Excessive Executive Compensation and the Failure of Corporate Democracy

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I. INTRODUCTION

In their famous 1932 treatise, Adolf A. Berle, Jr. and Gardiner C. Means described the separation between ownership and control that necessarily occurs in the modern corporation and warned of its consequences.1 Even then the stock of large corporations was so

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1. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND
widely disbursed that no shareholder—or even groups of shareholders—could control the corporation.\(^2\) Berle and Means noted that because concerted action by shareholders is all but impossible, those who select the proxy committee effectively control the corporation because they have the power to select the directors who, in turn, appoint those who will manage the company.\(^3\) Here the circle closes. As Berle and Means noted, the proxy committee is invariably appointed by existing management. Thus management selects the proxy committee, who selects the directors, who in turn select management. Management therefore becomes self-perpetuating and secure.\(^4\) "The concentration of economic power separate from ownership," wrote Berle and Means, "has, in fact, created economic empires, and has delivered these empires into the hands of a new form of absolutism, relegating 'owners' to the position of those who supply the means whereby the new princes may exercise their power."\(^5\)

Berle and Means believed that if corporate managers were motivated principally by a desire for personal profit, they would inevitably become unfaithful.\(^6\) No matter how much stock the corporation may give the manager in order to make his and shareholder interests congruent, managers can always "serve their own pockets better by profiting at the expense of the company than by making profits for it." They noted how managers could, for example, enrich them-
selves through secret self-dealing or trading on insider information. Berle and Means believed that these "economic autocrats" could not be controlled unless a new attitude prevailed, one which deemphasized the profit motive. It was, they believed, unrealistic to expect managers to concentrate on making a profit for shareholders and not become focused on making money for themselves. As long as managers were dedicated solely to making money, they would be corrupted by greed.

Berle and Means' solution was to teach corporate managers to put the larger interests of society first and to make decisions "on the basis of public policy rather than private cupidity." They argued that instead of working solely to maximize shareholder profit, managers should work to provide fair wages and security to employees and operate their companies in ways most beneficial to the public at-large. Managers must become infused with the desire to be economic statesmen, and to that end society must reward them not with profit or wealth, but with position and prestige. The courts, they felt, would have to enforce this concept, "justifying it by whatever of the many legal theories they might choose."

If they returned today to survey the current state of the corpo-

500 corporations were women and five of them were CEOs. Study: Women Hold 3% of Top Jobs, PHILADELPHIA INQUIRER, Aug. 26, 1991, at A4. This study may have identified more women CEOs than A Portrait of the Boss 1991, supra because it surveyed a different pool of companies or was conducted during a different year. In any event, the point remains the same: at best, only a minuscule number of the senior executives in the nation's largest companies are women. The Feminist Majority Foundation blames this on sex discrimination. Study: Women Hold 3% of Top Jobs, supra. The United States Department of Labor has also released a study concluding that both women and members of minority groups are victims of discrimination in the business world. See Caryl Rivers, Going Through the Glass Ceiling, PHILADELPHIA INQUIRER, Aug. 27, 1991, at A11.

8. See BERLE & MEANS, supra note 1, at 122-23.
9. Id. at 124.
10. Id. at 345-55.
11. See id. at 354.
12. Id. at 356. Berle and Means considered and rejected what are today referred to as the fiduciary and contractarian corporate models. See id. at 354.
13. Id. at 356.
14. See id. at 357. In a later work, Berle somewhat optimistically wrote: "Corporation executives as individuals are not capitalists seeking profit. They are men seeking careers, in a structure offering rewards of power and position rather than profit or great wealth." ADOLF A. BERLE, JR., POWER WITHOUT PROPERTY 68 (1959). Those who believe it unrealistic to expect anyone to be sufficiently motivated by non-monetary rewards can take comfort in, and be amused by, Berle's next sentence: "Probably an exactly similar situation prevails within any Communist commissariat." Id.
15. BERLE & MEANS, supra note 1, at 356. With respect to the forces that may have influenced the development of Berle's thinking, it is interesting to note that his father was a clergyman, theologian, university professor, and author of a number of books, including one entitled Character Building. See 4 WHO WAS WHO IN AMERICA 81 (1969).
rate America, Berle and Means would surely feel that their worst
nightmare had come true. They would find that the driving force
among those responsible for the nation's largest corporations is ava-
rice, not social responsibility. They would find that shareholders
behave more like casino gamblers than business owners; that direc-
tors are given large fees and perks to keep them quiescent; and that
managers live more like princes than Berle or Means ever dreamed
was possible. They would tell us that, by making them rich, we
have perverted the values of corporate managers. They would tell us
that we have created a vicious cycle: the large compensation of top
executives has eroded their consciences and fed their greed, which
has caused them to maneuver to get still more money, which in turn
has repeated and intensified the cycle. No one has stepped in to stop
it, and the absence of reproach has emboldened executives even
more.

It is not that society is indifferent. There is wide-spread revul-
sion over the money paid to the top executives of America’s largest
corporations. But the staggering sums continue to escalate none-

16. In their book, Barbarians at the Gate, Bryan Burrough and John Helyar give a
glimpse of how key executives at RJR Nabisco lived in the middle 1980s. The CEO's
perks—fully paid for by the company—included two maids for his home, memberships in
two-dozen clubs, and $30,000 worth of eighteenth-century porcelain china for his office.
BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE 93 (Harper Perennial ed.
1990). Top executives had at their disposal a fleet of maroon Cadillacs and chauffeurs in
matching uniforms because maroon was the favorite color of one executive, as well as a
fleet of jet airplanes, including two G4s that cost $21 million each. Id. at 92, 94. They
boarded these aircraft from a private terminal complete with an atrium, a Japanese gar-
den and Italian marble floors, and decorated with $600,000 in furnishings and $100,000
in art works. Id. at 92. The executive offices were even more lavish, and bowls of French
bonbons were distributed throughout the executive offices twice a day. Id. at 93. Some of
the executives became legends at the hotel near the corporate offices for giving $100 tips
to the shoe shine girl. Id. at 92-93.

17. Unless otherwise specified, the term “pay” will refer to total compensation
(including salary, bonuses and long-term compensation but excluding pension plans and
job perquisites or “perks,”) as will the phrases “was paid” and “received.” The term
“salary” will refer only to that component of compensation.

The perks that more than half of major corporations give top executives include use
of a company car and company airplane, memberships at country and luncheon clubs, and
financial counseling, estate planning and income tax preparation. See Popular Perks,

In many cases, the largest share of executive compensation comes from a long-term
compensation plan. In 1991, 20 of the 25 highest paid executives received most of their
compensation from some form of stock plan. See Steve Kichen & Eric S. Hardy, Putting it
in Perspective, FORBES, May 25, 1992, at 174, 175. These plans come in many varieties.
The most common are:

Incentive Stock Options. The company gives the executive the right to purchase
a certain number of shares at a stipulated price, called the “strike price” or
“option price,” within a designated period of time. The strike price is higher
than the current market value of the shares when the options are awarded. The
theless. In 1981, a survey of the 25 highest paid executives in the United States revealed that the twenty-fifth highest paid executive received $1.5 million, and the highest paid executive in the country received $5.7 million. There was a public outcry over these sums.

The concept is to give the executive an incentive to increase the value of the company's stock above the strike price. However, when the stock price declines, many companies often give executives "option swaps," which allow them to exchange old options for new ones with lower strike prices. See infra note 361 and accompanying text for more about lowering option strike prices.

**Nonqualified Stock Options.** These are similar to incentive stock options but the strike price is often below the current market price, thus allowing the executive to realize an instant profit.

**Stock Appreciation Rights.** The company gives the executive the right to realize the appreciation in the value of a certain number of shares of stock within a designated period of time. The executive is paid in cash, stock, or a combination of the two. The concept is to give the executive the same benefits as incentive stock options without requiring him to purchase the stock. Plans sometimes include *reload options* which give the executive the appreciation he would have received by exercising the option when the stock price reached its highest point during, typically, a ten-year time frame.

**Phantom stock.** These are similar to stock appreciation rights but include the total value of a certain number of shares of stock, not just its appreciated portion.

**Restricted stock.** The company makes either an outright gift of stock to the executive or allows him to purchase stock below the current market price but the executive cannot sell the stock for a specified period of time.


For more than forty years Business Week has published an annual survey of executive compensation in its first issue in May. Since 1988, Fortune has in June published an annual compensation survey by Professor Graef S. Crystal of the Haas School of Business at the University of California at Berkeley. One of the problems in determining how much an executive was paid in a given year is evaluating how much compensation he received through stock options, stock appreciation rights, and the like. Business Week uses the simple approach of considering all monies in the year received. Under this system an executive is considered to have received money from a stock option only in the year he exercised the option. This approach has the virtue of accuracy, but it makes year-to-year comparisons difficult because, for example, executives often receive stock options every year but exercise them at irregular intervals. Professor Crystal attempts to determine the value that an executive has received from his stock options each year by using a modeling process. This process uses a number of scenarios to project what an executive may earn on his options if he exercised them at the end of the option period, averages the values produced by the different scenarios and discounts the average back to the year in which he received the option. In the case of particularly large grants, Professor Crystal spreads the grant over three years. See Crystal, *How Much Do CEOs Really Make?*, supra note 17, at 72-73. This approach makes annual comparisons more meaningful, but it requires making assumptions about how much an option is worth which may of course differ from
A study was released that compared the pay of American CEOs with their foreign counterparts and with other Americans. It showed that in 1981, the CEO of Nissan made $140,000 and no one at Renault made more than $150,000. It noted that the average doctor in the United States made $81,000, the average top-level lawyer $83,966, the Governor of New York State $100,000 and the President of the United States $200,000. A distinguished scholar analogized the huge sums paid to CEOs to other “violations of the moral system” and pleaded for the courts to act. Nevertheless, by 1988 all of the 25 highest paid executives made more than $5.7 million each. The two top executives of RJR Nabisco made $42.8 million between them that year, and they were dwarfed by two Walt Disney Company executives who earned $32.1 million and $40.1 million respectively. The next year the two top RJR Nabisco executives retired with golden parachutes that were together valued at $98.7 million. Outrageous compensation is, moreover, not limited to only the top 25 executives. By 1991, at least 400 executives were making more than one million dollars, and CEOs at the nation’s largest 200 corporations were, on average, paid $2.4 million dollars each.
Surprisingly, compensation does not correlate with results: CEOs enjoyed an average pay increase of 9.4% in 1991 even though their companies’ profits declined 7% and the median price of their companies’ stock fell 7.7%. In the words of Professor Graef S. Crystal, who has performed extensive studies of CEO pay at 170 of the largest United States corporations, “[j]ust about all the rational factors you can think of, taken together, don’t play a big role in determining CEO pay, and some factors that you might expect to influence it, or that ought to in a perfect world, don’t matter at all.”

Not everyone agrees that executive compensation today is excessive. Highly-paid executives are fond of comparing their earnings with those of movie and sports stars. They point out that their pay is set by special compensation committees of their companies’ boards of directors after careful study that, among other factors, considers what comparable executives earn. Some believe that there is no such thing as “excessive” compensation and that anyone is entitled to as much as he can bargain for. Others argue that the topic is of little consequence because executive compensation constitutes only a small fraction of a company’s total expenses and makes only a few cents difference to any given shareholder.

Part I of this Article will address the question of when compensation is “excessive.” It will briefly review the history of executive compensation in the United States and consider various yardsticks that may be used to measure compensation. It is admittedly a value-laden topic—and that is precisely the point. For as the discussion of the Berle and Means’ theories has already suggested, enormous executive pay cannot help but have a large impact on corporate culture.

27. For the 9.4% increase in CEO pay and the 7.7% decline in median share prices see id. at 72. For the 7% decline in company profits see Byrne, supra, note 25, at 91. Under the Business Week system of measuring CEO pay, and for the larger pool of CEOs surveyed, CEO pay increased 7% in 1991. Id.

28. Graef S. Crystal, The Wacky, Wacky World of CEO Pay, FORTUNE, June 6, 1988, at 68 [hereinafter Wacky World of CEO Pay]. In 1988, Professor Crystal started testing to see whether CEO pay was affected by certain “rational factors.” He found that all nine rational factors that he examined together accounted for only 39% of the variation in CEO pay. Id. at 69.


30. See, e.g., KLEINFIELD, supra note 7, at 148. During the years 1988-89, the highest paid entertainers were Michael Jackson ($125 million), Steven Spielberg ($105 million) and Bill Cosby ($95 million). See PHILLIPS, supra note 18, at 182. In entertainment, however, the star is the product. People buy a Michael Jackson album to hear Jackson sing, or watch a Cosby television show to see Cosby perform, but people do not buy a Coke because Roberto C. Goizueta is the company’s CEO. The better comparison is to compare the CEO to the star’s manager. For a more recent comparison of earnings of celebrity actors, athletes, novelists, television anchors and the like, see Dana W. Linden & Dyan Machan, Put Them at Risk!, FORBES, May 25, 1992, at 158.
and, accordingly, on corporate behavior. Part I will also explore other possible consequences of excessive executive compensation. Does excessive executive compensation have a significant financial impact on the corporation or its shareholders? Does it affect the ability of United States companies to compete with foreign firms? What are the social and political ramifications of making a small class of persons enormously wealthy?

Part II will discuss the significance of excessive compensation to basic tenets of corporate democracy. In theory, directors set an executive's compensation and, in accordance with their fiduciary duties to the shareholders, compensate executives in the manner most advantageous to the company and its stockholders. If the directors fail to do so, the shareholders should, in theory, elect new directors. There is much debate about how well corporate democracy works and what should be done to strengthen it. This Article will argue that excessive executive compensation is a symptom of corporate dysfunction and that it is, therefore, relevant to the debate about what is wrong with the American corporation and how to fix it.

Part III of the Article will argue that judicial remedies are necessary to curb executive compensation, and that the courts are the last—but ultimately necessary—resort. It will review the history of executive compensation cases in the courts, tracing the attitude of the courts from an initial receptiveness to excessive compensation cases, through a long period of inhospitality to cases involving public companies, to the present time, when the courts appear ready to open their doors once again to shareholder derivative actions challenging excessive compensation.

I. EXECUTIVE COMPENSATION

A. History and Data: An Overview

The modern corporation was born at the beginning of the twentieth century. In 1896, New Jersey enacted the first legislation providing for the general formation of corporations.31 Previously, corporate charters were only available on an individual basis, which were granted through the introduction and passage of a bill by the state legislature.32 In 1901, the first large corporation, United States Steel Corp., was formally organized.33

33. See GORTON CARRUTH, THE ENCYCLOPEDIA OF AMERICAN FACTS & DATES 393 (8th ed. 1987). U.S. Steel was the first company that listed itself as having a billion dollars in
In the early part of the century, the great corporations were formed and developed by entrepreneurs—men like J.P. Morgan, William H. Vanderbilt and Henry Ford. But by mid-century an executive class had formed and taken control of the great companies. Sociologist C. Wright Mills wrote that by 1950 the CEOs of America's largest companies were no longer "country boys who have made good in the city," as they had been half a century earlier; they were members of an elite class born and bred for position. More than 70% of the CEOs' fathers had been business or professional men, as had most of their paternal grandfathers. This by itself defined a distinct group; during their fathers' lifetimes only 11% of the male population had been business or professional men, in their grandfathers' day no more than 9%. By 1950, only 6% of

assets, although about a third of that was "good will." Id.

34. C. WRIGHT MILLS, THE POWER ELITE 127 (paper ed. 1956). Mills, a professor of sociology at Columbia University, was one of the most influential sociologists of his time.

Mills was disdainful of Berle's "search for a corporate conscience." Id. at 126 n.II. Mills found corporate executives to be motivated primarily by profit and security and corporations to be totalitarian and dictatorial. Berle, he wrote, "mistakes expedient public relations for a 'corporate soul.'" Id. Despite these protestations to the contrary, Mills does not seem so far from Berle. Mills believed that declining morality resulted "from the fact that older values and codes of uprightness no longer grip the men and women of the corporate era." Id. at 344. "[T]he corporate rich now wield enormous power," he wrote, "but they have never had to win the moral consent of those over whom they hold this power." Id. He believed that the weakening of moral values was not due to any crises but rather to "a creeping indifference" and that a great deal of corruption "is simply a part of the old effort to get rich and then to become richer." Id. at 345-46.

Berle was an optimist; he believed that corporate leaders would learn to internalize higher values. Mills was a pessimist; as a sociologist, he saw that they had not, and he had little reason to believe things would change. That is what principally separated the two men.

35. Id. at 128. As of 1986, there was only one female CEO among the five hundred largest industrial companies in America (Katherine Graham of the Washington Post Company, who achieved her position through family control of the company). See KLEINFELD, supra note 7, at 8. Today there is no more than one female CEO in the thousand largest companies in America. See infra note 87 and accompanying text. See also supra note 7.

36. MILLS, supra note 34, at 128.

37. Id. Top corporate managers come disproportionately from an even more sharply delineated upper class. One recent study found that nearly half of all top corporate executives have either attended one of fourteen elite prep schools or come from families listed in the Social Register. See PETER W. COOKSON, JR. & CAROLINE H. PERSSELL, PREPARING FOR POWER: AMERICA'S ELITE BOARDING SCHOOLS 198 (1985). Another study found that 10% of members of the boards of directors of large American corporations attended one of thirteen of the nation's most elite prep schools. Id. at 196. Forty percent of parents who send their children to boarding school are business managers. Id. at 195.

Things were much the same when Mills surveyed them. Mills found, in 1950, that upper class boys generally attended one of a select group of eight prep schools (schools that continue to make up the core of the most elite thirteen or fourteen schools in the
top executives had entrepreneurial backgrounds, and the typical CEO had worked for the same company since age 29.\textsuperscript{38}

Some top executives were making big money in 1950. The president of E.I. du Pont de Nemours Co. made about $500,000 that year and the president of Bethlehem Steel Corp. made about $450,000.\textsuperscript{39} The highest paid executive in America was the president of General Motors, who made $581,000.\textsuperscript{40} Those were considerable sums; $500,000 in 1950 is equivalent to nearly $2,500,000 today.\textsuperscript{41} But only a handful of the CEOs received compensation of that magnitude.

As late as 1960, the average CEO of the top companies was earning only $190,383.\textsuperscript{42} CEO pay rose sharply over the next decade, underwent a slower rate of growth in the 1970s, and then skyrocketed during the Reagan and Bush administrations.\textsuperscript{43} During the 1980s, CEO compensation rose 212% while the wages of factory workers rose 53%.\textsuperscript{44} In 1956, veteran CEOs were making 34 times as much as the average factory worker; by 1990, they were making 130 times as much.\textsuperscript{45} Some executives made as much as hundreds of fac-

\textsuperscript{38} MILLS, supra note 34, at 131-32.

\textsuperscript{39} Id. at 129. These figures include salary and bonus but exclude any income from dividends.

\textsuperscript{40} Id. at 129-30. This sum includes salary and bonuses only. It is not known how much money he may have made in stock dividends.

\textsuperscript{41} Based on the Consumer Price Index (CPI). The CPI base line years are 1982-84 for which CPI = $1.00. In 1950, a CPI dollar was worth $1.515, and in 1988, it was worth $.846. See U.S. BUREAU OF THE CENSUS, STATISTICAL ABSTRACT OF THE U.S. 467 (110th ed. 1990). Thus, a 1950 dollar is worth about $4.65 in 1988, in terms of consumer purchasing power, and 500,000 1950 dollars was worth about $2,325,000 in 1988.

\textsuperscript{42} See John A. Byrne et al., Is the Boss Getting Paid too Much?, BUS. WK., May 1, 1989, at 46, 48, 52. CEOs were making nineteen times as much as engineers and thirty eight times as much as teachers. Id. at 48. But cf. Michael C. Jensen & Kevin J. Murphy, CEO Incentives—It's Not How Much You Pay, But How, HARV. BUS. REV. May-June 1990, at 138, 144, suggesting that CEOs in the top quartile of public companies earned, on the average, slightly more in the 1930s than in the 1980s (measured in constant 1988 dollars). The Jensen and Murphy figures are skewed by the fact that they are using only salary and bonus and are ignoring long-term incentives such as stock options. In the 1930s the CEO compensation consisted mostly of salary and bonuses, but in the 1980s long-term compensation made up a substantial portion of top executive compensation.

\textsuperscript{43} See Byrne, supra note 42, at 52. See also PHILLIPS, supra note 18, at 165-85.

\textsuperscript{44} Byrne, supra note 25, at 90.

\textsuperscript{45} Kate Ballen, Let Them Eat Bread, FORTUNE, Sept. 24, 1990, at 9. This figure was computed by Professor Crystal, who restricted his study to CEOs employed for at least
tory workers. The CEO of W.R. Grace, for example, made as much as 200 average factory workers, and the CEO of National Medical Enterprises made as much as 625 workers. Moreover, the gap in take-home pay grew even wider during this period. In 1960, CEOs faced a top personal income tax rate of 91%, but this was lowered to 28% during the Reagan administration while workers received no corresponding tax reductions.

