excessive executive compensation packages.²⁶⁵ The Proposed Regulations give shareholders substantial disclosure for evaluation, which leaves remedy as the focus here. Potential state law remedies to fill the gap between existing federal and state regulation of executive compensation seem to fall in three general areas: (1) increased court review; (2) shareholder approval of compensation arrangements; and (3) greater shareholder role in the election of directors.

One state law alternative to fill the gap would be to simply treat executive compensation decisions like other self-dealing transactions and submit them to a fairness review when the issue is litigated.²⁶⁶ Although this would still require shareholders to litigate instances of excessive compensation, raising the standard of review in litigation for such transactions would arguably have the effect of: (1) increasing the likelihood of success in excessive compensation cases; and (2) change the way in which compensation committees make decisions. Similarly, courts could treat executive compensation decisions as ones with demand futility automatically to overcome barriers to challenging compensation decisions. Professors Randall Thomas and Kenneth Martin have suggested that courts could require companies to justify significant deviations from medial levels of executive compensation:

[T]he strongest case in favor of courts looking closely at executive pay at public corporations is that they are best positioned to police abuses of the executive compensation process. . . .

A more difficult argument can be made in favor of courts policing the substance of outlier pay packages. This proposal is more likely to provoke claims of judicial incapacity and overreaching. . . . While this change would do little to stop the apparently inexorable rise in the levels of executive pay over the last decade, it would give angry shareholders a more direct method of challenging extraordinary pay packages.²⁶⁷

There is not much likelihood, however, that the courts or state legislatures will undertake substantive review of compensation packages in this manner.²⁶⁸

Another way state legislatures could address the problem of executive compensation would be to make directors more accountable to the shareholders for compensation

²⁶⁵ Pay Without Performance, *supra* note 1, at 10.

²⁶⁶ See, e.g., Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 COLUM. L. REV. 1867, 1899 (1992) (reviewing Graef Crystal: In Search of Excess (1991)) (arguing for an intermediate level of scrutiny in reviewing compensation packages); Detev Vagts, *Challenges to Executive Compensation: For the Markets or the Courts?*, 8 J. CORP. L. 231, 252-61 (1983) (arguing for testing of the reasonableness of compensation by comparing compensation levels with those of similar firms); Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59 (1992) (same). See generally, Randall Thomas and Kenneth Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. at 599-605 (discussing the arguments on both sides)

²⁶⁷ Randall Thomas and Kenneth Martin, *Litigating Challenges to Executive Pay: An Exercise in Futility?*, 79 WASH. U. L.Q. at 604-05.

²⁶⁸ *Id.* at 605.

decisions.²⁶⁹ State statutes already require shareholder approval of a number of board decisions.²⁷⁰ The same statutes could also require shareholder approval (or even non-binding review) of executive compensation agreements, or at least ones that include specified features.²⁷¹ Similarly, state law could allow shareholders to pass resolutions on executive compensation policy that is binding on the board, rather than precatory.²⁷² If shareholders could act collectively, there is also the possibility of passing a corporate bylaw related to executive compensation.²⁷³

The disadvantage of this accountability model is that it does not tackle the problem at the decision-making level with the compensation committee.²⁷⁴ Moreover, it is uncertain whether the shareholders as a group will be motivated to first, sift through the voluminous disclosure contemplated by the Proposed Regulations, and second, react by challenging corporate policy and decision makers.²⁷⁵ Further, having shareholders undertake this role diverges from the concept of a corporate board responsible to manage for shareholders who have ownership rights.²⁷⁶ This alternative might impact executive compensation decision-making, but may not be lead to optimal results as shareholders often desire not to have a substantial role in decision-making.

Perhaps the most effective way to police executive compensation is to empower shareholders by giving them more power vis-à-vis the directors in a general manner.²⁷⁷ That is, ensure that director interests are aligned with the shareholders. This change would most likely require the state legislature to act.²⁷⁸ Although state law gives shareholders great latitude to tailor charter provisions away from the default statutory rules, Professor Henry Hansmann has explained the preference for statutory defaults as follows:

²⁶⁹ Pay Without Performance, *supra* note 1, at 11.

²⁷⁰ See *supra* notes x-xx and accompanying text.

²⁷¹ Pay Without Performance, *supra* note 1, at 196-97; Lowenstein, *The Conundrum of Executive Compensation*, *supra* note 1, at 28 (recommending use of non-binding advisory votes annually on executive compensation matters); Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1046, 1047-48 (1999) (suggesting that even advisory resolutions of shareholders on compensation measures have an effect on subsequent compensation decisions).

²⁷² Pay Without Performance, *supra* note 1, at 198.

²⁷³ Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. at 1047-48. See also Del. Code Ann. tit. 8, § 109 (1991); N.Y. Bus. Corp. Law § 601 (McKinney 1986); Model Bus. Corp. Act § 10.20 (1996).