CEO compensation has fascinated many scholars, and in one form or another it has been studied by economists, sociologists, accountants and experts in management and industrial relations. There is, as a result, a large body of data on the subject. The researchers, however, have not spoken with one voice; not only have they been influenced by the differing approaches of their various disciplines, but they often have been affected by ideological perspectives. It is not surprising, therefore, that the literature furnishes a cacophony of discordant voices, and one can find conclusions to support almost any viewpoint. What is both surprising and highly significant, however, is that there is a general consensus on what is perhaps the most important single point: there is little, if any, relationship between what top executives make and how they perform.

One finds this conclusion in source after source. In 1989, two scholars reviewed the vast body of data concerning executive compensation and concluded that "most studies share something in common: the total amount of explained variance in executive pay attributed to firm performance is minimal, seldom exceeding 15 percent."

seventeen years. Professor Crystal used a modeling analysis. Using a different method, Business Week reported that in 1988, CEOs made 44 times as much as engineers, 72 times as much as teachers and 93 times as much as factory workers that year. Byrne, supra note 42, at 48. See supra note 18 for a description of the differences between the two methodologies.

46. Ballen, supra note 45, at 9.
47. See Byrne, supra note 42, at 49.
49. See infra notes 50-66 and accompanying text; see also LUNDBERG, supra note 20, at 441, who reviewed data available to him in the 1960s and concluded: "There is in fact no consistent relationship between high executive pay and company success."

In general, researchers equate CEO performance with company performance. This allows them to use objective yardsticks—such as company profits or shareholder return on equity—to measure CEO performance. Some fundamental assumptions are, however, being made when CEO performance is equated with company performance. While the assumptions are probably valid for large groups analyses, they are questionable in individual situations. This Article argues infra that courts should not assume that, in an individual case, a particular company's performance necessarily reflects the CEO's performance.
percent and often well under 10 percent.” In 1990, two other scholars—who are considered conservatives on the subject and argue that CEOs may be underpaid—conducted their own independent studies and concluded: “Whatever the metric, CEO compensation is independent of business performance.” Moreover, they found that the relationship between pay and performance was weaker in the 1980s than it had been fifty years earlier. And in the most recent edition of his classic treatise, The New Industrial State, John Kenneth Galbraith noted that, “[e]xecutive compensation in recent times has frequently increased in face of stationary or declining profits.”

In his independent studies, Professor Graef S. Crystal of the University of California at Berkeley found some correlation between pay and performance, but he concludes nonetheless that “in a disheartening number of other cases, no claim to superior corporate performance supports the CEOs’ exceedingly high pay.” A correlation may exist (albeit a weak one) because executives successfully use an increase in company performance to justify huge pay raises while poor performance results in less huge but still handsome increases. Crystal’s studies show that a 10% rise in company performance results, on the average, in a whopping 24% increase in CEO pay. But the converse is not equally true; a 20% decline in profits results, on the average, in a 7.5% increase in pay, and CEO pay still rises by an average of 6.1% when profits fall by 30%. It takes a cataclysmic decline of more than 70% before average CEO compen-

50. Tosi & Gomez-Mejia, supra note 48, at 185. The authors note, however, that some studies show a stronger correlation between pay and performance in owner-controlled firms. It is generally believed that someone who owns at least 5% of the company’s stock can exercise at least some degree of effective control, and the studies therefore define an owner-controlled company as a company in which a single holder controls at least 5% of the company stock. See id. at 170.

51. Jensen & Murphy, supra note 42, at 143. Michael C. Jensen and Kevin J. Murphy are, respectively, professors of business administration at Harvard University and the University of Rochester.

52. Id. at 143-44.


54. Graef S. Crystal, The Great CEO Pay Sweepstakes, FORTUNE, June 18, 1990, at 95. [hereinafter Crystal, CEO Pay Sweepstakes]. See also Charles A. O’Reilly et al., CEO Compensation Tournament and Social Comparison: A Tale of Two Theories, 33 ADMIN. SCI. Q. 257, 266 (1988), in which the researchers, including Professor Crystal, report additional studies that “show modest positive effects” of return on equity and sales on CEO compensation.

55. Crystal, CEO Pay Sweepstakes, supra note 54, at 95. Crystal measures performance on the basis of a “Performance IQ” that he develops by considering the total return to investors during the CEO’s tenure, the ten-year trend in total return, the five-year average ratio of stock price to book value, five-year growth of sales and assets, five-year volatility of sales and asset growth, five-year average of return on equity and five-year trend on return on equity. Id. at n.94.

56. Crystal, How Much Do CEOs Really Make?, supra note 17, at 76.
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sation shows any decline. Crystal's research also confirms that the relationship between pay and performance is weakening—not only over a fifty year span as shown in other research—but each year during the period 1988-90 as well.

CEOs are rarely fired for poor performance. Two recent studies examined more than 500 management changes and found only twenty cases where CEOs were terminated for poor performance. A third study compared companies in the top and bottom 10% of performance as measured by return on equity; it found that CEOs in the top performing companies had a 3% chance of getting fired while CEOs in the worst performing companies had a 6% chance of being terminated. These results were confirmed by a fourth study of 1,400 companies, which showed that CEOs with extremely poor performance were only slightly more likely to leave their jobs than those with average performance. CEOs average more than a decade in their positions, and most leave their jobs after reaching retirement age.

Many individual examples illustrate these data. In the 1950s, one of the highest paid executives in the United States was Eugene P. Grace of Bethlehem Steel Corporation—despite the fact that Bethlehem was continuously recording deficits and was paying no dividends to its shareholders. In the 1970s, A & P gave each of its two top officers an annual bonus of $100,000 despite what the New York Times termed their "lackluster performance." In the 1990s, the company that owns Southern California Edison gave its retiring CEO a gift of restricted stock worth more than half a million dollars, which prompted Professor Crystal to ask: "Whatever happened to

57. Id. But see Andrew R. Brownstein & Morris J. Panner, Who Should Set CEO Pay? The Press? Congress? Shareholders?, HARV. BUS. REV., May-June 1992, at 28, 32 (criticizing Professor Crystal's conclusion that poor performance does not result in pay cuts). In support of their own position, however, they offer nothing more than a small dose of anecdotal evidence. Brownstein and Panner also challenge the proposition that only a weak link exists between CEO pay and performance, citing, on this point, only an unpublished speech that a representative of Arthur Andersen & Co. made to the National Association of Corporate Directors. Id. at 30.

58. Crystal, How Much Do CEOs Really Make?, supra note 17, at 76.

59. See Jensen & Murphy, supra note 42, at 138, 142; see also JOHN K. GALBRAITH, THE AFFLUENT SOCIETY 86 (3d ed. 1976).

60. Jensen & Murphy, supra note 42, at 142.

61. Id.

62. Id. The fourth study found that CEOs with poor performance were only 6% more likely to leave their jobs than those with average performance. Poor performance was defined as having company earnings 50% below market averages for two consecutive years.

63. Id.

64. See LUNDBERG, supra note 20, at 441.

65. See GREEN & TENNERIELLO, supra note 19, at 19.
the gold watch as a retirement momento?\textsuperscript{66}

If pay is not related to performance, to what, if anything, is it related? First, as one might expect, studies show that executive compensation correlates with company size; i.e., the larger the company, the higher the CEO's pay.\textsuperscript{67} There is debate about why this is so. Some argue that the larger the company is, the more sophisticated and difficult the CEO job must necessarily be, and, therefore, the more money large companies must pay to attract and retain CEOs who have the greatest skill and experience. This theory, however, runs into trouble when one analyzes how company size is defined. Three factors are generally used to measure company size: assets, sales volume and number of employees. CEO compensation correlates only with sales volume; there is no significant relationship with assets and there is actually a negative correlation between CEO pay and the number of company employees.\textsuperscript{68} The complexity of the CEO job increases with the number of employees at least as much as it does with sales volume, if not more so. These data suggest that the relationship between company size and CEO compensation results from nothing more than the fact that larger companies have a greater capacity to pay high salaries.\textsuperscript{69}

The relationship between CEO pay and another variable is even more interesting: there is a positive correlation between CEO compensation and the salaries of outside members of the company's

\textsuperscript{66} Crystal, \textit{How Much Do CEOs Really Make?}, supra note 17, at 78. In a recently published book, Professor Crystal provides detailed descriptions of four companies and how they compensated their CEOs over a period of years. His observations include, for example, an analysis showing that the CEO of Champion International made $5 million in 1990 although his company ranked at the 8th percentile among the companies with the largest market capitalization in terms of shareholder return on equity (ROE). CRystal, \textit{IN SEARCH OF EXCESS}, supra note 17, at 96-98. He also traces the compensation history of Rand Araskog of ITT from the time he became CEO in 1980, when ROE was 15% and Araskog's compensation was $886,000, through the next ten years during which ITT shareholder ROE fluctuated between 4.7% and 11.7% and Araskog's compensation increased to $11.5 million. \textit{Id.} at 100-02.

\textsuperscript{67} See O'Reilly et al., supra note 54, at 258, reporting that "[t]here is abundant research linking firm size to CEO compensation." See also Crystal, \textit{How Much Do CEOs Really Make?} supra note 17, at 74; Crystal, \textit{CEO Pay Sweepstakes}, supra note 54, at 95; Graef S. Crystal, \textit{Seeking the Sense in CEO Pay}, \textit{FORTUNE}, June 5, 1989, at 96 [hereinafter Crystal, \textit{Seeking the Sense in CEO Pay}]; Crystal, \textit{Wacky World of CEO Pay}, supra note 28, at 69. This relationship is also a weak one; a 10% increase in company size appears, on the average, to result in a 2% rise in CEO pay. \textit{Id.}

\textsuperscript{68} See O'Reilly et al., supra note 54, at 266. These data are the product of regression analyses.

\textsuperscript{69} Other researches have concluded that although there is a statistically significant relationship between firm size and CEO compensation, the individual variances are so large as to suggest "that compensation policies are idiosyncratic." Peter F. Kostiuk, \textit{Firm Size and Executive Compensation}, 25 J. HUM. RESOURCES 90, 104 (1990).
There is an even stronger relationship between the CEO's compensation and the salaries of the outside members of the board who serve on the executive compensation committee. For every increment of $100,000 in the annual average salary of the outside directors on the compensation committee, the salary of the company's CEO can be expected to rise $51,000. The relationship is strongest with the salary of the director who chairs the compensation committee. According to Professor Charles A. O'Reilly III of the University of California at Berkeley, "[i]f the chairman of the compensation committee has a high salary, we can predict that the CEO will, too."

Among all of the other data, perhaps the most important remaining item is that there typically is an enormous gap between the pay of the CEO—or in some instances the pay of the two highest corporate officials—and the pay of the vice presidents. The president's compensation may be three times that of the vice president's. This pay differential does not square with "skill-level" justification of high CEO salaries. If it is in the corporation's interest to pay the CEO a salary at a certain level, is it not also in the company's interest to motivate the vice presidents—who often control divisions that are essentially, themselves, large companies—through similar compensation packages?

Economists have developed a number of theories to try and explain the compensation gap between CEOs and vice presidents. One theory is that the vice presidents have all tacitly entered into a

70. O'Reilly et al., supra note 54, at 265-66 and 268-69. See also The SEC and the Issue of Runaway Executive Pay: Hearings on S. 1198 Before the Subcomm. on Oversight of Government Management, Comm. on Governmental Affairs, 102d Cong., 1st Sess. 8 (1991) [hereinafter Hearings] (statement of Graef S. Crystal, Adjunct Professor of Organizational Behavior and Industrial Relations, University of California at Berkeley).
71. Hearings, supra note 70.
72. Id.
74. The data also show that there is no relationship between the CEO's age and pay, that companies headquartered in New York City and Los Angeles pay significantly more on the average than those headquartered elsewhere, and that the length of a CEO's tenure at the company has a negative correlation with his pay. See, e.g., Crystal, CEO Pay Sweepstakes, supra note 54, at 95; Crystal, Wacky World of CEO Pay, supra note 28, at 69; see also Kostiuk, supra note 69, at 95. At times studies show variances among different industries. See, e.g., Crystal, Seeking the Sense in CEO Pay, supra note 67, at 83, 100; and Crystal, How Much Do CEOs Really Make?, supra note 17, at 74. At other times studies fail to reveal any significant relationship between type of industry and pay. See, e.g., Crystal, CEO Pay Sweepstakes, supra note 54, at 95; Kostiuk, supra note 69, at 95.
75. See, e.g., O'Reilly et al., supra note 54, at 260.
76. Id.
type of tournament, each accepting reduced compensation in order to contribute to the ultimate prize—the CEO position—for which they are all competing. The tournament model is a strange idea, one that may make more sense in the musings of theoretical economists than in the real world. There is a simpler explanation: those in control reward themselves.

B. Consequences

The wealth that America's top CEOs are acquiring is massive by any measure. During the period 1980 to 1989, Michael D. Eisner, the CEO of Walt Disney Company, was paid a total of $61.9 million. That will not be the extent of his fortune. Eisner made $11.2 million in 1990 and $5.4 million in 1991, and at 49-years-of-age he can look forward to receiving many more years of similar earnings. Charles Lazarus of Toys "R" Us made $156.2 million during the 1980s. Anthony J.F. O'Reilly of H.J. Heinz made more than $75 million in 1991 alone. That is what these men made in compensation for their jobs; many CEOs have transactional opportunities to make still more money, above and beyond normal compensation. During mergers in 1990, for example, Steven J. Ross of Time-Warner made $78.2 million and Donald A. Pels of LIN Broadcasting made $186.2 million. Other CEOs have bailed out of their companies with golden parachutes worth as much as $53 million.

These are among the highest earning CEOs, but they are not the only ones amassing sizable fortunes. As previously noted, CEOs at the nation's 365 largest companies earn an average of about two million dollars a year, and most will stay in their jobs for more than ten years, many for twenty years or more.

Individuals have, of course, amassed great wealth in America

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77. Id.
78. See Pay Stubs of the Rich and Corporate, BUS. WK., May 7, 1990, at 56, 60.
79. See What 500 Companies Pay Their Bosses, FORBES, May 25, 1992, at 182, 196 (1991 pay and age; Eisner was 50 in 1992); and Byrne, supra note 25, at 90, 91 (1990 pay).
80. See Pay Stubs of the Rich and Corporate, supra note 78, at 60.
81. See Kichen & Hardy, supra note 17, at 175.
83. See supra text accompanying note 24.
84. See Jensen & Murphy, supra note 42, at 142 (reporting a study of 2,505 CEOs that found, on average, CEOs hold their jobs more than ten years). But see Robert Mims & Ephraim Lewis, A Portrait of the Boss, BUS. WK., Oct. 20, 1989, at 23-24 [hereinafter A Portrait of the Boss 1989] (reporting that of the 1,000 CEOs of the most valuable companies surveyed in 1989, the average tenure was less than nine years, and 111 had been in their jobs for at least twenty years).
before, but never has a group been enriched this way. The typical CEO of today is not like Henry Ford or Andrew Carnegie, who became wealthy through entrepreneurial accomplishment. Nor is he like Dr. Edward Land, who invented the Polaroid Land Camera, or Steven Jobs, the founding genius of Apple Computer. The special talent of today’s CEO is bureaucratic skill, the ability to rise through the corporate hierarchy to the office of chief executive officer. It is a personally useful talent, to be sure, but not one that benefits the greater society. CEOs are not becoming wealthy because of what they contribute but merely because of the position they occupy.

Enriching a group this way—and in this magnitude—has profound social, political and economic consequences.

1. Social. When sociologist C. Wright Mills surveyed the corporate scene nearly forty years ago, he found that top executives came from a clearly defined group. Things are much the same today. They are invariably white and male. Only one woman is the CEO of one of America’s thousand largest companies, and only one African American has ever headed such a company. Today CEOs are generally Protestant, most often either Presbyterian or Episcopalian.

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85. Cf. MILLS, supra note 34, at 161, who wrote in 1956: “There is maintained in America, and there is being created and maintained every year, a stratum of the corporate rich, many of whose members possess far more money than they can personally spend.” But never before have so many made so much. The magnitude of the current situation—both in terms of the size of the group and the fortunes being amassed—is unprecedented.


87. A recent Business Week survey of the thousand largest companies in the United States found that all had male CEOs. See A Portrait of the Boss 1991, supra note 7, at 180. In the most recent Forbes survey of 800 companies, one woman, Marion O. Sandler of Golden West Financial, appeared as a co-chief executive officer with her husband. See What 800 Companies Paid Their Bosses, supra note 79, at 182, 183. And there is one woman CEO among the Fortune 500—Linda Wachner of the apparel company Warnaco. See Susan Caminiti, America’s Most Successful Businesswoman, FORTUNE, June 15, 1992, at 102.


89. A Portrait of the Boss 1989, supra note 84, at 28. There appears to be more religious heterogeneity among CEOs today than in earlier times. In 1956, Mills wrote that there were fewer Jews and Catholics among the top executive group than in the population-at-large. MILLS, supra note 34, at 128. And writing in 1968, Lundberg said that Jews constituted only 0.5% of the executive population, although they then represented 3% of the general population. LUNDBERG, supra note 20, at 301, quoted in VANCE PACKARD, THE PYRAMID CLIMBERS 36 (1962). However, a survey of the CEOs of the top 1,000 corporations in 1989 found that 62% of the responding CEOs identified themselves as Protestant, 23% as Catholic and 13% as Jewish. See A Portrait of the Boss
They typically attended a well-known university, worked for their present company for more than 22 years and made their way to the top through the finance, accounting or marketing department.

According to Professor G. William Domhoff, CEOs are drawn from both the middle and upper-classes, but those with middle-class origins are assimilated into the upper-class. The upper-class is a socially cohesive group that shares common backgrounds, training and values. CEOs are not propelled into the upper-class by virtue of acquiring great wealth; it is more the other way around. They are selected for gradual assimilation, often by a mentor or superior. The process of assimilation is gradual and complex, involving both the CEO and his wife, who, over time, are invited to participate in charitable projects, join cultural and social organizations, and become trustees of educational and cultural institutions. Their original membership in the upper-class—or their successful assimilation into

1989, supra note 84, at 28.

90. The most commonly attended undergraduate schools were—in descending order—Princeton, Yale, Harvard, Pennsylvania, Northwestern, Stanford and Cornell. More than 15% have an undergraduate degree from one of these seven universities, and nearly 10% of the CEOs received a graduate degree from Harvard. See A Portrait of the Boss 1991, supra note 7, at 180. Scanning the roster of CEOs shows that many attended state universities or other well-regarded but not necessarily elite schools. See The Corporate Elite, BUS. WK., Nov. 25, 1991, at 185-216. But elite schools predominate. The eight, comparatively small Ivy League schools had 159 alumni heading one of the thousand largest companies in 1990, compared to only 93 alumni of Big Ten schools. See A Portrait of the Boss 1990, supra note 86, at 11. Moreover, according to one recent study, the proportion of CEOs who attended Ivy League schools is increasing. See Susan Caminiti, Where the CEOs Went to College, FORTUNE, June 18, 1990, at 120, 121. For data concerning colleges attended by CEOs in earlier decades, see supra note 37.


92. See G. WILLIAM DOMHOFF, WHO RULES AMERICA NOW? 74-75 (1983). Domhoff, a professor of sociology and psychology at the University of California at Santa Cruz, notes, for example, that while two-thirds of CEOs attended public high school, they often send their children to the elite boarding and day schools that provide the traditional training ground of the upper-class, and that while only 29% of CEOs went to an Ivy League college, 70% of their children do so. CEOs may be drawn from a somewhat broader band of the social spectrum today than forty years ago, when Mills noted that chief executives came from upper and “upper-middle” class families. See MILLS, supra note 34, at 128.

93. Building on the work of E. Digby Baltzell and others, Domhoff defines the upper-class in terms of “an interrelated set of social institutions, organizations, and social activities.” DOMHOFF, supra note 92, at 18. Domhoff considers the following principal indicators of membership in the upper-class; being listed in The Social Register, attending one of a particular group of select boarding and day schools, or being a member of one or more of a particular group of clubs. See id. at 44-47. He estimates that the upper-class comprises 0.5% of the general population. See id. at 49.

94. This is not to say that wealth is not associated with membership in the upper-class. Domhoff writes that although “[t]here are newly rich people who are not yet assimilated into the upper class,” and although some never will be, “for the most part it is safe to conclude that the people of greatest wealth and highest income are part of—or are becoming part of—the upper class.” Id. at 43-44.
it—is undoubtedly one of the attributes that qualifies them for eventual promotion to CEO.

One consequence of excessive executive compensation is, therefore, a revitalization of the upper-class.95 Those CEOs who come from upper-class families bring new fortunes into their families; those from middle-class or upper-middle-class origins bring fresh blood and wealth into the upper-class. And, indeed, the upper-class has recently been accumulating a much greater share of the nation’s wealth. The most recent data show that the wealthiest 0.5% of United States households own nearly 29% of the nation’s net worth—up from 14.4% in 1976 and higher than anytime since 1939.96 Excessive executive compensation was not the sole cause of this redistribution of wealth;97 other, and even larger, forces were at work during the same period.98 But it was a significant factor.99

95. The wealth of upper-class members benefits the entire class, not just the families who possess it. A rich upper-class family can be expected to support upper-class institutions by, for example, sending their children to elite schools, becoming active in the various cultural and social organizations which the upper-class patronize, and—most important of all—making generous contributions to these institutions. Moreover, upper-class members tend to do business with other upper-class members, so that a member of the upper-class will generally provide business to bankers, investment advisors, lawyers and others from his own class.

96. See Susan Dentzer, *A Wealth of Difference*, U.S. NEWS & WORLD REP., June 1, 1992, at 45, 46 (1989 data); PHILLIPS, supra note 18, at 11 and Appendix B, reproducing figures compiled by the Joint Economic Committee of Congress and the Federal Reserve Board (data from 1922-83). See also Sylvia Nasar, *Fed Gives New Evidence of 80's Gain by Richest*, N.Y. TIMES, Apr. 21, 1992, at A1 (reporting that during the period 1983-89 the portion of the nation’s total private net worth owned by the wealthiest one percent of U.S. households increased from 31% to 37%). As the share of the wealthiest one percent swelled, the share of the next wealthiest nine percent shrunk significantly and the share of the remaining 90% shrunk more modestly. These data reflect a large shift of wealth from the upper-middle-class to the upper-class and provide further evidence of the revitalization of the upper-class. Id.

97. Income distribution shifted from the bottom 80% of the total population to the 20% with the greatest incomes—and especially to the top 1%. During 1977-88, the average income declined by 14.8% for the lowest decile of American families; by 8% for the second lowest decile; by more than 6% for the third, fourth and fifth deciles; and by more than 4% for the sixth and seventh deciles. The eighth and ninth deciles stood closest to even; income increased by 1.8% for the eighth and increased by 1.8% for the ninth. The income was redirected to the top tenth decile which experienced a 16.5% rise in income during this period—and especially to the highest earning one percent of the population, whose income rose a whopping 49.8% during this period. See PHILLIPS, supra note 18, at 17.

2. Political. In much the same way that it invigorates the upper-class, excessive executive compensation strengthens the national Republican Party and, in particular, its conservative wing.  

Conservatives have long worshipped America's top executives. As Professor Clinton Rossiter, who was himself a conservative, explained, conservatives have a deep-rooted belief that society needs an aristocracy, and the American aristocracy is drawn from the "business community rather than a landed interest or priesthood or military class." Thus, continued Rossiter, "the fact is that American conservatism must, first of all, enlist and serve the interests of American business or abdicate responsibility for the future of the Republic."  

As Rossiter's writings make clear, modern American conservatives have a deep-rooted belief in Social Darwinism. The theory of Social Darwinism was first expressed by Herbert Spencer, a British writer, about the same time Charles Darwin was publishing *The Origin of the Species*. Spencer articulated a theory of evolution through natural selection for human beings in society that paralleled Darwin's theory for the animal kingdom. He argued that there was a natural struggle for subsistence and that society benefited by allowing this struggle to occur without interference. The strongest—the most intelligent, skillful, adaptable and self-controlled individuals—would survive and propagate while the weaker members of the species would not. The famous phrase, "the survival of..."
the fittest,” is Spencer's, not, as is generally assumed, Darwin's.107

Spencer's chief disciple in the United States was William Graham Sumner, a professor of political science at Yale University, who wrote:

[M]illionaires are a product of natural selection, acting on the whole body of men to pick out those who can meet the requirements of certain work to be done . . . . It is because they are thus selected that wealth—both their own and that entrusted to them—aggregates under their hands . . . . They get high wages and live in luxury, but the bargain is a good one for society. There is the intensest competition for their place and occupation. This assures us that all who are competent for this function will be employed in it, so that the cost of it will be reduced to the lowest terms.108

Spencer and Sumner's ideas greatly influenced American thought, particularly within the business community and intellectual circles.109 Their admirers included John D. Rockefeller, Oliver Wendell Holmes, and Walt Whitman, who wrote that "extreme business energy" and an "almost maniacal appetite for wealth" were indispensable to human progress.110 Few people today would admit to believing in Social Darwinism; it smacks of fascism and is ill fitted for our current political climate.111 Yet it undergirds modern conservatism nonetheless.112 Rossiter venerated an aristocracy drawn from the elite of the business community because he believed that

108. See HOUSTADTER, supra note 104, at 58 (quoting Sumner). Sumner also said: "Let it be understood that we cannot go outside of this alternative: liberty, inequality, survival of the fittest; not-liberty, equality, survival of the unfittest. The former carries society forward and favors all its best members; the latter carries society downwards and favors all its worst members." Id. at 51.
109. See JOHN J. BURNS, THE CROSSWINDS OF FREEDOM 43 (1989); GALBRAITH, supra note 107, at 122; HOUSTADTER, supra note 104, at 44-47; PHILLIPS, supra note 18, at 59-60. According to recent polling data, most Americans still venerate the rich. See Cooper & Freedman, supra note 99, at 34, 37.
110. See HOUSTADTER, supra note 104, at 44-47 (quoting WALT WHITMAN, DEMOCRATIC VISTAS 44 (1912)).
111. Id. at 48. While visiting the United States in 1882, for example, Spencer said that although the American character might not have yet been sufficiently developed, "the eventual mixture of the allied varieties of the Aryan race forming the population would produce 'a finer type of man than has hitherto existed.'" Id. (quoting Spencer).
112. But see ROBERT NISBET, CONSERVATISM: DREAM AND REALITY 88-89 (1986), who believes that Social Darwinism represented a passion for continual progress that characterizes liberalism. "In conservatism," he says, "there is an inversion of progress" and a love of tradition and custom. Id. at 89. However, his argument that Social Darwinism is inconsistent with conservatism because of its desire for change is more persuasive with respect to the traditional conservatism of Edmund Burke than to the New Right. The conservatives of the Reagan administration promoted sweeping change and called their tenure the "Reagan Revolution." See generally PEGGY NOONAN, WHAT I SAW AT THE REVOLUTION (1990).
cream rises to the top. Ronald Reagan suggested something similar when he said: "What I want to see above all is that this remains a country where someone can always get rich."113

What could please top executives more than an ideology that idolizes them and believes that they must indeed be extraordinary individuals to have surpassed scores of other bright and ambitious individuals while rising through the corporate ranks?114 Nevertheless, America's top executives were slow to join the conservative movement. The large majority of them have long been Republican,115 but they generally were pragmatists who eschewed ideology.116 It was, moreover, counterproductive for them to be wedded to the conservative movement when it was not in power. But that changed in the Reagan era.117 Finally, it was pragmatic for chief

113. See PHILLIPS, supra note 18, at 52 (quoting Reagan).
114. C. Wright Mills imagined his readers asking, "But didn't they have to have something to get up there?", and answered it this way: The answer is, 'Yes, they did.' By definition, they had 'what it takes.' The real question accordingly is: what does it take? And the only answer one can find anywhere is: the sound judgment, as gauged by the men of sound judgment who select them. The fit survive, and fitness means, not formal competence—there probably is no such thing for top executive positions—but conformity with the criteria of those who have already succeeded. To be compatible with the top men is to act like them, to look like them, to think like them: to be of and for them—or at least to display oneself to them in such a way as to create that impression.

115. See LUNDBERG, supra note 20, at 471; KLEINFIELD, supra note 7, at 8.
116. As Mills so colorfully put it, chief executives do not find their ideology in either Burke or Locke. Rather, "[t]heir ideological source is Horatio Alger." MILLS, supra note 34, at 329.
117. Some businessmen with right-wing leanings helped to fund the conservative movement while it grew during the 1970s, but most top executives—pragmatists as always—waited until it became clear that conservatives would come to power. After Ford lost the 1976 presidential election, astute observers realized that conservatives would likely take control of the Republican Party. When Reagan was elected President in 1980, those top executives who had held back were safely able to join the movement.

The pattern is illustrated by the history of the Heritage Foundation. The Heritage Foundation was formed in 1973 with contributions from Joseph Coors of the Adolph Coors Brewing Company and Richard Scaife, an heir of the Mellon family fortune, both of whom had long been active in the conservative movement. See JOHN S. SALOMA III, OMINOUS POLITICS: THE NEW CONSERVATIVE Labyrinth 14 (1984). When Ronald Reagan was elected President, the Heritage Foundation presented Edwin Meese III, who was heading
executives to make a reciprocal commitment to conservatism; after all, nothing could better serve their interests than having conservatives continue to control the national Republican Party and for the Republican Party to continue in power.\(^{118}\)

Chief executives of America's largest corporations are not only personally wealthy, but they also control institutions with enormous resources. They are now using those resources to support the conservative Republican establishment. They have, for example, formed Political Action Committees (PACs) at their corporations to provide direct financial support to candidates. In 1974, there were 89 corporate PACs, compared to 201 labor union PACs.\(^{119}\) By mid-1976, the number of corporate PACs more than tripled, and corporate PACs outnumbered labor PACs 294 to 246.\(^{120}\) Fifteen years later the number of labor PACs had grown to 339—and the number of corporate PACs to 1,745.\(^{121}\) Corporate PACs raise over $100 million during an election cycle.\(^{122}\)

Perhaps even more significant is the corporate funding of a conservative infrastructure of think tanks, lobbies and political advocacy organizations.\(^{123}\) Business funding created or reinvigorated Reagan's transition team, with a 3,000 page report that it termed "a blueprint for conservative government." Id. at 15-16; see also WILLIAM A. RUSHER, THE RISE OF THE RIGHT 255-56 (1984). The Reagan administration adopted two-thirds of Heritage's 3,000 policy recommendations. See id. at 256. Never before had a policy organization so influenced a transition. Within a year, 87 of the nation's largest corporations were contributing to the Heritage Foundation, including, for example the Mobil and Gulf oil companies, Smith Kline Corporation and Chase Manhattan Bank. See SALOMA, supra, at 18.

118. The term "national" Republican Party is used to highlight presidential politics. There is a somewhat different strategy for legislative politics. While the business community will generally prefer a Republican to a Democrat—all other things being equal—it recognizes that Democrats control Congress and it remains practical enough to support entrenched congressional incumbents who hold important committee posts, be they Republican or Democrat, in something of an "if you can't beat them, co-opt them" strategy. In the 1989-90 election cycle, for example, corporate PACs contributed $8.4 million to Democratic senatorial candidates compared to $13.5 million to Republicans. Ninety-six percent of the corporate PAC money contributed to the Democratic senatorial candidates, however, went to incumbents. Although they also contributed more to incumbent Republicans than Republican challengers, corporate PACs gave Republican challengers a total of more than $3.3 million compared to less than $300,000 contributed to Democratic challengers. See PAC Activity Falls in 1990 Elections, PRESS RELEASE, (Fed. Election Comm'n, Washington D.C.), Mar. 31, 1991, at 3.


120. Id.

121. Id.

122. Corporate PACs raised a total of $106,310,888 during the 1989-90 election cycle. See PAC Activity Falls in 1990 Elections, supra note 118, at 2.

123. See generally DOMHOF, supra note 92, at 82-112; THOMAS B. EDSALL, THE NEW POLITICS OF INEQUALITY 107-30 (1985); SALOMA, supra note 117, at 63-80. Kevin Phillips is careful to stress that the impetus of the new conservatism (and particularly of radical
the Heritage Foundation, the Hoover Institution, the Center for the Study of American Business, the National Bureau of Economic Research and the American Enterprise Institute. These think tanks provide a steady flow of conservative ideas that have kept both the Democratic Party and moderate elements within the Republican Party on the defensive in public policy debate. Other organizations were formed to sell these ideas to policy makers. The Law and Economics Center at Emory University, for example, sponsors seminars for judges, law professors and economists that are designed to indoctrinate them in conservative views of antitrust and corporate law. The Business Council holds retreats where business leaders and government officials intermingle in seminars and panel discussions, as well as on the tennis court and golf course. Direct lobbying is coordinated by the Business Roundtable, while public relations offensives and grass-roots activities are conducted by the United States Chamber of Commerce. The Business Roundtable, composed of 190 CEOs of the nation’s largest companies, was formed in the 1970s; the U.S. Chamber of Commerce was a “stodgy” old organization that was transformed into an aggressive promoter of conservative and pro-business views.

Excessive executive compensation, therefore, has significant political ramifications. Whether one considers this to be a good or bad thing may depend on her political persuasion, but there are people across the political spectrum who believe that greed has gone too far. Conservative theorist Kevin Phillips is, for one, openly disgusted by the sums that top executives are making, as well as with the general era of greed stimulated by the Reagan revolution. Other conservatives may wonder: if the chief executives are so extraordinary—if they are, indeed, the “best men” that human evolution has so far produced—why are they so greedy? Success is one

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124. See generally EDSALL, supra note 123, at 118-20.
125. See SALOMA, supra note 117, at 75-76.
126. See DOMHOFF, supra note 92, at 133-35.
127. See id. at 135-36; SALOMA, supra note 117, at 66-68; LEONARD SILK & MARK SILK, THE AMERICAN ESTABLISHMENT 252-58 (1980). With respect to social and class dimensions, it is interesting to note that the Business Roundtable grew out of informal meetings of top executives at the exclusive Duquesne Club in Pittsburgh. SILK & SILK, supra, at 255-56.
128. See SALOMA, supra note 117, at 79.
129. See generally PHILLIPS, supra note 18, especially at 154-85.
130. KOSSITER, supra note 101, at 185.
thing, gluttony quite another. The best men are supposed to have not only "mental power" and "energy," but "character" as well. They are supposed to have a sense of noblesse oblige and concern for the public good. It may not be surprising, therefore, that even conservatives are becoming disgusted with top executives' lack of self-restraint.

3. Economic. The money used to pay excessive executive compensation is taken away from other uses. While it is possible to speculate how this money would otherwise be used, it is, of course, impossible to state with certainty that if a particular company were not paying excessive executive compensation the prices of its products would be lower, or its stock dividends higher, or that it would spend more money on research and development, or on modernization of its facilities, or that the salaries of other employees would be higher, or that there would be fewer layoffs. This uncertainty is the chief executive's ally. It allows him to argue that his compensation represents only a minuscule fraction of the company's annual sales or expenses and that it is therefore inconsequential.

Nevertheless, the money that is unnecessarily spent on excessive executive compensation has other possible uses. One compensation expert has noted that executive compensation packages "represent investment decisions on the order of building a plant."

Comparisons with other human resources might also be made. As

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131. These phrases were Robert A. Taft's. See id.
132. The normally conservative business press has also fallen away from CEO ranks.

Typical of editorials in leading business periodicals is the following:

"In a difficult economy that has many bosses eliminating jobs and cutting vital budgets for capital projects, product development, and marketing, the lack of restraint is disturbing . . . . In short, last year's $1.9 million average pay for U.S. CEOs seems out of whack with corporate performance, employee sacrifices, and the whole tenor of these recessionary times. Predictably, many shareholders and employees are fed up . . . . It's time for corporate boards to face up to the growing public concern over executive pay. If they don't, a backlash against business could easily develop."


133. For example, Hicks Waldron, the CEO of Avon Products, complains that at the annual shareholders' meeting, shareholders don't ask "legitimate questions. They ask about the company planes and compensation and limousines and all the horseshit, not the critical problems of running a . . . three-billion dollar company." KLEINFIELD, supra note 7, at 214. A similar sentiment was expressed by F. Ross Johnson, the CEO of RJR Nabisco, when he was discussing possible cost cutting measures that would be necessary for a leveraged buy-out of his company to succeed. "I don't want a bunch of nerds telling me whether to take a limo or not. That's all chickenshit. What you need to worry about is the price of tobacco or the price of assets I'm selling. I want to deal with the big issues." BURROUGH & HELYAR, supra note 16, at 266.

previously noted, some top executives are paid as much as hundreds of factory workers, which means that if it were not saddled with the burden of excessive compensation for a single executive, a company could instead employ hundreds of workers. Or, rather than hundreds of factory workers, the money could put dozens of additional scientists or engineers to work in research and development. The human resource comparisons have special resonance when one considers that America's largest 500 industrial companies have not collectively generated a single new job in more than a decade.

Excessive executive compensation collectively drains billions of dollars away from more productive uses in the nation's economy. It also weakens the ability of United States companies to compete with their foreign counterparts. During a recent year, for example, the CEO of Chrysler made $17.6 million while the CEOs of competitors Peugeot and Honda were paid $250,000 and $450,000, respectively. During the same year that Exxon paid its CEO more than $5.5 million, British Petroleum paid its chief executive $582,000, and the CEO of Royal Dutch/Shell received $500,000. The CEO of General Electric was paid $12.6 million that year, the CEO of JVC $290,000. While top American chief executives average nearly $2 million, their Japanese counterparts make $352,000 per year on the average, including pay, benefits and perks. These discrepancies exist despite the fact that foreign executives are generally subject to higher taxes and costs of living than the Americans.

II. EXCESSIVE EXECUTIVE COMPENSATION AND CORPORATE DEMOCRACY

In theory, excessive executive compensation should not be possible. Compensation for a company's top executives is established by its board of directors, and the board should be setting compensation in a fashion that is in the best interests of the corporation and its shareholders. Should the board fail to do this, the shareholders

135. See supra note 45 and accompanying text.  
137. See Shawn Tully, American Bosses Are Overpaid, FORTUNE, Nov. 7, 1988, at 121, 124. The figures are for 1987. The highest paid foreign executives were in West Germany; during 1987, the CEOs of Volkswagen and Daimler-Benz made $1 million and $1.2 million respectively. See id.  
138. Id. at 136.  
139. Id. at 121.  
141. Tully, supra note 137, at 128. Data suggest that top European executive pay may rise somewhat in response to American pay but that the pay of top Asian executives will not. Id.
EXECUTIVE COMPENSATION

should—in theory—retire them and elect new directors.

The compensation that top American executives receive is certainly large, but is it "excessive?" It is no surprise that corporate executives and directors generally contend that it is not. They argue that the compensation of senior executives is set by a special compensation committee of the corporation's board of directors, that this committee is generally composed entirely of independent directors and that it makes its decision after engaging outside consultants and studying their report.

Is there a way to determine whether compensation is excessive, or is excessiveness subjective? It is argued below that there are objective principles by which compensation can be evaluated, and that an evaluation using these criteria leads to the conclusion that the sums being paid to the top executives of America's largest corporations are generally excessive. The proposition should not be overstated; setting an individual's compensation necessarily involves subjective judgment. Nevertheless, excessiveness in compensation is not a wholly abstract concept, such as beauty; it can be evaluated within a framework of objective principles, and if it is not possible to state objectively how much a particular individual should be paid, it is often possible to declare that an individual has been paid too much.

A means of determining whether executive compensation is excessive is useful for at least three reasons. First, excessive compensation is a useful barometer. An epidemic of excessive compensation signals widespread corporate dysfunction; it means that things are not as they are supposed to be.

Second, and even more importantly, excessive compensation provides not only a symptom of the illness but a means of evaluating possible cures. Many scholars already agree that there are fundamental flaws in corporate structure, but there is much disagreement about corporate reform. For example, some scholars believe corporations would function better if shareholders had more power, while others want to strengthen boards of directors. Many of the disagreements stem from fundamentally different visions of the corporate mission. Examining proposals for corporate reform in terms of excessive executive compensation will not resolve these differences, but it does offer opportunities to test proposals for reform against a specific dysfunction.

Third, some basis for determining excessiveness is necessary before remedies can be prescribed. A court must be able to determine that compensation is excessive before it can grant relief to correct the abuse.

A. Defining “Excessive” Compensation

How much should an executive be paid? As a theoretical question, it is not hard to answer. Two, or perhaps three, criteria should be used to set a top executive’s pay. First, the company should try to buy the services of its top officials as inexpensively as possible—just as it should try to purchase any service or product as cheaply as possible. A top executive’s pay should, therefore, depend on the executive labor market; if a company wants to retain a particular executive it should pay him enough so that competitors will not woo him away with larger salaries. If the employee is readily mobile this generally means paying a competitive wage within the industry.

Second, an executive should be paid in the most cost-effective way that will maximize his performance. Many employees receive some form of incentive to stimulate their best efforts. Paying salespersons on a commission basis is perhaps the most obvious example of an incentive payment system. Sometimes non-incentive premiums are necessary to keep an employee performing well. There are valued employees whose skills are not marketable to other employers for one reason or another, and while it is not necessary to raise these employees’ pay to retain them, it nevertheless may be necessary to give them periodic raises to “keep them happy,” that is, to keep their morale high so that they will work energetically.