²⁷⁴ See *supra* Part IV.A.

²⁷⁵ Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. at 1033 (“Compensation plans are complex, technical documents that cannot be readily understood without a substantial amount of knowledge about the intricacies of different types of pay programs.”).

²⁷⁶ Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. at 1030-33 (asking whether shareholders should be engaged in the supervision of executive compensation matters).

²⁷⁷ See, e.g., Lucian Bebchuk, *Beyond Disclosure*, *Forbes*, January 19, 2006.

²⁷⁸ Certainly state law gives shareholders great latitude to tailor charter provisions away from the default statutory rules.

The provisions of corporate law are essentially contract terms that can be repeatedly reformed by a third party--the state--to adapt them to changing circumstances. Thus, paradoxically, the great advantage of law over contract in organizing corporations is that rules of law are more easily changed.²⁷⁹

Giving the shareholders more power could be accomplished by giving the shareholders a greater role in setting director compensation by virtue of a statutory provision requiring shareholder approval of director compensation packages. Additionally, the shareholders might also have a more meaningful role in the appointment and reelection of the board, which could also be accomplished by statutory changes.²⁸⁰

Reinvigorating the director election process could go a long way in improving executive compensation decision-making by establishing a check on the alignment of director-shareholder interests.²⁸¹ Yet, these potential changes would still leave core decision-making on compensation matters with the board and compensation committees themselves, which is consistent with the authority of the board to manage corporate affairs. Although the SEC has proposed rules that would allow shareholders a greater role in the nomination process and access to the proxy, a similar result seems more naturally effectuated under state law. Even if shareholders don't always vote on all matters before them on a regular basis, shareholders might be more active if there are alternatives to sitting directors or an ability to withhold votes from a sitting director who has voted in favor of an excessive compensation package.

State legislatures undoubtedly have an interest in maintaining their control over corporate governance matters as a whole. As the Supreme Court stated in *Cort v. Ash*:²⁸² "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation."²⁸³ A number of alternatives are certainly available for state readjustment of executive compensation practices. Of these, giving shareholders more involvement in the nomination and election of directors appears to be an attractive option as it should not seriously impact the director's role in managing the corporate enterprise.

Those who believe that executive compensation needs further policing, however, can expect the proponents of the existing state corporate governance regime that does not meaningfully distinguish compensation decisions from other routine corporate decisions to say that there is no problem with executive compensation practices and that allowing

²⁷⁹ Henry Hansmann, *Corporation and Contract*, 8 AM. L. ECON. R. 1, 2 (2006).

²⁸⁰ Pay Without Performance, *supra* note 1, at 207; Claudia Deutsch, *Behind Big Dollars, Worrisome Boards*, New York Times, Sec. 3, at 7 (April 9, 2006); Lucian Bebchuk, *Beyond Disclosure*, Forbes, January 19, 2006.

²⁸¹ Pay Without Performance, *supra* note 1, at 207-8.

²⁸² *Cort v. Ash*, 422 U.S. 66, 78, 80, 95 S.Ct. 2080, 2087, 2090, 45 L.Ed.2d 26 (1975).

²⁸³ 422 U.S., at 84, 95 S.Ct., at 2091.

shareholders greater involvement in corporate affairs is a bad thing.²⁸⁴ Even with Delaware's pro-business history, that might be a difficult position if public outrage over executive compensation continues or another corporate scandal comes to light.

C. Special Concerns About Self Regulated Organizations

An alternative to state or federal action is simply self regulation of executive compensation by the corporate community. Corporations engage in a form of self regulation with respect to corporate governance, primarily through listing requirements of SROs, such as the New York Stock Exchange, Inc. ("NYSE") and the National Association of Securities Dealers Automated Quotations, Inc. ("NASDAQ"). For instance, SRO rules require members to have a majority of independent directors.²⁸⁵ Further, the compensation and nominated committees must be staffed with these independent directors.²⁸⁶ The compensation committee itself must have a charter and the committee must review and approve company goals related to executive compensation.²⁸⁷

More recently, however, the SROs enacted new listing standards in an attempt to strengthen board independence requirements and expand shareholder approval requirements for certain executive compensation plans.²⁸⁸ Under NYSE requirements shareholder approval is a requirement: (1) for equity compensation plans; (2) prior to the issuance of common stock to directors, officers and related parties in the event such issuance exceeds one percent of the number of shares of common stock of the company or one percent of the voting power prior to issuance and (3) prior to the issuance of common stock if the stock will have voting power exceeding twenty percent of the voting power or twenty percent of the common stock.²⁸⁹ NASDAQ Rule 4350 is similar and

²⁸⁴ The Business Roundtable responded to the SEC's efforts to increase shareholder access to the ballot with a letter arguing that there is no need for reform and that it would actually be bad to let shareholders have greater access to the election process. Letter from Henry A. McKinnell, Chairman, The Business Roundtable, to Jonathan Katz, Secretary, Securities and Exchange Commission (December 22, 2003), available at <http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf> (last visited July 25, 2006). For a critique of this position, see Lucian Bebchuk, *Corporate Governance: Directors vs. Shareholders?: The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557 (2005).