Although in practice it may be difficult to determine the optimum level of an incentive payment, the theory is simple: an incentive payment should not exceed the value of the production it will stimulate. An employer should not, for example, pay a salesperson a 6% commission if a 4% commission would motivate him to put forth his best effort; nor should an employer pay a 6% commission instead of a 4% commission unless the profit on the increased sales will be greater than the 2% differential.

The last factor that an employer might consider is fairness, although this is a debatable one. An employee who puts forth a special effort may “deserve” extra money even if the premium is not necessary to retain the employee or keep him happy, or an employee’s salary might be raised to make it equivalent to that of other employees with the same job even if (theoretically) he never would have discovered a difference. This is a questionable criterion because it violates the rule that the company should buy services at the lowest possible cost, but in the real world fairness is generally good business because it is important to employee morale.

After considering these criteria, it is possible to state a succinct definition as follows: Excessive executive compensation is compensation that is higher than is necessary to (1) hire or retain the executive, (2) provide the optimum incentive to the executive, or (3) be
fair. Under this definition, the compensation paid to many top executives at the largest United States corporations is patently excessive.

B. Applying the Definition

Excessive compensation is not justified by the executive labor market. It is unlikely, for example, that other companies would have stolen John A. Young from the Hewlett-Packard Company or Martin S. Davis from Digital Equipment Corporation if they had been paid, say, half a million dollars each rather than the $9.8 million and $11.9 million that they were respectively paid in 1990. And it is not only because shareholders' returns in both companies fell by more than 400% that year, or because Business Week and Fortune placed both men on their lists of executives who gave shareholders the least for their money. It is because there is little mobility in the chief executive labor market.

The CEO labor market is highly restricted because the expertise of running a particular company is often specific to that company, or to a few other companies in its industry. This expertise is not easily transferable. CEOs have generally worked their way up through the ranks in the company they head. On the average they work for the same company for 25 years, and more than 42% have never worked for another firm. The typical CEO leaves his seat through retirement, not by moving to another job.

Most CEOs are promoted from below, and it surely is not necessary to offer a vice president a gargantuan sum to persuade him to accept the top job. Career-oriented people want to climb the ladder. They are happy to be offered a position with more responsibility and prestige for its own sake. Of course, they expect that the higher position carries a higher salary; indeed, salary is one of the indicia of the relative importance of a particular position. The conventional wisdom is that most people will accept a promotion for a 10% raise, but an executive may receive a 300% raise when he is promoted to

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143. See Byrne, supra note 25, at 90, 93.
144. Id.; Crystal, How Much Do CEOs Really Make?, supra note 17, at 72, 73-74.
145. See Vagts, supra note 22, at 237.
146. Id. at n.27 (reporting data that indicates that only about 15% of all CEOs reach that position without prior service in the company).
147. See A Portrait of the Boss 1989, supra note 84, at 23.
148. See James D. Cox & Harry L. Munsinger, Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion, LAW & CONTEMP. PROBS., Summer 1985, at 83, 95 n.57 (reporting a 1975 study that showed that 42.5% of 400 top executives in the 300 largest corporations had worked for only one company). This study apparently included both CEOs and, in some instances, the second highest official as well.
149. See Jensen & Murphy, supra note 42, at 138, 142.
In the main, therefore, the sums being paid to chief executives exceed what is necessary to hire or retain them. Nor are the sums being paid to CEOs necessary to motivate them to put forward their best efforts. First, the data indicate that executive pay is not being calculated to provide optimum incentives. As previously discussed, there is only a weak correlation between pay and performance. Second, the amounts paid to chief executives violate any common sense understanding of what is required to motivate someone to put forward his best effort. Will someone work harder or more creatively to get a $500,000 bonus than a $250,000 bonus? Will he work even harder for a million dollar bonus, and harder still for five million dollars? Few people would think so. Once the carrot is big enough to encourage total effort, a bigger carrot is wasteful. Moreover, it is unnecessary to depend only on financial incentives; people are also motivated by pride, by satisfaction from doing their job well, by a desire for appreciation and respect. There is even reason to suspect that excessive pay may be counterproductive—that people perform less well when they receive enormous sums for their work, be they baseball players, college presidents, chief executives or anyone else.

Fairness is, of course, a subjective concept. J.P. Morgan reportedly believed that no one should be paid more than 1.3 times as much as those on the next lowest rank. One management expert has said that a chief executive should not make more than twenty times as much as the company's lowest-paid employee; another believes that no one is worth more than $300,000 a year.

150. See supra note 75.
151. See supra pp.17-22.
152. There is reason to believe that CEOs are not significantly motivated by their compensation packages. See New Heresy: Maybe Pay Doesn't Motivate, FORTUNE, June 18, 1990, at 102.
156. See Ann Landi, When Having Everything Isn't Enough, PSYCHOL. TODAY, Apr. 1989, at 27; and STANTON A. COBLENTZ, Avarice: A History 225-46 (1965). See also infra note 419.
158. See Byrne, supra note 25, at 90, 93 (reporting the view of management consultant Peter Drucker).
159. See Joani Nelson-Nerchlor, The Pay Revolt Brews, INDUSTRY WK., June 18,
business press now routinely publish stories that attempt to identify
the most over- and under-paid CEOs, based on ratios of the CEO's
pay to the company's shareholder return or on computer models
that weigh many factors that one would expect to be considered in a
rational compensation system. Many CEOs insist that their pay is
fair, but their arguments are more inflated by hubris than supported
by a clear rationale. It is hard to argue that it is fair for chief
executives to be paid—on the average and absent any special contri-
bution—more than the President of the United States, the Vice
President, the Attorney General, the Secretaries of State and
Defense, the Speaker of the House of Representatives and all nine
justices of the United States Supreme Court combined.

1990, at 28, 30 (quoting Kendall Hutton).
160. The annual Business Week series uses this method.
161. Professor Crystal uses this method for his annual Fortune series. See supra note 18.

162. In his book, Talking Straight, Chrysler CEO Lee Iacocca describes a conversa-
tion he had with Douglas Fraser about Iacocca's $20.5 million compensation in 1986.
Fraser, who was both the head of the UAW and a member of Chrysler's board of directors,
told Iacocca that although he liked Iacocca and thought he was doing a terrific job, he was
nevertheless voting against Iacocca's compensation package. According to Iacocca, Fraser
explained: "I've been with the UAW all my life and the most I've made is $75,000 for run-
ning that big institution. I don't think you need ten times as me [sic]." LEE IACOCCA,
TALKING STRAIGHT 112 (1988) (Actually, of course, Iacocca made more than 273 times as
much as Fraser). Iacocca says that Fraser's comments reveals that "even he had the
mind-set of a true socialist." Id. He also defends the $20.5 million by noting: "What was a
whopping salary ten years ago just about covers the mortgage and car payments today." Id.
at 110.

When Hicks Waldron, CEO of Avon Products, Incorporated, was asked about his pay,
said in part: "If we hit the budget this year [1986], I'll get, say, eight hundred and fifty
thousand dollars [excluding $240,000 that the company was paying to subsidize
Waldron's cooperative apartment and its contributions to his pension and retirement
plans]. As I look around at the world out there, I'd have trouble being critical of that com-
ensation. . . . [C]ompare yourself to thirty-five bucks an hour for a carpenter. If he puts
in the hours I put in—and I figured it out once—it comes to a hundred and twenty thou-
sand dollars." See KLEINFIELD, supra note 7, at 148. If Waldron works the hours of the
average CEO, id. at 8, he was making nearly $400 per hour.

Another incident involving Waldron is revealing. At an annual shareholders' meet-
ring, a shareholder rose to complain about the "tremendous expense" the company
incurred by subsidizing Waldron's personal cooperative apartment. "I'm afraid living in
New York is a great expense for everyone," replied Waldron. See id. at 236. He would
have been more accurate if he had said, "I'm afraid my living in New York is a great ex-
 pense for you."

163. This calculation is based on the fact that CEOs at the largest 200 companies
have an average annual pay of $2.4 million. See supra note 25. The annual salaries of
federal officials are: President of the United States, $200,000; Vice President of the
United States, $160,600; members of the Cabinet, $138,900; Speaker of the House,
$160,600; Chief Justice of the United States Supreme Court, $160,600; Associate Justices
of the U.S. Supreme Court $153,600. See THE 1991 INFORMATION PLEASE ALMANAC 41
It is beyond reasonable dispute, therefore, that most of the nation's largest corporations are paying their top executives more than is necessary for corporate purposes.

C. Corporate Dysfunction

The epidemic of excessive executive compensation is strong evidence that the nation's largest corporations are, in some fundamental way, dysfunctional. If the boards of directors were making decisions based on what was in the best interests of the corporation and its shareholders, they would be paying their top executives much less. At least in the compensation area, they are putting the interests of top executives above those of the company. They are, in fact, enriching these executives at the expense of their companies, in breach of their fiduciary obligations.164

This is not the first time that there has been evidence of serious problems in corporate America. A series of corporate scandals swept across America in the 1960s and 1970s,165 and it became apparent that the nation's largest companies were routinely engaging in criminal behavior.166 Reformers focused on making the boards of directors more independent and having them play a more active oversight role. The American Bar Association, the New York Stock


165. The Watergate investigations led to a startling series of revelations about corporate behavior. It was discovered that many of America's largest companies had secret slush funds from which they routinely made unlawful political payments to United States public officials, often in cash. See CHARLES E. SILBERMAN, CRIMINAL VIOLENCE, CRIMINAL JUSTICE 58-60 (1978). It was also discovered that there was a wide-spread corporate practice of obtaining business from foreign countries by bribing their military officers or government officials. See id. A number of other cases particularly shocked the public conscience, e.g., the Ford Motor Company decided not to recall Pinto automobiles to correct a defective gas tank because it would be cheaper to pay claims in the projected number of explosions; the Beech-Nut Company knowingly passed sugar water off as apple juice in its baby drinks.

166. One study found that 63.7% of the 582 corporations surveyed had been sanctioned for committing a crime, and another survey found that 23% of America's 500 largest companies had been convicted of a major crime or paid a civil penalty for serious misbehavior within the past ten years. See MONKS & MINOW, supra note 157, at 135 (describing studies published by MARSHALL CLINARD & PETER YEAGER in ILLEGAL CORPORATE BEHAVIOR (1979) and CORPORATE CRIME (1980), and a U.S. News & World Rep. survey published in RUSSELL MOKHIBER, CORPORATE CRIME AND VIOLENCE 19 (1988)). See also Patrick J. Ryan, Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation in Section 2.01(a) of The American Law Institute's Principles of Corporate Governance, 66 WASH. L. REV. 413, 417 n.7 (1991).
Exchange, the SEC and even the Business Roundtable urged companies to appoint more outside directors. In 1976, a subcommittee of the American Bar Association recommended that public companies establish three committees to conduct oversight functions of corporate activity (audit, nominating and compensation committees), that all members of these committees be outside directors, and that a majority of them be fully independent, i.e., not engaged in material transactions with the corporation or related to company executives. The following year, at the urging of the SEC, the New York Stock Exchange adopted a rule requiring all companies listed on the exchange to have audit committees composed entirely of independent directors.

The reformers were generally successful. “Today about 90% of public companies have compensation committees.”

The number of outside and independent directors has been increasing both on the full boards of directors and on the audit, compensation and nominating committees. None of this, however, has stemmed the rising tide of excessive compensation, and it is now clear that these reforms have been ineffectual.

It is not hard to discern why. The independent director has turned out to exist only in theory; in the real world all directors are

167. See Roberta S. Karmel, The Independent Corporate Board: A Means to What End?, 52 GEO. WASH. L. REV. 534, 544-45 (1984). The terms “outside” and “nonmanagement” directors mean directors who are not employed as company managers; the terms “independent” or “nonaffiliated” directors mean directors who are not employed by the company and who do not directly or indirectly benefit from material transactions with the company (such as the company’s lawyers, accountants, suppliers). See, e.g., id. at 546 nn. 74-75, 547 n.79. The terms may be illustrated as follows: The company’s general counsel—i.e., the individual who is employed by the company and heads its in-house legal staff—would be an inside director. A lawyer in private practice would be an outside director, but if his firm were the company’s primary outside legal counsel or otherwise received substantial fees from the company, he would not be an independent director.

168. More specifically, the proposal required that all members of the nominating committee be independent directors and that each of the other two committees be composed entirely of outside directors, with a majority being fully independent. ABA Comm. on Corp. Laws, Corporate Director’s Guidebook, 32 BUS. LAW. 5, 35-36 (1976). It also urged that outside directors comprise the majority of the full board. Id. at 33.

169. See Russell B. Stevenson, Jr., The SEC and Foreign Bribery, 32 BUS. LAW. 53, 70 (1976).


beholden to management. They are, first, indebted to management for their jobs. It is generally accepted that—nomination committees notwithstanding—the CEO really controls the nomination of directors.\textsuperscript{172} One recent survey of directors who served on nominating committees of the 500 largest corporations found that the CEO initially recommended 90-100\% of all directoral nominees.\textsuperscript{173} There is, after all, a chicken-or-the-egg phenomenon at work: the members of the nominating committee were themselves originally selected by the management and owe it their loyalty. No one is going to be ungrateful enough to suggest, for example, that the CEO not attend nominating committee meetings, and even though most nominating committees are chaired by an independent director, chief executives frequently attend nominating committee meetings.\textsuperscript{174}

It is the CEO who has the time and interest to recruit new prospects for the board of directors. Seventy-seven percent of all directors are top executives of other corporations—more than half of them chief executives\textsuperscript{175}—and if they believed someone would make a good director, they would be more likely to propose him for the board of their home company than for the board of the company they serve only as directors. Moreover, management's ability to control the board is so critical and sensitive a matter that any attempt by a director to propose additions to the board might well be considered a serious breach of corporate etiquette.\textsuperscript{176}

\textsuperscript{172} See, e.g., Barnard, supra note 171, at 49 ("With few exceptions, the CEO still dominates the nominating committee, which accedes to the CEO's wishes."); Brudney, supra note 155, at 610 ("The independent director has rarely been appointed without at least the prior approval of management, a factor not without impact on his critical detachment."); Cox & Munsinger, supra note 148, at 97 ("Under conventional procedures, directors are handpicked by the chief executive officer."); Ronald J. Gilson & Reinier Kraakman, Reinventing the Outside Director: An Agenda for Institutional Investors, 43 STAN. L. REV. 863, 875 (1991) ("Eleven financially independent outside directors depend on management for their tenure as directors, since management typically selects its own outside directors."); Joel Seligman, A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project, 55 GEO. WASH. L. REV. 325, 331 (1986) ("Nomination of directors by anyone other than incumbent management is virtually impossible."); Tosi & Gomez-Mejia, supra note 48, at 169 ("Top executives play a major role in appointing the board").

\textsuperscript{173} The survey was conducted in 1989 by Professor Jayne W. Barnard of the Marshall-Wythe School of Law, The College of William & Mary. The results, however, are based on a very small sample; only thirteen responses were received from a pool of 85 people surveyed. See Barnard, supra note 171, at 50 n.77.


\textsuperscript{175} See Cox & Munsinger, supra note 148, at 95.

\textsuperscript{176} It is generally understood that, "management often installs on the board people who are economically and psychologically sympathetic, if not indebted, to the chief executive officer and who are therefore disinclined to challenge him." Lewis D. Solomon, Restructuring the Corporate Board of Directors: Faint Hope—Faint Promise?, 76 MICH. L.
Directors of major corporations have reasons to want to stay in the management’s good graces. Directorships have become very valuable. Directors of major American companies make, on the average, $32,352 in annual retainer and meeting fees. Some companies pay much more; directors at PepsiCo, for example, receive $75,000 and additional fees are typically given to members of special board committees, with even larger fees to the committee chairs. These fees boost the average total compensation to $45,650. Two-thirds of the nation’s largest companies have retirement plans which continue to pay retired directors fees for a period equivalent to their board tenure or even for their lifetimes. Many companies give still more: stock grants, life insurance, medical and dental coverage, golden parachutes, company products. Directors of General Motors Corporation, for example, often get free GM cars.

These are sweet rewards for about one hundred hours of work a year, which is the average time that directors of major corporations spend on board business. For many this is just the beginning. CEOs are adept at bestowing other gifts on individual board members. Perhaps the most traditional is the consulting contract: a CEO will flatter a board member by telling him that the corporation needs the benefit of his unique expertise and will implore him to consult with the company on a special project. Some directors are even given continuing consulting contracts for which they are, naturally, paid handsomely. There are any number of other special favors and emoluments, large and small, that a CEO can give board members. The CEO of RJR Nabisco, for example, granted one director an exemption from the seventy-year-old retirement age, encouraged directors to use the corporate jets for personal trips, boosted the special fee of the board chairman to $150,000, and honored particular directors by donating millions of dollars to their alma maters.

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178. Id. at 94.
179. See Monks & Minow, supra note 157, at 175.
180. Id. at 174.
181. See Dobrzynski, supra note 177.
182. See id.; see also Monks & Minow, supra note 157, at 175-76.
183. See Monks & Minow, supra note 157, at 176.
184. In a 1988 survey, CEOs estimated that directors spent about 108 hours on board-related business, including preparation for and travel to and from meetings. See id. at 175. Another survey of 352 companies found that in 1990 board members worked, on average, 96 hours. See Dobrzynski, supra note 177.
185. At RJR Nabisco, for example, one director was given a six year consulting contract for a total fee of $180,000 per year. See Burrough & Helyar, supra note 16, at 97.
to endow chairs or build structures bearing their names.\textsuperscript{186} It would take an unusual person, indeed, to jeopardize his relationship with those who control this kind of largesse.

There are also intangible benefits that may be even more valuable than the monetary rewards.\textsuperscript{187} A directorship of a major corporation is a prestigious position. It provides a rare opportunity to become well-acquainted with other influential people. And it is an unusual educational experience; directors have the chance to see, from the inside, how another major company is operated.

There are powerful forces that bind directors not only to management, but to each other as well. Directors are cut from the same cloth as chief executives—they are predominately white, Protestant, Republican males who graduated from elite colleges.\textsuperscript{188} That is hardly surprising since so many directors are chief executives themselves, but the homogeneity of boards of directors is striking nonetheless.\textsuperscript{189} There has been little more than a tip of the hat to calls for diversity, causing Professor Crystal to offer the droll observation that a board of directors is "ten friends of management, a woman and a black."\textsuperscript{190} Nor has there been a significant effort to appoint directors with special sensitivity to issues of social responsibility.\textsuperscript{191}

Executives and directors are often bound by a reciprocal self-interest. The most blatant examples are executives who sit on each other's compensation committees—which, in fact, actually occurs\textsuperscript{192}—but there are many other interrelationships as well. In one instance the compensation committee of a major corporation was chaired by a director who was a college chancellor.\textsuperscript{193} Although, on

\textsuperscript{186} See id. at 97. Making contributions to directors' favorite charities has become popular at many companies. See MONKS & MINOW, supra note 157, at 176-77.
\textsuperscript{187} See generally Barnard, supra note 171, at 75-76; Cox & Munsinger, supra note 148, at 93-94.
\textsuperscript{188} See Cox & Munsinger, supra note 148, at 106. Ninety-three percent are white males who attended college. Id. Fifty-six percent graduated from one of fifteen elite colleges, compared with a only 14% who attended the top ten state universities. Id. Seventy-three percent are Protestant, although Protestants comprise only 58% of the general population. Id. at n.110. See also Brudney, supra note 155, at 612; Solomon, supra note 176, at 586.
\textsuperscript{189} See, e.g., Cox & Munsinger, supra note 148, at 105.
\textsuperscript{190} See MONKS & MINOW, supra note 157, at 77.
\textsuperscript{191} See Brudney, supra note 155, at 648.
\textsuperscript{192} A search of 788 of the largest public companies identified 39 instances where CEOs sat on each other's boards of directors, which suggests that this exists in about 5% of such firms. See Alison Leigh Cowan, Board Room Back-Scratching?, N.Y. TIMES, June 2, 1992, at D1. In 1990, Fortune magazine discovered three instances in which top executives were sitting on each other's compensation committees. According to Fortune, none of them saw a conflict of interest. See The People Who Set the CEO's Pay, FORTUNE, Mar. 12, 1990, at 59-60, 66.
\textsuperscript{193} This incident is described in MONKS & MINOW, supra note 157, at 77.
its face, there was no conflict of interest, the CEO happened to chair the college's board of trustees, and the corporation made large contributions to the college. The chancellor may have technically been an independent director, but few would consider him truly free to exercise independent judgment. And even absent reciprocal business dealings, directors—most of whom are themselves top corporate executives—have a personal interest in promoting high executive compensation.

The theory of the independent board of directors has simply not been realized. Management is generally in complete control of the board of directors. When members of the Board of Directors of Avon Products were interviewed, none of them could remember any matter on which they had opposed the CEO. H. Ross Perot revealed that when, in 1985, he voted against acquiring Hughes Aircraft Company, it was the first time since the Depression that any member of the General Motors' board of directors had voted against management. And there are data that suggest that directors—including independent directors—do not even act to curb instances of serious management misbehavior such as self-dealing and misappropriation of funds. It is now widely recognized that, as one scholar succinctly put it, "[b]oards rarely vote other than unanimously on issues of importance to the CEO."

194. Under proposed ALI principles, a director is not independent if he is the principal manager of a business organization to which the corporation made commercial payments that, over a two year period, exceeded 5% of the organization's gross revenues or $200,000, whichever is more. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.34(a)(4) (Proposed Final Draft 1992) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE]. The college might not be deemed to be a business organization for these purposes, but even if it were, in many instances it would take enormous contributions to exceed the 5% threshold since the gross revenues of major universities run into the hundreds of millions of dollars. See id. § 1.04.

195. The strong correlation between what directors make in their primary jobs and what the CEO makes (see supra note 70 and accompanying text) suggests that directors may have more than a generic interest in promoting high executive compensation. Just as the CEO may use the pay of more highly paid directors as a basis of comparison to urge that his compensation be increased, directors may compare themselves to more highly paid CEOs for similar purposes.

196. The directors were interviewed by Sonny Kleinfield, a New York Times reporter. See KLEINFIELD, supra note 7, at 238.

197. See Barnard, supra note 171, at 77 n.248.

198. See Brudney, supra note 155, at 617 n.54. See also John C. Coffee, Jr., "No Soul to Damn; No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment, 79 MICH. L. REV. 386, 393 (1981).

199. Barnard, supra note 171, at 77. John Kenneth Galbraith describes directors as follows: "That the directors of the modern corporate giant are figureheads, selected by management for their reputation for acquiescence or at best for learned conformity and to show a tolerant attitude toward blacks and women, is now widely recognized." GALBRATH, supra note 53, at xxx.
The board of directors is supposed to ensure that management is honest, competent and devoted to the best interests of the company. It is instead management's tool. Management often insulates itself from criticism by taking controversial matters to the board. But that is only eyewash—an attempt to pass ratification off as decision-making. The epidemic of excessive executive compensation provides powerful verification that the board of directors is management's lapdog, not the owners' watchdog.

D. Corporate Reform

1. Board of Directors. Scholars now generally accept the fact that large corporations do not function as intended, and there is no shortage of proposals for reform. Most proposals focus on the board of directors. It has been suggested that shareholders directly nominate and elect one director; that they nominate 20%-25% of the board; that large shareholders directly nominate board candidates; that there be two boards, one of "loyal cabinet advisers" selected by management and another of "supervisory directors"; that all directors be reelected every five years; that there be professional, full-time directors; that directors have their own staff; and—most frequently of all—that there be more independent directors.  

200. See, e.g., GALBRAITH, supra note 53, at 89, wherein Professor Galbraith warns of "the danger of confusing ratification with decision."

201. New York Times reporter Sonny Kleinfield spent ten months observing the activities of the chief executive officer of Avon Products. He had free rein of the company offices and was allowed to observe the CEO throughout the day. He attended board of directors meetings and interviewed directors. On the subject of executive compensation, Kleinfield concluded: "Why do executives make such seemingly scandalous sums of money? Easy. They are the ones who decide how they should be compensated. Boards of directors do no more than offer pro forma blessings (and directors pretty much serve at the pleasure of the chief executive)." KLEINFIELD, supra note 7, at 145.

202. See Gilson & Kraakman, supra note 172, at 873, ("In the corporate governance debate, all arguments ultimately converge on the role of the board of directors in general, and on the role of outside directors in particular.").

203. See Barnard, supra note 171, at 55 (describing a proposal by Mortimer M. Caplin).

204. See id. at 60 (describing a proposal by Professor Louis Lowenstein).

205. See id. (describing a proposal by the Wall Street Journal).

206. See id.

207. See Martin Lipton & Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. CHI. L. REV. 187 (1991). This proposal, however, has been criticized as something of a sham that is, in fact, designed to protect directors by making them vulnerable once every five years instead of every year. See MONKS & MINOW, supra note 157, at 194.

208. See Gilson & Kraakman, supra note 172, at 891-92.

209. Arthur Goldberg made this proposal when he sat on the board of directors of TWA and he resigned when it was rejected. See MONKS & MINOW, supra note 157, at 78.

210. See, e.g., ABA Comm. on Corp. Laws, Corporate Director's Guidebook, 33 BUS.
The reformers' focus on the board of directors flows from an ingrained orthodoxy. Even reformers are wedded to the conceptual corporate model of an entity with three constituent parts: shareholders, directors and managers. If the board of directors is not doing its job, the logical approach is to try to reform it so that it will work. It is, however, an approach doomed to failure; everything we now know about boards of directors tells us that they are fundamentally flawed and cannot be fixed. It is not just that management has the ability to buy the loyalty of directors, although that is more than sufficient for management to control the board. Even more powerful forces are at work.

One of these is the law of small group dynamics. When someone joins a board of directors, he enters a prestigious group of successful individuals. He is flattered by inclusion in this group and his self-image is massaged. This good feeling, however, will only be sustained if he receives positive feedback from his fellow directors. He wants to be accepted and liked. He knows that he will spend a great deal of time with his fellow board members over a period of years and he wants to have a pleasant experience. He realizes that he is but one voice and one vote among many, and if he is going to have any influence he must be able to work with his colleagues.

He is subject to potent psychological carrots and sticks. Positive feedback enhances his self-esteem and reinforces a craving for more, while negative feedback feeds a fear of rejection. He learns quickly that the group is cohesive, operates by consensus and is characterized by a "cult of politeness." The pressures to conform are enormous. In fact, the greater the value the individual places on his continued membership in the group, the greater the pressure to conform. These are only some aspects of a dynamic that psychologists call "groupthink."

There are also other forces that inhibit dissent. One is the lim-

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211. See Cox & Munsinger, supra note 148, at 91-99. See also Barnard, supra note 171, at 76-79; Brudney, supra note 155, at 610-13, 633-43; Coffee, supra note 198, at 396-97.
212. See Cox & Munsinger, supra note 148, at 92.
213. See Karmel, supra note 167, at 552.
214. See Barnard, supra note 171, at 77 (quoting Mary Gardiner Jones). See also Myron Magnet, Directors, Wake Up!, FORTUNE, June 15, 1992, at 85-86, suggesting that the cult of politeness is so rigid that when one director had the temerity to ask about criticisms of one of the company's products that had appeared in the press "he drew looks of such shocked disbelief that he felt as if he'd belched at the dinner table."
216. See IRVING L. JANIS, GROUPTHINK (2d ed. 1982).
ited information that directors possess. Directors are busy people who can devote only limited time to their directoral responsibilities.\textsuperscript{217} Limited time means limited knowledge. An independent director would be at a considerable disadvantage in any debate with an inside director, who spends all of his time on corporate business. It would even be rare for directors to learn enough to cause them to question management since management furnishes them with their information and has the ability to cull, color, bury and explain data. John Kenneth Galbraith explains it this way: "Heavy dockets, replete with data, are submitted to the board. Recommendations are appended. Discussion is brief, stylized and superficial. Most of the participants are old men.\textsuperscript{218} Given the extent and character of the group participation, rejection would be unthinkable.\textsuperscript{219}

There is little reason to believe that increasing the number of independent directors will have any impact on corporate governance. There is, in fact, every reason to believe that it will not. Studies have shown that outside directors are particularly passive\textsuperscript{220} and that they contribute little to corporate governance.\textsuperscript{221} Research has even shown that corporate performance declines when independent directors comprise more than thirty percent of the board.\textsuperscript{222} And consistent with all of this are data that demonstrate that CEO compensation is unrelated to whether the majority of the board is composed of inside or outside directors.\textsuperscript{223}

None of the other proposals offer a reasonable hope of meaningful reform. Directors might know more if they had their own staffs,\textsuperscript{224} for example, but it is unlikely that more knowledge would itself significantly change board behavior. Directors would still be subject to the same pressures to please management and their fellow directors. No reform is going to make much of a difference unless it changes the type of people who become directors.\textsuperscript{225} As long as

\textsuperscript{217} See, e.g., Brudney, \textit{supra} note 155, at 622; Karmel, \textit{supra} note 167, at 543; and Solomon, \textit{supra} note 176, at 535.

\textsuperscript{218} Galbraith is not necessarily right on this point. The average age is 56. \textit{A Portrait of the Boss} 1991, \textit{supra} note 7, at 180.

\textsuperscript{219} \textit{Galbraith, supra} note 53, at 89.

\textsuperscript{220} See Barnard, \textit{supra} note 171, at 78 (citing MYLES MACE, DIRECTORS: MYTH AND REALITY 52-53 (1986)).

\textsuperscript{221} See Baysinger & Butler, \textit{supra} note 171, at 578 (citing MYLES MACE, DIRECTORS: MYTH AND REALITY 185 (1971). \textit{Cf.} Brudney, \textit{supra} note 155, at 635.

\textsuperscript{222} Baysinger & Butler, \textit{supra} note 171, at 575.

\textsuperscript{223} See Crystal, \textit{Wacky World of CEO Pay}, \textit{supra} note 28, at 69.

\textsuperscript{224} The board's staff would, however, have to obtain information from the corporate employees, who would of course owe their loyalty to management.

\textsuperscript{225} Professor Lewis D. Solomon studied instances in which courts required individual changes to the board of directors. In one case, for example, the SEC brought an action against Mattel, alleging that the company had issued false and misleading reports. The
boards of directors are populated with top corporate executives, things will remain much the same.

2. Shareholders. Only shareholders can change the board of directors and other reform proposals therefore deal with them. The historical obstacle to shareholder action has been summed up by a maxim known as the “Wall Street Rule,” which holds that it is more efficient to sell a particular stock than it is to try to reform the company. Moreover, the stock of major companies is so dispersed that even shareholders who wanted to would find it difficult to develop a coalition with enough votes to elect a competing slate of directors.

There are other impediments to shareholder action. One impediment is that when shareholders look at all of the factors that affect the value of a particular stock, a single element, such as excessive executive compensation, appears to be nothing more than the proverbial flea on the elephant’s back. A Reebok International shareholder might, for example, be upset that the chief executive is making $14.8 million per year, but that figure represents less than one percent of Reebok’s annual sales. Other factors—such as Reebok’s competitive position in the industry—loom larger. Another handicap is something of a paradoxical corollary to the Wall Street Rule. The Reebok shareholder might compare the CEO’s compensation to company profit rather than sales (the CEO’s pay is almost ten percent of Reebok’s profit) and conclude that it is indeed significant. But if he sells Reebok, what will he buy when so many companies pay excessive compensation? Thus, it is more efficient to sell than fight for reform, and more efficient still to do nothing at all.

Nevertheless, there are those who argue that there is real potential in shareholder action. They believe that the growth of institutional investors represents a sea change in our economic system. Today institutions own more than half of the total equity in the

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litigation was settled by a consent decree that required Mattel to make substantial changes to its board of directors, including appointing a majority of independent directors to the full board and to a number of key board committees. He concluded that “the results of these settlements have been disappointing. New directors have been drawn from the same elite as old directors; new boards have not been notably more aggressive than unreformed boards.” Solomon, supra note 176, at 596.

226. For use of the term, see EDWARD S. HERMAN, CORPORATE CONTROL, CORPORATE POWER 147 (1981); Barnard, supra note 171, at 45. For discussion of the dynamic generally, see GALBRAITH, supra note 53, at 84; Lyman Johnson, The Delaware Judiciary and the Meaning of Corporate Life and Law, 68 Tex. L. Rev. 865, 900 (1990).

227. See infra notes 235-54 and accompanying text.


229. Reebok’s annual sales were $2.16 billion in 1990. See id. at 109.


Fortune 500, and they therefore have the collective power to control those companies. The largest group of institutional investors is private pension funds, which have $667 billion in equity investments. State and local pension funds have $290 billion in equity holdings, mutual funds have $239 billion, and billions more are held by insurance companies, universities and foundations. Therefore, the argument runs, stock holdings are more consolidated than ever before, and it is now feasible for large institutional shareholders to band together and elect truly independent directors.

There are, however, problems with this thesis. Stockholdings are not as consolidated as the size of total institutional equity might suggest. Although some institutions have enormous holdings, even the largest does not have the power to elect directors in a major corporation. For example, one of the largest equity holders is the California Public Employees Retirement System (CalPERS), which has investments totalling $60 billion. But CalPERS holdings are dispersed among nearly 3,000 companies, and it generally owns between 0.7% and 1% of a particular company's total stock. Therefore, although CalPERS is a large shareholder, it is far from a controlling one. When in 1990, for example, CalPERS opposed the re-election of Roger B. Smith, the controversial former CEO of the General Motors Corporation, to the GM board of directors, it was able to vote 4.7 million shares against Smith—a large block of shares indeed but, nevertheless, less than 0.8% of G.M.'s total outstanding common stock.

Institutional investors diversify widely. Many institutions are required by law to be diversified. Most large institutional stockholders consider diversification to be the only prudent investment policy, and there is a growing use of indexed investments—buying and holding a portfolio that reflects a weighted composite of a large pool of stocks, such as the Wilshire 5000. The Federal Employees' Retirement System is required by law to make indexed investments and most of CalPERS' portfolio is indexed. Perhaps 10% of the total of all equity investments are now indexed.

232. See Lipton & Rosenblum, supra note 207, at 205. See also MONKS & MINOW, supra note 157, at 183 (noting that institutions own 50% of the fifty largest companies).
233. See MONKS & MINOW, supra note 157, at 183.
234. See id.
236. See Barnard, supra note 171, at 82 n.274.
238. See, e.g., HERMAN, supra note 226, at 149.
239. See MONKS & MINOW, supra note 157, at 220.
240. By 1991, eighty-five percent of CalPERS' stocks are expected to be indexed. See Gilson & Kraakman, supra note 172, at 864.
241. MONKS & MINOW, supra note 157, at 253. The trend toward indexing is likely to
With their individually small percentages of total outstanding shares in any particular company, institutional investors cannot wield power unless they engage in concerted action. However, they have not demonstrated a willingness to do so. During a 1990 battle over the control of Lockheed Corporation, for example, CalPERS supported a dissident group, while the New York City Employment Retirement System (NYCERS) voted in favor of management. That same year, another battle was waged over a management-sponsored proposal to increase retirement benefits for G.M. executives. Many were offended by the timing of the proposal; it was made just as CEO Roger B. Smith was retiring and increased his pension from $700,000 to $1.2 million a year. Although this type of decision is normally made by the board of directors, G.M. relented to considerable pressure brought by the UAW and a number of institutional investors and agreed to let stockholders vote on the matter. The Michigan State pension fund voted its 8.8 million shares of G.M. stock against the increases, but CalPERS voted for the proposal and management ultimately prevailed by an 83% to 17% margin.

The evidence that institutions fail to reach a consensus about how to vote in proxy battles is not only anecdotal; data demonstrate that institutional investors have historically not united to elect directors or reject policies that are principally designed to protect the personal interests of top executives. Even those who advocate

continue in light of studies showing that pension funds do not benefit from active management. See id. at 252.


243. See Fund Backs Lockheed, N.Y. TIMES, Mar. 29, 1990, at D10. The New York City plan was probably influenced by management's promise to appoint at least one director from a list of individuals acceptable to the company's large institutional shareholders.


245. See id.

246. Management could have excluded from its proxy statement any shareholder proposal relating to the pension matter under SEC Rule 14a-8(c)(8), 17 C.F.R. § 240.14a-8 (1990), which allows management to exclude any proposal that relates to the company's ordinary business. The Commission has historically considered all matters relating to executive compensation to be ordinary company business, although in recent years it has carved out three exceptions to this rule: proposals relating to golden parachutes, proposals to require companies to disclose more detailed information concerning their executive compensation and proposals to create shareholder advisory committees. See Hearings, supra note 70, at 114-16 (statement of Linda C. Quinn, Director, Division of Corp. Finance, SEC).

247. Despite its overwhelming victory and the fact that it has never lost a proxy fight, G.M. management vowed never again to allow shareholders to vote on a matter of this type. See G.M. Vote Backs Rise in Pensions, supra note 244, at 33.

248. See Gilson & Kraakman, supra note 172, at 893 n.91. But see Barnard, supra note 171, at 74 ("By 1990, an increasing number of shareholder proposals, particularly
concerted institutional action concede that institutional investors are extremely diverse and do not share a common agenda. The public pension plans, for example, have marked differences with private pension funds—ERISA qualified plans which are controlled by their corporate sponsors—by far, the largest single group of institutional stockholders. The managers of these funds must walk a tightrope, balancing their fiduciary obligation to vote their proxies in the best interests of the plan's beneficiaries against their need to please the corporate management which appoints them. They would find it difficult to join a coalition dedicated to weakening management's control over boards of directors.

Expectations for institutional shareholders are not new. This is what Adolf Berle wrote more than thirty years ago:

those initiated by institutional investors, were winning majority votes.

The media is eager to portray institutional shareholders as feisty, public-spirited and ready to do battle, but there is little hard information about genuine shareholder victories. See, e.g., Thomas McCarroll, The Shareholders Strike Back, TIME, May 4, 1992, at 46, which discusses efforts by CalPERS and the United Shareholders to persuade companies to voluntarily adopt reforms and suggests that "many corporate boards are choosing to negotiate a peaceful settlement with aggressive shareholders rather than face an embarrassing tongue-lashing." Id. at 48. Yet the concessions described are modest, and the only battle mentioned—an attempt to cap the pay of top executives at Baltimore Gas & Electric—ended in defeat for shareholders.

In 1992, the New York City Employment Retirement System (NYCERS) waged a proxy fight for reforms designed to make Reebok's board of directors more independent. At least in large part, the effort was prompted by the more than $58 million that Reebok's CEO earned during the five-year period 1987-91. The reforms would, for example, have prohibited representatives of Reebok's major suppliers and customers from sitting on its board. NYCERS itself owned 300,000 shares of Reebok stock, yet it failed to muster more than 20% of shareholder votes for its proposals. See Jonathan Yenkin, Reebok Shareholders Reject Limits on Those Who Set Executive Pay, PHILADELPHIA INQUIRER, May 6, 1992, at E10.

See, e.g., MONKS & MINOW, supra note 157, at 182; and HERMAN, supra note 226, at 138. See also Bernard S. Black, Agents Watching Agents: The Promise of Institutional Investor Voice, 39 UCLA L. REV. 811, 826-27 (1992). Nevertheless, Professor Black of Columbia Law School argues for what he calls "institutional voice." He believes that representatives of large institutional shareholders should have seats on corporate boards of directors. He hopes that they will be catalysts creating stronger boards—that, with them, boards will more actively monitor corporate performance, challenge misguided management plans, and use quiet persuasion to clear boards of deadwood and even, when necessary, to retire CEOs. Id. at 839. Professor Black appears to hope more than predict that this will be the result. He does not overstate his case. There is "limited direct evidence that some institutions already do valuable monitoring," he notes, adding perhaps his strongest argument: "Importantly, there is little evidence that greater stakeholder oversight will be harmful." Id. at 819.

See MONKS & MINOW, supra note 157, at 188.

The Department of Labor has said that proxies are plan assets, thereby putting managers at risk if they fail to exercise due care to vote their proxies in the best interests of the plan. See, e.g., BARNARD, supra note 171, at 83.

See, e.g., MONKS & MINOW, supra note 157, at 188.
We have seen that the holdings of common stock are gradually—or perhaps rather rapidly—beginning to be concentrated in the professional managers of the pension trust funds and mutual funds. To a somewhat less extent, the same is true of the great insurance companies. We thus dimly discern the outline of a permanently concentrated group of officials, holding a paramount and virtually unchallenged power position over American industrial economy.

As of today, four or five pension trust or mutual fund managers, if they get together, are quite able to ignore the 'management slates' for directors, get up slates of their own, and vote in their candidates. In place of the unorganized stockholders, none of whom has the energy or the money to mobilize his fellows, there are now centers of power already capable of carrying out such mobilization. Tomorrow these centers will be able, without having to ask assistance from individual stockholders, to deliver a controlling vote at will.

The "tomorrow" about which Berle was writing has come and gone. Data suggest that the growth in pension plans peaked some years ago, and the total percentage of equity holdings in institutional hands may be starting to decline.

Some advocate regulatory reforms to facilitate collective institutional action. In June of 1991, United States Senator Carl Levin (D-Mich.) proposed legislation that would, among other things, permit large investors to directly nominate directoral candidates and ensure that proxy votes be counted by a neutral third party. Some argue that institutional investors are hamstrung by SEC rules that require shareholders holding more than 5% of an issuer's stock to

253. BERLE, supra note 14, at 52-53.
255. The bill is known as the Corporate Pay Responsibility Act, S. 1198, 102d Cong., 1st Sess. (1991). It would amend the Exchange Act of 1934, 15 U.S.C. § 78n (Supp. II 1990), to (1) declare that the compensation of directors and the CEO shall be considered proper subjects for action by shareholders; (2) provide for clear and comprehensive disclosure of director and senior executive compensation in the company's SEC filings; (3) allow any person or group holding 3% of a corporation's voting stock or one million dollars worth of its stock to nominate persons for election to the board of directors and require that proxy votes be counted by a neutral third party; and (4) require that an independent third party tabulate proxy votes and keep shareholders' votes confidential. At the time of this writing the bill is before the Securities Subcommittee of the Senate Banking, Housing and Urban Affairs Committee and the prospects for its success are, at best, uncertain. See also infra note 427.