²⁸⁵ Pay Without Performance, *supra* note 1, at 11.

²⁸⁶ Pay Without Performance, *supra* note 1, at 11.

²⁸⁷ Pay Without Performance, *supra* note 1, at 195.

²⁸⁸ See, NYSE, Listed Company Manual, P 303A.08, available at <http://www.nyse.com/lcm/1078416930957.html?enable=section&number=3&ssnumber=312.00> (last visited July 17, 2006) [hereinafter NYSE]; NASDAQ, Marketplace Rules, IM 4350-5, available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000656, as amended, available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000656 (last visited July 17, 2006) (these amendments have been approved but the effective date has not yet been announced)[hereinafter NASDAQ]. See also, Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. 971, 1000-11 (2004)(concluding that these measures do address some abuses but do not change the executive compensation decision making process).

²⁸⁹ NYSE, *supra* note 299, at 312.03.

mandates shareholder approval of certain equity compensation plans.²⁹⁰

Although these efforts increase shareholder involvement in compensation matters, they do so only on a marginal basis, with respect to certain equity compensation plans.²⁹¹ Even for these plans, shareholder involvement in the awards made under such plans is only contemplated in a limited situation where the award is enough to strike the one percent threshold, a scenario unlikely in the context of a publicly held company. The SRO rules related to equity compensation plans will not result in changes needed to executive compensation practices as a whole.

SRO rules leave executive compensation practices as a whole undisturbed. Shareholder involvement is only with respect to a small aspect of executive compensation. The rules requiring independent directors do not change the character of executive compensation decisions since these directors are still subject to influences that impair their ability to act more in line with shareholder interests, such as a desire to get reelected and to get along with the current CEO.²⁹² While it might be possible for listing requirements to be substantially amended to overhaul the way in which interests are aligned and the way in which compensation, particularly equity based, is used,²⁹³ such reforms appear unlikely given the current relationships between executives and directors.

Moreover, the SROs have always had the ability to act in this area, yet have failed to take action. Despite shareholder calls for increased disclosure, most companies are only responding to the threat of SEC requirements under the Proposed Regulations.²⁹⁴ If past practice is any indicator, companies will not make changes to executive compensation practices on their own, even in the face of shareholder objections once enhanced disclosure is made.²⁹⁵

VI. Conclusion

The Proposed Regulations, even with the shortcomings discussed above, is nevertheless likely to become final regulation. Even if the prospects for revising executive compensation accountability is not at hand, disclosure is meaningful and companies will have to comply. One can anticipate some problems in applying the Proposed Regulations to specific compensation agreements, perquisites and retirement and severance benefits. These problems with disclosure, information overload and the looming challenge of boilerplate, remain to be resolved.

²⁹⁰ NASDAQ, *supra* note 299, at IM4350-5.

²⁹¹ Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. at 1012-13.

²⁹² *See infra*, Part IV.A.

²⁹³ Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 WAKE FOREST L. REV. 971, 1000-11 (arguing that reforms to listing requirements could potentially cure many of the problems with executive compensation).

²⁹⁴ Lucian Bebchuk, *Beyond Disclosure*, Forbes, January 19, 2006.

²⁹⁵ Lucian Bebchuk, *Beyond Disclosure*, Forbes, January 19, 2006.

As we address the broader issues raised by ever rising executive compensation packages, we must recognize that using information disclosure as a primary regulatory approach is an ambitious goal and may not be workable in the absence of other measures. While the lesser goal of the Proposed Regulations of increasing disclosure is in reach, some of the issues such as defining compensation elements present under the Existing Regulations will remain. Companies will be subject to an increased burden of information disclosure as a filed document creating liability for misstatements under the Exchange Act, but while the information is supposed to help the public understand executive compensation packages and practices, there is no specific remedy to shareholders in the absence of a lack of due care, good faith or waste to react to the information presented short of selling their stock.

Although the federal government has traditionally been involved in information disclosure of the type set forth in the Regulations and has on occasion entered the realm of corporate governance more directly, corporate governance is traditionally a matter for state government regulations. Creating a system of corporate governance where the decision makers concerning executive compensation matters are accountable to the shareholders is daunting. While finalizing the Proposed Regulations may have a calming effect on a public that objects to compensation packages that do not relate to performance of the executive, a closer examination reveals that this issue is far from resolved and will require more attention.