Senator Levin did succeed, however, in amending the Bank Reform Bill, S. 543, 102d Cong., 2d Sess. (1991), to provide that federal banking agencies shall prescribe standards to prohibit, as an unsafe and unsound banking practice, the excessive compensation of bank officers or directors. See 107 CONG. REc. H11, 769-70 (daily ed. Nov. 26, 1991).
file a statement with the Commission before forming a voting group. While changes in proxy procedures may be useful, there is little reason to expect that they would result in dramatic change. It might be a nuisance for institutions to have to file a statement with the SEC disclosing the formation of a voting group, but it is hardly an insurmountable obstacle.

The problems are more substantive than procedural. Notwithstanding all of the hopes and elegant theories, two unfortunate realities remain constant: (1) shareholdings are still, and probably will always be, widely dispersed, and efforts to organize a controlling coalition are difficult and expensive; and (2) it is more efficient for shareholders—large and small alike—to devote their resources to investment strategies than to matters of corporate governance. Waiting for institutional shareholders to finally sweep aside a century of stockholder passivity and replace it with vigorous and responsible ownership may be like waiting for Godot.

III. JUDICIAL REMEDIES

The law generally assumes that corporate democracy works. "Acting through their power to elect the board of directors or to insist on protective provisions in the corporation's charter," the Supreme Court has written, "shareholders normally are presumed

256. 17 C.F.R. §§ 240.13d-1 and 240.13d-2 (1990). Others, however, argue that it is not clear that the rules would be deemed to apply to a collective effort by large investors to elect individual directors and that, in any event, the burden of filing a statement with the SEC has been exaggerated. See Gilson & Kraakman, supra note 172, at 897.

257. Professors Ronald J. Gilson and Reinier Kraakman have reviewed the suggested procedural reforms and concluded that "none of the regulatory requirements most frequently cited as barriers to coordinated action by institutional investors are truly significant in their own right." Gilson & Kraakman, supra note 172, at 904.

Political economist Robert B. Reich of Harvard University also has little faith that institutional investors will become a more significant force. See Robert B. Reich, Suite Greed, AM. PROSPECT, Winter 1992, at 14, 16. He urges that executive compensation that is more than twenty times the salary of the lowest-paid employee in the company be deemed unreasonable and not deductible as a business expense. He concedes, however, that this will not end excessive compensation. For more about the tax consequences of excessive compensation see infra note 438.

258. Kayla J. Gillan, Assistant General Counsel of CalPERS, estimates the cost of launching a potentially effective proxy fight at $500,000. Telephone Interview with Kayla J. Gillan (Oct. 28, 1991). Difficulties abound. Stock is frequently held in street name or by fiduciaries who may or may not have voting power, and it takes a massive effort to identify and communicate with the individuals who have voting power. The largest block of shareholders are private pension funds, which are directly or indirectly controlled by corporate management. In their capacities as trustees, banks often control large blocks of stock, but commentators note that "[a] bank trust department has nothing to lose from voting with management on every proxy, and a lot to gain in commercial relationships." MONKS & MINOW, supra note 157, at 200-01.
competent to protect their own interests."\textsuperscript{259} It is, however, an erroneous assumption. As a practical matter, shareholders do not have the ability to elect directors, and in the real world managers are in complete control of their corporations. This may not be undesirable in all respects; managers know their businesses better than do shareholders or directors. But managerial control is problematic whenever there is a conflict of interest between manager and corporation, and the most direct conflict centers around the area of executive compensation.

Excessive executive compensation will continue unless it is externally restrained. The most appropriate place for this to happen is in the courts. Because they cannot vindicate their legitimate interests at the proxy ballot box, shareholders should be able to bring their grievances to court. Until recently, however, shareholders seeking to restrain excessive compensation found the courts' doors closed. Although more than half a century ago the Supreme Court gave courts a mandate to hear shareholder cases challenging executive compensation, a growing faith in corporate democracy—combined with an acquired distaste for class actions of all types, including shareholder derivative actions, and a deliberate pro-business strategy—induced courts to turn these cases away.\textsuperscript{260} The result has been decades of unrestrained greed. The courts, meanwhile, have watched how these disputes have been resolved outside the courthouse, and many courts appear ready to open their doors to shareholders once again.

A. Rogers v. Hill and its Progeny

The landmark case regarding executive compensation is \textit{Rogers v. Hill},\textsuperscript{261} a 1933 Supreme Court case arising out of shareholder action against the American Tobacco Company, alleging that the company's top officers had been paid unreasonably large salaries and seeking restitution. One suspects that if today compensation consultants were to evaluate the plan then used by the American Tobacco Company, they would proclaim it to be an enlightened and progressive compensation system, even by contemporary standards. The plan was what is most chic today—an incentive system—and provided that if the company's net profits exceeded a certain amount, ten percent of the excess was to be paid as a bonus to the company's president and five vice presidents, allocated among them in designated proportions.\textsuperscript{262}

\textsuperscript{260} See infra pp. 52-68.
\textsuperscript{261} 289 U.S. 582 (1933).
\textsuperscript{262} Id. at 584 n.1.
The plan was established by a bylaw that had been ratified at an annual shareholders' meeting nearly twenty years earlier. It worked without controversy for many years, but by 1930 the president was receiving an annual salary of $168,000, cash credits of $273,470, and—pursuant to the bylaw—a bonus of $842,508. Additionally, the vice presidents were each being paid a salary of $50,000, cash credits of about $90,000, and a bonus of $409,495.263 How, one might ask, did the directors adjust the officers' salaries in view of their wildly escalating bonuses? They raised them, more than doubling the president's salary in a span of two years (while his automatic bonus increased from $280,203 to $842,508), and raising the vice presidents' salaries by a third in a single year, notwithstanding the fact that a vice president's bonus that year leaped from $115,141 to $409,495.264

The Court held that the bylaw was valid and that the bonus formula was not unreasonable per se.265 And because the shareholders had allowed the bonus program to continue from year to year without changing it, the Court presumed that the majority of the shareholders still supported it.266 Nevertheless, the Court held that even majority will could not "justify payments of sums as salaries so large as in substance and effect to amount to spoilation or waste of corporate property."267 It found that the bonuses had "by reason of increase of profits become so large as to warrant investigation in equity,"268 and it ordered the district court to determine whether and to what extent the payments constituted a waste of corporate funds.269

It is surely no accident that Rogers occurred during the depths of the Depression.270 While women earned $2.39 to $2.78 for a fifty-five hour work week in sweatshops and men, fortunate enough to work, made seven-and-a-half cents an hour in construction jobs,271 and while teachers in Kansas made $280 a year and many districts closed the their schools entirely for lack of funds,272 the president of the American Tobacco Company was earning $1,283,978 a year.

263. See id. at 585 n.2.
264. See id.
265. Id. at 590.
266. Id. at 591.
267. Id.
268. Id. at 591.
269. See id. at 591-92.
270. 1932 is considered "the cruelest year" of the Depression. See WILLIAM R. MANCHESTER, THE GLORY AND THE DREAM 32 (1973). The Supreme Court handed down its decision in May 1933, two months after Roosevelt's inauguration and during his famous "hundred days" of action.
271. See id. at 38.
272. See id. at 40.
Even the notoriously conservative Supreme Court\textsuperscript{273} of 1933 probably found this obscene. There was no dissent despite the fact that the decision implicitly calls into question basic tenets of corporate democracy, contract rights and the belief that one’s compensation should be set by the marketplace, not the government. It is historically unfortunate that the case was settled before the district court held a hearing;\textsuperscript{274} it would have been interesting to know how the courts would have received likely arguments, among them the president’s taking credit for the company’s profit and the plaintiff’s rebuttal that the company’s executives were merely the beneficiaries of social forces (the number of cigarette smokers was rapidly increasing during this period and the entire industry was flourishing).\textsuperscript{275}

One year later, a New York court handed down a decision in an action that shareholders brought against the National City Bank of New York Company’s challenging sums that top executives received under a predetermined incentive compensation plan.\textsuperscript{276} The plan had been established by the bank’s board of directors. The court found that the overwhelming majority of the directors were “outside” directors who were financially disinterested in the compensation plan, noting that it was accepted corporate practice to have predetermined incentive compensation plans that gave officers a percentage of company profits.\textsuperscript{277} The court set forth the applicable legal standard as follows:

The rule is established that directors of a corporation acting as a body in good faith have a right to fix compensation of executive officers for services rendered to the corporation, and that ordinarily their decision as to the amount of compensation is final except where the circumstances show oppression, fraud, abuse, bad faith, or other breach of trust. If clear oppression, bad faith, or other breach of trust is shown, the courts will give redress and determine to what extent the compensation is excessive. But plaintiffs must bring the case within one of the exceptions that are in each case predicated on a breach of legal duty with consequent damage to the corporation.\textsuperscript{278}

No evidence of fraud or bad faith was proffered. Nevertheless,

\textsuperscript{273} The 1933 Court is widely considered to have been conservative despite the presence of Louis D. Brandeis and Benjamin N. Cardozo. See ROBERT BORK, THE TEMPTING OF AMERICA 192 (1990); and BURNS, supra note 109, at 87-96.

\textsuperscript{274} See Vagts, supra note 22, at 253.

\textsuperscript{275} See MANCHESTER, supra note 207, at 38. In fact, American Tobacco lost its number one position in the industry to the R.J. Reynolds Co. in the 1930s. See BURROUGH & HELYAR, supra note 16, at 48.


\textsuperscript{277} Id. at 113.

\textsuperscript{278} Id. at 117 (citations omitted).
relying on Rogers, the court implicitly held that if the sums were unreasonably large, the compensation itself could demonstrate oppression or abuse. The top bank executives were making even more than the officials of the American Tobacco Company. Thus, the compensation was so large that—notwithstanding the bank's “stupendous” profits—"they do warrant a full investigation by this court of equity . . . to determine whether there was in fact a deliberate or actionably negligent waste of corporate assets and, if so, to what extent."279 The court appointed a referee to hear the facts, reach a judgment and file a report with the court.280

In 1946, a New Jersey court rendered a decision in a shareholder derivative action that had been brought against the other major tobacco company, R.J. Reynolds.281 The facts of the case were similar to those in Rogers. Like its arch rival, American Tobacco, R.J. Reynolds had a program that set aside 10% of any profit above a certain threshold for bonus payments.282 And just like American Tobacco, R.J. Reynolds established the program in a bylaw that its shareholders ratified in 1912.283 There were, however, three important differences between the two cases: first, unlike the American Tobacco plan that benefited only six top executives, all company employees were eligible to participate in the R.J. Reynolds program;284 second, the R.J. Reynolds executives were paid much less than their American Tobacco counterparts; and, third, the R.J. Reynolds case was not commenced until 1940285 and not decided until 1946, an economically brighter time than the period when Rogers was litigated.

The trial court held a hearing that lasted many months286 and handed down a long opinion. One of the plaintiffs' main attacks was that the bonuses were allocated among the participants in proportion to the number of shares of stock they owned.287 The plaintiffs argued that the participants were not being rewarded for their work but were merely receiving higher dividends than other shareholders. Because it highlighted the relative egalitarianism of the plan, it may not have been the best strategy; in contrast to the six participants in

279. Id. at 116.
280. Id. at 119. The referee found that the executive compensation was excessive in certain respects. See Vagts, supra note 22, at 254 n.108.
282. Id.-at 650.
283. See id.
284. See id.
285. Two separate cases were consolidated, one of which was filed in November 1940 and the other in April 1941. See id. at 649.
286. Id. at 650.
287. Id. at 655.
the American Tobacco plan, more than 2,000 R.J. Reynolds employees benefited from their company's program. Indeed, Reynolds had an unusually progressive compensation tradition. Its founder, R.J. Reynolds, wanted his company to be owned and controlled by its workers, and he did everything to put company stock in employees' hands. He created two classes of stock: Class A, with voting rights, was sold to employees and Class B, without general voting rights, was sold to outside investors. He helped employees get bank or company loans to buy company stock, and, of course, sweetened their dividends with the bonus program. Employees from all levels of the company bought stock; for years one of the company's largest shareholders was a factory worker.

At trial, company executives waxed eloquent about how the company's success had "unquestionably been stimulated" by the bonus program. They provided the court with a number of analyses—some based on a twenty year time frame, others on thirty years—showing that Reynolds had given its stockholders a higher return on their investments than any of the other major tobacco companies and had paid its officers a smaller percentage of its total earnings than two of its three competitors. The highest salary that R.J. Reynolds had ever paid one of its executives was $100,000. The highest total compensation any Reynolds executive received was $508,000 (earned in 1931 by Bowman Gray, the man who succeeded R.J. Reynolds as president of the company) which included both Gray's annual $34,000 salary and the return on his stock (i.e., the normal dividend and the 10% bonus) in which Gray had made a substantial investment. "In view of this showing," wrote the court, "[we] cannot find the salaries of the officers and directors were not fair and reasonable."

The court's opinion does not tell us whether the plaintiffs challenged the fact that the analyses of company performance were based on twenty and thirty year time spans. They should have. It appears that R.J. Reynolds managed the company brilliantly until

288. Id.
289. See BURROUGH & HELYAR, supra note 16, at 45.
292. See BURROUGH & HELYAR, supra note 16, at 48. R.J. Reynolds was unusually progressive in other areas too; it had a medical and dental clinic for workers, a day care for their children and a lunchroom providing meals to workers at cost. See id. at 45, 49.
293. R.J. Reynolds Tobacco Co., 48 A.2d at 656.
294. Id. at 691.
295. Id. at 692.
296. Id. at 691. The numbers have been rounded off to the nearest dollar figure.
297. Id.
his death in 1918, but that his successors merely coasted for many years thereafter. Writers who have studied the company describe Bowman Gray as "a details man who had neither the dynamism nor the imagination to ignite real growth," and after he died in the mid-1930s, they tell us, "Reynolds endured more than a decade of tepid management." Analyses of company performance that reached so far back in time may have reflected the performance of R.J. Reynolds, himself, as much as of the current managers.

Bowman Gray’s salary was only $34,000 when American Tobacco was paying its president $441,000. Additionally, Gray was earning $474,000 on stock he bought while his counterpart at American Tobacco was being given an additional $842,508 without having made any investment. There is a possible pitfall in measuring one top executive’s compensation against another’s; if the salary being used for comparison purposes is excessive, the yardstick is distorted and the comparison becomes meaningless. Nevertheless, the discrepancies between Gray and his American Tobacco counterpart were so great that it is difficult to fault the court’s decision.

These cases provide a sound foundation for the principle that shareholders complaining about executive compensation are entitled to have a court determine, either in the first instance or on review of a master’s report, whether the sums are excessive. In none of the cases did plaintiffs provide evidence that those who established the compensation plans acted in bad faith. The plans had been formulated years earlier and may have been reasonable at the time; yet even if they were developed with the best of motives, the courts found that compensation could be so patently large as to constitute "waste," "spoilation," "oppression" or "abuse."

In later years, however, the road forked. Courts continued to apply the principles enumerated in Rogers to closely held companies, but took a different path in cases involving public companies.

298. BURROUGH & HEYLAR, supra note 16, at 47.
299. Id. at 48.
300. For Bowman Gray’s compensation see supra note 295 and accompanying text; for the compensation of the president of the American Tobacco company see supra p. 85. A 1930 salary is being used for the president of American Tobacco and a 1931 salary for Bowman Gray; the case opinions do not furnish data for the same year. The salary of the president of the American Tobacco Company includes both salary and cash credits.
301. See also Winkelman v. General Motors Corp., 44 F. Supp. 960, 969 (S.D.N.Y. 1942), in which the court made certain adjustments to the salaries of General Motors executives, even though they were making only half as much as their counterparts at American Tobacco and National City Bank and the G.M. salaries were, in the main, warranted by a “keen rivalry for executives in the automobile industry.”
302. E.g., Wilderman v. Wilderman, 315 A.2d 610 (Del. Ch. 1974) (holding that the defendant-executive had the burden of justifying the reasonableness of his compensation
B. The Business Judgment Rule

In the modern era, courts have generally turned away shareholder cases challenging executive compensation within public companies. While Rogers has never been overruled and is seldom even criticized, it is almost entirely ignored. It is rarely cited in modern compensation cases. It quietly disappeared from the legal landscape, and in its place courts erected nearly impregnable barricades that, for decades, protected executive compensation from judicial review. It appears, however, that the barricades may soon be dismantled.

The principal fortification for protecting excessive executive compensation from review has been a legal doctrine known as the business judgment rule. The rule is not new—it has been traced back at least 150 years, nearly a century before Rogers—and it was not developed specifically for compensation matters. It is a ge-

303. The “modern era” for these purposes began after the Second World War, when faith in American business was rejuvenated.

304. The best empirical data suggest that defendants prevail over plaintiffs in shareholder derivative litigation by a ratio of 20:1. See, e.g., John C. Coffee, Jr., The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation, LAW & CONTEMP. PROBS., Summer 1985, at 5, 9 n.22 (1985) [hereinafter The Unfaithful Champion].

neric rule that applies to the board's judgment on any business matter. The business judgment rule is defined as "a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." The presumption is deemed to be rebuttable, but one who seeks to challenge a board decision has the burden of showing that directors made the decision without being adequately informed, that they made it in bad faith, or that they did not honestly believe the decision was in the best interests of the company. It is not a burden that can often be carried.

The business judgment rule was developed for two reasons. First, courts believed it prudent to defer to boards of directors, who are presumed to have had greater expertise on business matters than courts. Second, courts believed that corporations would have trouble recruiting directors if they were liable for decisions that turned out badly.

One commentator has said that there are really two separate principles serving different objectives: the business judgment rule shields directors from liability while the business judgment doctrine protects the business decision from judicial review. However, courts seldom, if ever, use the term "business judgment doctrine." Both principles are generally subsumed under the label "business judgment rule," blurring any distinction between them. The nomenclature can be confusing, but the distinction is an important one. In an excessive compensation case, a court would probably be more willing to find for plaintiffs if the remedies were limited to an injunction against continuing abuse and restitution by the overcompensated executives. A court might be reluctant to order directors to pay damages because they made a compensation decision with which it later disagreed. It might even balk at hearing such a case if

308. See infra note 344 and accompanying text.
309. It has been said the rule was developed for four reasons: the two described in the text, and in addition: ensuring that corporations have strong, central management which can formulate and carry out consistent business plans free of shareholder interference; and encouraging management to engage in appropriate risk-taking and experimentation by relieving them of the worry of having their decisions subject to retroactive review. See E. Ashton Johnson, Note, Defenders of the Corporate Bastion in the Revlon Zone: Paramount Communications, Inc. v. Time Inc., 40 CATH. U. L. REV. 155, 161 (1990). A fifth possible purpose of the rule might be to force corporate disputes to be resolved through the exercise of corporate democracy.

310. See Hinsey, supra note 305, at 611-12. For a discussion of this issue with respect to the business judgment rule and the Principles of Corporate Governance see infra note 344.
a finding for plaintiffs would automatically result in personal liability for the directors.

Courts, of course, have the tools to fashion appropriate remedies, especially since shareholder derivative actions are equitable in nature and courts sitting in equity have great remedial discretion. Nevertheless, the two underlying purposes behind the business judgment rule may have become so confused that there has been a general failure—by both parties and courts—to differentiate them. It does not make things easier to call one principle the business judgment rule and the other the business judgment doctrine, and for clarity's sake this article will not use those terms. The term "business judgment rule" will be used as it is commonly understood—the rule that shields both the decision of the board of directors from judicial review and the directors from personal liability—and distinctions will be drawn when discussing various remedies.

There is a second potentially confusing feature of the business judgment rule. Because a shareholder derivative action seeks to enforce a right belonging to the corporation, the board of directors of the corporation claims the right to determine whether the prosecution of such an action is in the best interests of the company. Ever since Justice Brandeis' famous opinion in United Copper Securities Co. v. Amalgamated Copper Co.311 in 1917, it has been the rule that "[w]hether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management,"312 and that "[c]ourts interfere seldom to control such discretion."313

Thus, the business judgment rule provides two layers of defense: at the inner layer, it protects the business judgment of the board of directors on the substantive issue (e.g., the compensation of the CEO), and at the outer layer, it protects the board's decision about whether litigation challenging the substantive issue should be permitted (e.g., whether a derivative action challenging the CEO's compensation should go forward). The Supreme Court, however, did not say that courts must always respect the board's judgment, only that the courts should "seldom" interfere because the board's decision is "ordinarily" entitled to judicial deference, and issues concerning when courts must grant a board's request to dismiss derivative

311. 244 U.S. 261 (1917).
312. Id. at 263.
313. Id. at 263-64. See also Burks v. Lasker, 441 U.S. 471, 487 (1979) (Stewart, J., concurring) ("The business decisions of a corporation are normally entrusted to its board of directors. A decision whether or not a corporation will sue an alleged wrongdoer is no different from any other corporate decision to be made in the collective discretion of the disinterested directors.").
actions have long been among the most sensitive in corporate law.\textsuperscript{314} In 1979, the Supreme Court held that state law governs whether boards of directors have the authority to dismiss derivative actions.\textsuperscript{315} The states, meanwhile, were engaged in a vigorous competition to bring businesses into their states by offering pro-business—and pro-management—corporate laws.\textsuperscript{316} The acknowledged ‘winner of what Justice Brandeis called a race of laxity,\textsuperscript{317} and what Professor William L. Cary described as a “race for the bottom,”\textsuperscript{318} was Delaware. It was not only the Delaware legislature that promoted pro-management policies; the courts also became enthusiastic boosters of the state strategy,\textsuperscript{319} and advertisements touted the

\begin{itemize}
  \item \textsuperscript{314} See, e.g., \textit{Lattin}, supra note 164, at 419 (emphasis added).
  \item \textsuperscript{315} \textit{Burks v. Lasker}, 441 U.S. at 486. The Court overturned a ruling of the Second Circuit, which had held that “disinterested directors of an investment company do not have the power to foreclose the continuation of nonfrivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties.” See \textit{id}. at 475.
  \item The Supreme Court continues to give great deference to state law in this area. It recently held that, even in cases under federal law, courts should look to state law to determine whether a shareholder is required to make a prelitigation demand on the board of directors. \textit{Kamen v. Kemper Fin. Servs., Inc.}, 111 S. Ct. 1711 (1991). In that case, a shareholder brought a derivative action against a mutual fund. Her substantive claims involved alleged violations of a federal statute regulating mutual funds. Federal law therefore applied to all aspects of the case, and federal common law controlled matters relating to derivative actions. Drawing upon the \textit{ALI's Principles of Corporate Governance (see supra note 194 and infra notes 330-54)}, the Seventh Circuit adopted the “universal demand rule” for purposes of federal law. Under this rule, shareholders must always make a demand on the board of directors before instituting a derivative action. Because plaintiff did not make a timely prelitigation demand, the Seventh Circuit dismissed her action. The Supreme Court reversed. It held that uniform federal rules should be developed only when there is a distinct need for nationwide legal standards. It found no such need. Moreover, it held that because corporations are creatures of state law and parties expect that state law will control their corporate affairs, “[t]he presumption that state law should be incorporated into federal common law is particularly strong” in this area. \textit{Id}.
  \item \textsuperscript{316} \textit{See} Cary, \textit{supra} note 31. In this famous article, Professor William L. Cary of Columbia University described how important it was to Delaware to keep winning the race against her sister states to have the most lax—i.e., the most pro-management—corporate laws, and thereby to attract companies to incorporate in the state. At the time Cary wrote his article, 40% of all New York Stock Exchange companies were incorporated in Delaware (see \textit{id}. at 671) and Delaware received nearly 25% of all her tax revenues from corporate franchise taxes. See \textit{id}. at 671, 669.
  \item \textsuperscript{317} \textit{See Liggett Co. v. Lee}, 288 U.S. 517, 558-59 (1933).
  \item \textsuperscript{318} \textit{See} Cary, \textit{supra} note 31, at 705.
  \item \textsuperscript{319} Cary described how the legislature, the courts and the bar worked together to promote this policy. \textit{See id}. After reviewing court decisions involving proxy contests, misleading proxy materials, directors’ duty of care and other issues, Cary lamented that “[p]erhaps there is no public policy left in Delaware corporate law except the objective of raising revenue.” \textit{Id}. at 684. He wrote:
    Judicial decisions in Delaware illustrate that the courts have undertaken to
“exceptionally favorable” treatment that corporations could expect from Delaware courts. Therefore, in 1979, when the Supreme Court held that state law would control whether boards of directors could seek dismissal of shareholder derivative actions, it placed this issue in the hands of courts that were falling over one another in trying to please corporate management.

At the same time, a general distaste for both class action and securities derivative litigation was developing. There was a time when class actions were viewed as means of encouraging a cadre of private attorneys general who would vindicate the rights of the weak against corporate Goliaths (and make the Goliaths pay for the service), and the derivative action was thought to be “the chief regulator of corporate management.” But in the 1960s and early 1970s, a number of attorneys specializing in this work became rich by filing private actions that piggybacked on federal indictments or SEC proceedings. Many saw this as a kind of ambulance chasing. The lawyer’s case did not begin with a disgruntled client; it began when an indictment or consent decree was filed at the federal courthouse. If the violation occurred in an area that also afforded private remedies—such as in the antitrust or securities area—and the defendant had a deep enough pocket, lawyers would then search for clients with standing to represent the class of victims. Within days of an indictment being reported in *The Wall Street Journal*, lawyers carry out the ‘public policy’ of the state and create a ‘favorable climate’ for management. Consciously or unconsciously, fiduciary standards and the standards of fairness generally have been relaxed. In general, the judicial decisions can best be reconciled on the basis of a desire to foster incorporation in Delaware. It is not clear, however, that the revenue thermometer should replace the chancellor’s foot. This trend should be reversed.

Id. at 670.

Delaware was not alone in running what is often called “the race to the bottom.” Other states competed for corporations by trying to provide even more relaxed regulation. In Pennsylvania, for example, the Corporation Law Committee of the Pennsylvania Bar Association bombarded the General Assembly with so many requests for statutory changes that the legislative leadership requested a ten year moratorium on further changes to the state’s corporation law. During that time Pennsylvania lost a number of corporations to other jurisdictions, including Atlantic Richfield Co., Equimark Corp. and Gulf Oil Corp., all of which reincorporated in Delaware. As soon as the moratorium ended, Pennsylvania rejoined the race by making sweeping revisions to its corporate law. See Title 15 Revision Subcomm. Pennsylvania Bar Assn., Highlights of the General Association Act of 1988, 15 PA. C.S.A., 1991 Pamphlet.


321. See, e.g., The Unfaithful Champion, supra note 304, at 5-6.


323. See The Unfaithful Champion, supra note 304, at 40-41; Bryant R. Garth et al., Empirical Research and the Shareholder Derivative Suit: Toward a Better Informed Debate, LAW & CONTEMP. PROBS., Summer 1985, at 137, 139.
around the country would file private actions on behalf of the injured class.\(^\text{324}\) Instead of becoming the heroic Davids slaying Goliaths, the class action bar began to be perceived as parasites who did not do the hard work of ferreting out and proving wrongdoing but merely lived off the work of others.\(^\text{325}\)

The boom in class actions that occurred during the 1960s and 1970s appeared to conservatives to be part and parcel of a liberal legal system. When Republicans campaigned for judges who would exercise “judicial restraint,”\(^\text{326}\) they meant, in part, judges who would interfere less with business, and when Ronald Reagan became President in 1980, a concerted effort was undertaken to fashion a more pro-business judiciary.\(^\text{327}\)

\(^{324}\) The problem was exacerbated when courts adopted formulae calculating attorneys’ fees in such actions on the basis of the amount of time spent on the matter. The Third Circuit began the trend in Lindy Bros. Builders, Inc. v. American Radiator & Standard Sanitary Corp., 487 F.2d 161 (3d Cir. 1973), an antitrust case, in which it made the “lodestar” for determining the attorney fee the figure derived by multiplying the number of attorney hours in the case times the usual hourly billing rates for the individual lawyers involved. Other circuits followed suit. See, e.g., Evans v. Sheraton Park Hotel, 503 F.2d 177 (D.C. Cir. 1974); Furtado v. Bishop, 635 F.2d 915 (1st Cir. 1980); Detroit v. Grinnell Corp., 495 F.2d 448 (2d Cir. 1974); Copper Liquor, Inc. v. Adolph Coors Co., 624 F.2d 575 (5th Cir. 1980). Although courts were to increase or decrease the lodestar on the basis of other factors, including the contingent nature of the case, the complexity of the issues, the quality of the work and the result obtained, the additional factors were generally used only to increase fees. See, e.g., Zoll v. Eastern Allamakee Community Sch. Dist., 588 F.2d 246, 252 (8th Cir. 1978) (“The minimum award should generally be not less than the number of hours claimed times the attorney’s regular hourly rate.”).

The lodestar method seemed modern and sophisticated. Lawyers filed voluminous computer print-outs reflecting their time, and courts felt they were dealing with objective data. But plaintiffs’ lawyers learned that the way to obtain big fees was to generate large numbers of attorney hours. Not only would this create a hefty lodestar, but it would also make the case appear complex and help persuade the court to adjust the lodestar upward. Defense attorneys—who were themselves being paid by the hour—had their own incentive to allow litigation engines to run at full speed. Thus, the courts created a system that encouraged churning attorney hours.

At first there was something in this for the courts. There was a certain cachet in presiding over behemoth cases and deciding sophisticated issues involving “complex” litigation and antitrust and securities law. But over the years the mystique started to wear thin.

\(^{325}\) See The Unfaithful Champion, supra note 304, at 8, and in particular, sources cited at n.19 of that article.

\(^{326}\) See, e.g., REPUBLICAN NATIONAL CONVENTION, REPUBLICAN PLATFORM 37 (1988).

\(^{327}\) During the Reagan administration, subscribing to a particular view of conservatism—which included a pro-business bias—was a prerequisite for nomination to the federal bench. See HERMAN SCHWARTZ, PACKING THE COURTS 3-9, 40-41 (1988). During his two terms Reagan appointed over 300 judges to the federal bench, thereby changing the character of the federal judiciary. See id. at 58. At the same time, big business launched a campaign to have state legislatures enact pro-business legislation in areas that had traditionally been reserved to the courts, which may have deterred judges from
Because of the confluence of these factors—the Supreme Court’s decision that state law controls how the business judgment rule should be applied in derivative actions, the states’ race to the bottom and a general disenchantment with derivative actions—a body of law developed that largely closed the courthouse doors to derivative actions. This left management in total control. The only people who could challenge management were disgruntled shareholders, but they were shut out of the one place that a challenge could effectively be made. For many, the need to reopen the courthouse doors appeared obvious. Many state courts—led, surprisingly, by the Supreme Court of Delaware—came to the view that the pendulum had swung too far and, as discussed below, are beginning to open their doors once again. But leaning against the doors is the heavy weight of the American Law Institute (ALI).

The ALI is on the threshold of finally adopting its Principles of Corporate Governance (Principles). The ALI instituted its Corporate Governance Project in 1978, and over the ensuing years issued draft after draft of proposed Principles. Most of the latest version, Tentative Draft 11, was formally approved at the ALI’s 1991 annual meeting. The Principles cover the wide panorama of corporate governance issues. Whether or not the Principles represent the future on such subjects as the business judgment rule and shareholder derivative litigation remains to be seen. There is good reason to believe they do not. They do, however, provide an accurate snapshot of the common law as it was when it was most deferential to corporate boards of directors and most hostile to derivative actions.

Under the Principles, before a shareholder may file a derivative action, she must make a written demand on the board of directors making rulings that could be characterized as anti-business. See Carl T. Bogus, Pistols, Politics and Products Liability, 59 U. CIN. L. REV. 1103, 1158-64 (1991).

328. Because derivative actions are generally considered to be a special kind of class action, class actions and derivative actions often have similar appearances. Yet courts generally recognize that derivative actions have their own unique characteristics, and there is data that suggest that courts have become far more hostile to class actions than to derivative actions. See Garth et al., supra note 323, at 144.

329. See discussion infra part III.D.

330. See discussion of ALI Principles supra note 194.

331. See Melvin A. Eisenberg, Overview, An Introduction to the American Law Institute’s Corporate Governance Project, 52 GEO. WASH. L. REV. 495 (1984). Professor Eisenberg is Chief Reporter to the ALI’s Corporate Governance Project.

332. The ALI approved most of Tentative Draft 11, subject to minor revisions. Among the parts specifically approved were Part IV (which includes the business judgment rule, § 4.01), and Part V (which includes provisions relating to executive compensation, § 5.03). Those portions of Part VII dealing with shareholder derivative actions, §§ 7.01-7.19, have not yet been approved. See Actions Taken with Respect to Drafts Submitted at 1991 Annual Meeting, 14 A.L.I. REP. 3, 9 (1991).

333. Only those aspects of the ALI principles that apply to actions challenging
that it institute the action on behalf of the company.\textsuperscript{334} The board may then review the matter itself or, more commonly, refer it to a committee of the board—generally known as the Special Litigation Committee (SLC)—to determine whether bringing such an action would be in the best interests of the company.\textsuperscript{335} The SLC must have at least two members, none of whom have a direct interest in the matter,\textsuperscript{336} its evaluation must be "adequately informed under the circumstances," and its determinations and conclusions must be set forth in writing,\textsuperscript{337} but it is subject to no other significant requirement.\textsuperscript{338}

If the SLC determines that the litigation is not in the best interests of the company but the shareholder files a lawsuit nonetheless, the committee may file a motion asking the court to dismiss the case.\textsuperscript{339} The court must grant that request unless the plaintiff, who has the burden of proof,\textsuperscript{340} demonstrates either that there were material and unjustified departures from the procedural requirements described above,\textsuperscript{341} or that the "committee's determinations and conclusions are so clearly unreasonable as to fall outside the bounds of discretion of the board or committee."\textsuperscript{332} Only the most sloppy committee would fail to comply with the simple procedural requirements; thus, the court review will almost certainly focus on the second requirement.

When is an SLC's determination to seek termination of a derivative action so unreasonable that it falls outside the bounds of its discretion? The answer is, arguably, never. In an excessive compensation case, even if the pay of the senior officers were blatantly excessive, the SLC might nevertheless decide that a lawsuit would

\textsuperscript{334} Id. § 7.03(a). Plaintiff may be excused from making a written demand only if she can make "a specific showing that irreparable injury to the corporation would otherwise result." Id. § 7.03(b).

\textsuperscript{335} PRINCIPLES OF CORPORATE GOVERNANCE, supra note 194, §§ 7.05(b)(1) and 7.07. Instead of appointing an SLC, the board may request that the court appoint a special committee to evaluate the matter, id. § 7.05(b)(2); however, it is unlikely that this would ever occur.

\textsuperscript{336} Id. § 7.09(a)(1).

\textsuperscript{337} Id. §§ 7.09(a)(3)-(a)(4). The writing must set forth the committee's "determinations and conclusions with sufficient specificity to enable the court to conduct the review required under § 7.10." Id. § 7.09(a)(4).

\textsuperscript{338} Id. § 7.09(a). The committee should be assisted by counsel of its choice and such other agents it considers necessary. Id. § 7.09(a)(2).

\textsuperscript{339} Id. § 7.05(a)(3).

\textsuperscript{340} Id. §§ 5.03(b) and 7.13(d).

\textsuperscript{341} Id. § 7.08(b).

\textsuperscript{342} Id. § 7.10(a)(1), which is incorporated § 7.09(c) (relating to excessive executive compensation cases).
be inadvisable because it would alienate the company's officers, embarrass the company, be too expensive, be too uncertain (all litigation is, of course, inherently uncertain), or renege on prior commitments.

To what extent may the court consider the merits of the substantive issue when evaluating the SLC's determination? For example, in evaluating a request by an SLC to terminate a derivative action that challenged the CEO's compensation, could the court consider the fact that the compensation appeared blatantly excessive? A chain of cross-references in the *Principles* loosely links the section dealing with judicial review to the sections about excessive compensation and the business judgment rule, which suggests that its drafters assumed that the court would review the underlying compensation decision. 343 Moreover, it is so hard to meaningfully analyze the SLC's decision without considering what the SLC considered that any attempt to do so violates common sense.

If the court proceeded to the inner layer, however, it would probably evaluate the substantive decision under the rubric of the business judgment rule. 344 The *Principles* set forth the heart of the

343. Section 7.10 is the section dealing with judicial review of board or committee (e.g., SLC) motions requesting dismissal of derivative actions. That section reads, in pertinent part:

(a) **Standard of review.** In deciding whether an action should be dismissed under § 7.08 (Dismissal of a Derivative Action Against Directors), the court should apply the following standards of review:

(1) If the basis of the claim is that the defendant violated a duty set forth in Part IV (Duty of Care), other than committing a knowing and culpable violation of law, or if the underlying transaction or conduct would be reviewed under the business judgment rule under § 5.03 ... , the court should dismiss the claim unless it finds that the board's or committee's determinations and conclusions are so clearly unreasonable as to fall outside the bounds of the discretion of the board or committee.

*Id.* § 7.10 (emphasis added) (cross-references to sections not pertaining to compensation omitted).

Section 5.03 deals with the compensation of directors and senior executives. Section 7.10(B)(3) does not expressly incorporate § 503 by reference; nevertheless, one can argue that the implication is that the court will consider the underlying transaction, under the standards applicable to that transaction. Under § 5.03, a senior executive who receives compensation from the corporation fulfills his duty of fair dealing to the corporation if the compensation is authorized or ratified by disinterested directors "in a manner that satisfies the standards of the business judgment rule ([§ 4.01])." *Id.* § 5.03(a)(2). Thus, through this series of cross-references—§ 7.10, which refers to § 5.03, which in turn refers to § 4.01—the court may find itself evaluating not only the SLC's decision to terminate the litigation but also the underlying decision of the compensation committee, under the rubric provided by the *Principles* version of the business judgment rule set forth at § 4.01.

344. "Probably," but not necessarily. There is some room to argue that it should not apply the business judgment rule to the compensation decision itself.

Section 4.01 of the *Principles*, which sets forth the ALI's version of the business
judgment rule, is, by its own terms, only concerned with whether officers or directors have violated their duty to the corporation, i.e., in an excessive compensation case, with whether directors who awarded excessive compensation to company executives should themselves be liable in damages, and not with whether the compensation is excessive or with other possible remedies, such as an injunction or restitution from the executives. However, one of the comments to the section reads:

*e. Application of § 4.01 to enjoining or setting aside an action or transaction.*

Part IV (which includes § 4.01) addresses factual situations in which a finding that a breach of the duty of care has occurred could lead to the imposition of various kinds of remedies. Among those remedies could be an injunction preventing the consummation of a transaction or equitable relief setting aside a transaction. Section 4.01 deals with standards of care for purposes of determining whether these remedies are potentially available against directors and officers, just as it deals with standards of care for purposes of determining whether monetary damages may be imposed.

 Normally an effort to enjoin a pending transaction, or to set aside a consummated transaction, not involving a conflict of interest such as an interested director's transaction (Part V) (which includes § 5.03, dealing with the compensation of senior executives) .. will involve Subsection (c) [the heart of the business judgment rule], since any corporate transaction of importance is likely to have taken place as a consequence of an exercise of business judgment. The substantive issue would be whether the corporate decisionmaker has met the standards of § 4.01. However, a different substantive standard for injunctive relief would be applicable in certain cases involving conflicts of interest or transactions in control (e.g., §§ 5.02 and 6.02).

*Id.* § 4.01 cmt. e.

The comment will probably lead most courts to conclude that the business judgment rule applies to the substantive issue. It is difficult, however, to be sanguine with that conclusion.

The first paragraph of comment e makes it plain that the business judgment rule was written to govern director liability. The second paragraph says that the rule will “normally” be applicable to a review of the substantive issue “not involving a conflict of interest.” Because under the Principles there is no conflict of interest when a compensation committee—composed solely of independent directors—sets executive compensation, the most likely conclusion is that the rule applies when reviewing the substantive compensation decisions.

But there are troubling aspects to this analysis. What does the word “normally” in comment e mean? It suggests there are exceptions but offers no clarification. Indeed, the second paragraph seems like an afterthought. The rule was specifically drafted to govern director liability but then slops over into evaluations of the underlying transaction. Once again, the distinction between what one commentator called the business judgment rule and the business judgment doctrine become blurred. See supra note 309 and accompanying text.

One might argue that additional support for the view that the business judgment rule should be applied to underlying compensation decisions can be found in § 5.03(2). That section, which deals specifically with the compensation of senior directors, cross-references § 4.01. But this argument has the same disadvantage. Like § 4.01, § 5.03 expressly applies only to the issue of whether one who has received the compensation has breached his duty of fair dealing to the corporation. Moreover, comment h to § 5.03 indicates that the drafters were concerned about avoiding “any double recovery against the director or senior executive who received the compensation and the directors who authorized the payment” and were not focusing on how to analyze the substantive compensation issue. *Id.* § 5.03 cmt. h.
business judgment rule as follows:

(c) A director or officer who makes a business judgment in good faith fulfills his duty under this Section if:

(1) he is not interested in the subject of his business judgment;
(2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and
(3) he rationally believes that his business judgment is in the best interests of the corporation.345

Assuming that the board takes care to appoint only disinterested members to its committees and the committees' review of matters are not so brusque as to indicate patent bad faith, the focus must be on the third criterion. How may a plaintiff show that committee members did not rationally believe in their decision? The ALI has not adopted the "rational basis test" that courts often use to review administrative agency decisions.346 That test uses an objective standard. The ALI has deliberately made the standard the subjective rational belief of the committee members themselves. The comments explain:

The phrase 'rationally believes' is intended to permit a significantly wider range of discretion than the term 'reasonable,' and to give a director . . . a safe harbor from liability for business judgments that might arguably fall outside the term 'reasonable' but are not so removed from the realm of reason when made that liability should be incurred. Stated another way, the judgment of a director . . . will pass muster [if he] believes it to be in the best interests of the corporation and that belief is rational.347

Any plaintiff trying to meet this burden faces a herculean task. It is one thing to show that a compensation decision was unreasonable; it is quite another to prove that the people who made the decision did not, themselves, have a rational belief in it. There are only three ways to do that. The first is to prove that the committee members acted in deliberate bad faith (and hence lacked any belief, rational or irrational, that their decision was in the best interests of the company). The second is to show that the committee members

345. Id. § 4.01(c) (emphasis added) (cross-references to other sections omitted).
346. The rational basis test was developed in Rochester Tel. Corp. v. United States, 307 U.S. 125 (1939), and Gray v. Powell, 314 U.S. 402 (1941). The test is met if the decision of the agency has factual support in the record and a reasonable basis in law. See NLRB v. Hearst Publications, 322 U.S. 111 (1944). See also KENNETH C. DAVIS, ADMINISTRATIVE LAW TEXT 549-51 (3d ed. 1972).
347. PRINCIPLES OF CORPORATE GOVERNANCE, supra note 194, § 4.01 cmt. d. Once again, the comments make it plain that the business judgment rule was drafted to give directors "a safe harbor from liability"—not to provide a means for evaluating the underlying transaction. See id.
did not have the mental capacity to make their decision, that they were, for example, deranged or intoxicated. The third is to show that the decision itself is patent lunacy. This is not hyperbole. It will not do to prove that the compensation is unreasonable; a plaintiff must show that it is so obviously excessive that no person of sound mind could believe it appropriate.

There are always ways to rationalize compensation decisions: If the company did well, the money was a reward. If the company did poorly, it was still a reward because only managerial skill prevented the losses from being worse. If the company's performance could not possibly have been worse, the compensation was necessary to provide incentive and boost morale. And every company but one can argue that it is not paying top of the scale. The business judgment rule might be appropriate for determining whether directors should be liable for business decisions that were, in hindsight, judged to be wrong. But there are serious problems when it is indiscriminately applied to protect business decisions from judicial review. Procedurally, the rule has a mirrors-within-mirrors effect. In an excessive compensation case, the SLC's decision to terminate a derivative action so vividly reflects the underlying compensation decisions that it is difficult, if not impossible, to analyze it by itself. More fundamentally, the business judgment rule erects insurmountable obstacles to realistic challenges of any board decision. Companies need effective management, and management will be badly encumbered if dissenting shareholders can demand that courts second-guess its every decision. But some matters should be subject to judicial review—among them, suspiciously high compensation for top executives and directors. The ALI's version of the rule contains no mechanism for discriminating between business judgments that should be protected and those that should not.

The business judgment rule may be satisfactory for determining whether directors are personally liable for their decisions, but it is not an appropriate tool for evaluating whether a business decision should be subject to judicial review.

C. Gift or Waste of Corporate Assets

Can a plaintiff circumvent the business judgment rule by arguing that excessive executive compensation constitutes a gift or a waste of corporate assets? In Rogers,348 the Supreme Court found that compensation could be "so large as in substance and effect to amount to spoilation or waste of corporate property,"349 and that a

348. 289 U.S. 582 (1933).
349. Id. at 591.
bonus could be so disproportionate to the services rendered as to constitute "in reality a gift in part." In determining whether complaining shareholders were entitled to demand that the compensation be subject to judicial review, the Court looked not at the subjective motives of the board of directors but at the size of the compensation itself. It held that the compensation was "so large as to warrant investigation in equity in the interest of the company," and it remanded the case to the district court for trial. The ALI's Principles reject this approach. Their focus is consistently on the state of mind of members of the board of directors or its committees.

Anyone challenging executive compensation as being so great as to constitute a waste of corporate assets—as was done in Rogers—would have to overcome the ALI's definition of waste. The Principles define "waste of corporate assets" as either an expenditure for which there is no consideration received in return or, if the company does receive consideration, it is "so inadequate in value that no person of ordinary sound business judgment would deem it worth that which the corporation has paid." To prevail, the corporation would only have to produce one individual—one expert witness, for example—who was capable of exercising ordinary business judgment and believed that the compensation was appropriate.

Moreover, an argument can be made that, under the ALI Principles, a plaintiff cannot challenge compensation authorized or ratified by the board of directors even if the compensation constitutes a waste of corporate assets. The Principles set forth two tests: one for compensation awarded or ratified by the board or directors; the other for compensation authorized or ratified by shareholders.

350. Id.
351. Id.
352. The opinion formally remands the matter for "further proceedings in conformity with this opinion," id. at 592, but it is clear a trial would be necessary. The case was settled before trial. See Vagts, supra note 22, at 253.
353. PRINCIPLES OF CORPORATE GOVERNANCE, supra note 194, § 1.42 (emphasis added).
354. Section 5.03 reads in pertinent part:
(a) General Rule. A director or senior executive who receives compensation from the corporation for services in that capacity fulfills his duty of fair dealing to the corporation with respect to the compensation if:

(1) the compensation is fair to the corporation when approved; or

(2) the compensation is authorized in advance or ratified by disinterested directors or, in the case of a senior executive who is not a director, authorized in advance by a disinterested superior, in a manner that satisfies the standards of the business judgment rule; or

(4) the compensation is authorized in advance or ratified, by disinterested shareholders, and does not constitute a waste of corporate assets at the time of the shareholder action.
Compensation ratified by shareholders is evaluated under the waste of corporate assets definition but compensation authorized by directors is evaluated under the business judgment rule, even if it constitutes a waste of corporate assets.

The ALI's *Principles* are a throwback to the late 1970s, codifying case law that developed when the courts were most hostile to shareholder derivative actions. A 1978 Delaware case\(^5\) illustrates how courts typically dealt with shareholder derivative actions at that time. A stockholder brought a derivative action on behalf of Household Finance Corporation (HFC), challenging monies paid to top executives under the company's stock option plan. The compensation committee originally developed a stock option for the company's senior executives. The plan reserved a pool of 150,000 shares of common stock for the program, authorized the compensation committee to grant senior executives options to purchase stock from the pool and made the market value of the HFC common stock on the dates the options were granted the strike prices for the stock.\(^6\)

The plan was later approved by the full board of directors and ratified by the shareholders,\(^7\) and, over several years, seven top HFC executives were granted options to purchase an aggregate of 134,200 shares of common stock at prices ranging between $24 and $35.\(^8\)

Subsequently, the market price of HFC stock fell dramatically.\(^9\) The compensation committee met to reevaluate the stock option plan. There were four people present at the meeting: two of the three members of the committee, both of whom were disinterested board members, and two other directors who were not members of the committee and who were, in fact, executives participating in the stock option plan.\(^10\) The committee decided to allow the executives to exchange their stock options for new ones with a $17 per share strike price, which was then the market price of HFC stock.\(^11\)

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\(^{5}\) Id. § 5.03(a) (cross-references to other sections omitted).

The comments state:

> Substantive provisions that incorporate [the definition of waste of corporate assets] provide a limited scope of judicial review of shareholders' actions. A limited scope of review is also provided for directors' actions under the business judgment rule.

\(^{6}\) Id. at cmt. to § 1.42 (cross-references to other sections omitted).


\(^{8}\) 356. See 386 A.2d at 1147.

\(^{9}\) 357. See id. at 1146.

\(^{10}\) 358. See id. at 1148 n.4. The figures are rounded off to the nearest dollar.

\(^{11}\) 359. See id.

\(^{12}\) 360. See id. at 1155.

\(^{13}\) 361. The committee also waived a requirement that no executive be granted options to purchase more than 15,000 shares of stock in a twelve month period. See id. at 1149.
After a derivative action was instituted challenging the reduction of the option strike prices, the shareholders ratified the compensation committee’s action by a vote of 32.7 million to 2.4 million shares.\footnote{362}

The lower court held that under Delaware law, when stockholders ratify a transaction the directors do not have to show the transaction was fair; instead, plaintiff has the burden of proving "that no person of ordinary, sound business judgment would be expected to view the consideration received by the corporation as a fair exchange for the value which was given."\footnote{363} The court noted that plaintiff would have been entitled to a trial had he alleged that the transaction constituted a waste of corporate assets\footnote{364} because only a unanimous shareholder vote can ratify a gift or waste of company assets.\footnote{365} But it held that plaintiff made no such claim, and it dismissed the case.\footnote{366}

The Delaware Supreme Court reversed in part.\footnote{367} It held that plaintiff’s allegations were sufficient to support a claim that the option swap amounted to a gift or a waste of corporate assets\footnote{368} and that he was entitled to a trial.\footnote{369} But based on a state statute that made the judgment of directors conclusive “as to the consideration for the issuance of [stock] options and the sufficiency thereof,”\footnote{370} the court held that plaintiff should be permitted to try to prove that there was no consideration for the option swap—i.e., that there was a complete absence of consideration.\footnote{371}

Boards of directors commonly lower strike prices in this fashion. For example, by 1986 Frank Lorenzo, then CEO of Continental Airlines, had acquired options to purchase 125,000 shares of the company’s stock at $14.375 per share and an additional 250,000 shares at $29.25 per share. After the company’s stock plunged, the board cancelled Lorenzo’s options and reissued them with a $9.25 per share strike price, also giving him the same option on 650,000 additional shares. Things still went badly under Lorenzo’s stewardship. The board then, in effect, lowered the strike price on all of Lorenzo’s option to $4.625 per share. See CRYSTAL, IN SEARCH OF EXCESS, supra note 17, at 134-36. Apple Computer lowered its CEO’s option strike prices no less than six times during the period 1981-92. See Geoffrey Colvin, How to Pay the CEO Right, FORTUNE, Apr. 6, 1992, at 60, 62-63.

\footnote{362. The votes are rounded off to the nearest 100,000 shares. See Michelson v. Duncan, 386 A.2d 1144, 1150 n.9 (Del. Ch. 1978).

363. Id. at 1152 (citing Gottlieb v. Heyden Chemical Corp., 91 A.2d 57 (Del. Ch. 1952), a case that is also cited in Comment e to § 5.03 of the Principles of Corporate Governance).

364. Id. at 1151-52.


366. 386 A.2d at 1156.

367. 407 A.2d at 214.

368. Id. at 223-24.

369. Id. at 223.

370. See id. at 223-24 (quoting 8 Del.C. § 157).

371. It may be impossible to prove that there was no consideration whatever. There is always arguably some consideration, if nothing more than “continued employment,”
This is very far from Rogers, which held that compensation that bears "no relation to the value of services for which it is given . . . is in reality a gift in part," and cannot survive the protest of a single shareholder.\textsuperscript{372} The HFC case, however, reflects the case law at its most extreme point. Shortly thereafter the pendulum began to swing back.

D. Zapata and its Progeny

In 1981, the Supreme Court of Delaware handed down a decision in the case of Zapata Corp. v. Maldonado.\textsuperscript{373} Zapata is perhaps the most significant derivative decision in the past half-century. It represents a dramatic change in direction by the Supreme Court of Delaware, a court that—because of the number of corporations established in that state—traditionally has had a great impact on corporate law.

In Zapata, a shareholder had brought a derivative action without first making a demand on the company's board of directors. He sued ten officers and directors, alleging that they breached fiduciary duties to the company and violated the federal securities laws, and he stated that it would have been futile to have made a demand on the board because all of the directors were defendants in the action.

The board appointed two new outside directors and made them the sole members of a Special Litigation Committee (SLC).\textsuperscript{374} The board gave the SLC the final authority to determine whether the litigation was in the best interests of the company, and the committee determined that it was not.\textsuperscript{375} This was hardly surprising. While SLCs sometimes recommend pursuing actions against lower echelon personnel, they invariably decide not to pursue litigation against senior officers or fellow directors.\textsuperscript{376} According to Professor James D. Cox of Duke University, there is not a single reported decision in which a SLC recommended litigation against a fellow director, nor is there any reported instance where a board or directors approved of "loyalty" or "diligent efforts." The court did not determine whether plaintiff could prevail by establishing an inadequacy of consideration, \textit{id.} at 224, which is a more realistic standard.

\textsuperscript{372} Rogers v. Hill, 289 U.S. 582, 591 (emphasis added) (quoting Swan, J., dissenting in 60 F.2d 109, 113 (1932)).

\textsuperscript{373} 430 A.2d 779 (Del. 1981).

\textsuperscript{374} The company called its committee the "Independent Investigation Committee," \textit{see id.} at 781, but it had the same function as a special litigation committee and for consistency throughout the article the label Special Litigation Committee or SLC will be used. The litigation had been in progress for four years before the SLC was established. \textit{See id.} at 787.

\textsuperscript{375} \textit{See id.} at 781.

\textsuperscript{376} Cox & Munsinger, \textit{supra} note 148, at 103 n.97.
continuing litigation that was initiated by a shareholder. 377

What was ultimately surprising, however, was the decision handed down by the Supreme Court of Delaware. The court was first faced with the question of "whether the board, tainted by the self-interest of a majority of its members, can legally delegate its authority to a committee of two disinterested directors." 378 There was good reason to conclude that it could not. A board that wanted an SLC to make a particular determination could appoint members who were predisposed to reach that conclusion. Yet the court held that even a biased board could appoint an SLC. 379 This aspect of the decision was consistent with the court's pro-business history. 380

But the court also stated that "[b]oard members . . . will not be allowed to cause a derivative suit to be dismissed when it would be a breach of their fiduciary duty." 381 With those seemingly innocuous words the court committed itself to a significant change in policy. No longer could courts accept, on its face, a determination by a board or an SLC that litigation was not in the best interests of the company. There would have to be some form of judicial review to ensure that the directors complied with their fiduciary duty, and—most significantly—the review would have to focus on the decision itself rather than on the committee process. Ironically, once the court permitted biased board members to select the members of the SLC, it may have committed itself to the final result; the most fundamental procedural element had been compromised and it would have been folly to rely on process-oriented safeguards.

The court sought "a balancing point where bona fide stockholder power to bring corporate causes of action cannot be unfairly trampled on by the board of directors, but the corporation can rid itself of detrimental litigation." 382 To balance these interests, it

379. Id. The court wrote that a state statute obliged it to so hold. That statute, however, provided only that a contract or transaction between a corporation and one or more of its officers or directors was not void merely because the officers or directors were present at the meeting at which the contract or transaction was authorized if one of three elements were present: (1) the material facts are fully disclosed and transaction is authorized by a majority-vote of disinterested directors; (2) the material facts are fully disclosed and the transaction is approved by the shareholders; or (3) the contract or transaction is fair to the corporation. See DEL. CODE ANN. TIT. 8, § 144(a) (1974). The SLC was not established by disinterested directors or ratified by the shareholders, and the court could have held that it was inherently unfair for biased directors to select SLC members.
380. See supra notes 316-20 and accompanying text.
381. 430 A.2d at 783.
382. Id. at 787.
mandated a two-step review of company motions to dismiss derivative lawsuits. In the first step, the court is required to scrutinize the independence and good faith of the SLC and the bases of its conclusion.\(^3\) The court incorporated two watershed departures from prior case law into this step: it shifted the burden of proof from the plaintiff to the company, and it required the court to examine not only the independence and good faith of the committee, but the "reasonableness" of its determination.\(^4\) If the company fails to show that the committee was independent, that it proceeded in good faith and that its determination was reasonable, the court must not dismiss the litigation.\(^5\)

If the company meets that burden, the court may, in its discretion, proceed to a second step in which the court would "determine, applying its own independent business judgment, whether the motion should be granted."\(^6\) Thus, even if the SLC were independent and made its decision in good faith—and even if its determination were reasonable—the court could still decline to accept its judgment. It could deny the SLC's motion because it disagreed with its conclusion or simply because it believed that the shareholder's grievance deserved further consideration.\(^7\) The court declared that this second step was the "essential key" to balancing the prerogatives of the board of directors with the rights of shareholders.\(^8\)

Zapata formally applies only to cases in which the plaintiff would be excused from making a pre-litigation demand on the corporation; i.e., where the plaintiff can show that it would be futile to ask the board to prosecute the action on the company's behalf.\(^9\) That is how the court intended its decision to be read; the opinion notes that "[t]he context here is a suit against directors where demand on the board is excused."\(^10\) This is, however, an undesirable distinction. It encourages plaintiffs to create demand-excused cases by naming directors defendants in the action.\(^11\) In an excessive compensation

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383. Id. at 788.
384. Id.
385. Id. at 788-89.
386. Id. at 789.
387. Id.
388. Id.
391. Courts are quick to condemn this tactic. "[S]imply naming every director as a defendant in a complaint along with conclusory allegations of wrongdoing or control by wrongdoers is insufficient to make the directors interested for purposes of pleading demand futility," one court wrote recently. Stoner v. Walsh, 772 F. Supp. 790, 802 (S.D.N.Y. 1991). The Second Circuit even scoffed at suing directors as "sleight of hand that is slower
case, for example, a plaintiff may bring the action against only the over-paid executives, seeking restitution of the excessive portion of their compensation; it is not productive to encourage him to sue directors as well.

Even more importantly, in the real world it is invariably futile to demand that the company institute litigation, especially when senior officers (who generally are themselves members of the board of directors) are defendants. The Zapata court seemed to realize this when it wrote:

[N]otwithstanding our conviction that Delaware law entrusts the corporate power to a properly authorized committee, we must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role. And the further question arises whether inquiry as to independence, good faith and reasonable investigation is sufficient safeguard against abuse, perhaps subconscious abuse.392

Zapata has had—and is continuing to have—an enormous impact in the field of securities derivative litigation. The Supreme Court of Delaware sent a signal that "the race to bottom" was over, that no longer would the Delaware courts be handmaidens to corpo-

than the eye." Lewis v. Graves, 701 F.2d 245, 249 (2d Cir. 1983) (original emphasis). See also Haber v. Bell, 465 A.2d 353, 355, 358 (Del. Ch. 1983), where plaintiffs named all thirteen of the individual directors as defendants but the court nevertheless dismissed the action because plaintiffs only demonstrated that two directors had a personal financial interest in the matter.

Yet, is there a sound basis for these decisions? If plaintiffs seek restitution from directors—and are, as a matter of law, entitled to do so—are the directors not in fact interested parties? Genuine claims should not be disregarded simply because they are in part asserted for tactical reasons. There is nothing sinister in making good tactical choices in litigation, and tactical considerations always play a role in selecting defendants.

Nor is it satisfactory to deem directors to be disinterested because the company has a directors liability insurance policy. Someone who is potentially liable on a claim is generally considered to be an interested party regardless of whether he is insured. Moreover, coverage will often be uncertain, dependent upon the interpretation of prolix policy exclusions and the nature of the ultimate findings of fact. Directors may, for example, be covered if a finder of fact determines they acted negligently but not if they acted wrongfully, recklessly or in bad faith. Directors may claim to be insured yet nevertheless harbor concerns that the insurance company will disclaim coverage. Even if the insurance company defends them, it may do so under a reservation of rights.

One can sympathize with the frustration that leads courts to condemn the tactic of suing directors as synthetic or "transparent." Lewis v. Graves, 701 F.2d at 249. But when a party can circumvent a rule by making entirely proper tactical choices, the problem is with the rule, not the party's tactics.

392. Zapata, 430 A.2d at 787.
393. See Cary, supra note 31, at 705.
rations established in that state. The end of the race has liberated the courts of sister states as well. *Zapata* began a gradual but powerful tidal change.

Two years after *Zapata*, a lower court in Delaware was presented with a routine derivative case. A shareholder sought to bring an action on behalf of Meyers Parking System, Inc. (Meyers), challenging an employment contract between the company and the chairman of its board of directors. Under the contract, the chairman received a base salary of $150,000 per year plus a bonus of five percent of the pre-tax profits of the company above a certain threshold. From the totality of circumstances, the arrangement had the markings of a sweetheart deal. The chairman was 75 years old, he held a position with another company, and could not devote all of his efforts to Meyers. Both the company and the chairman could have terminated the contract; but in that event, the company was obliged to engage the chairman as a consultant at a reduced rate of compensation and to continue to pay him for consulting services regardless of whether he still was able to perform any services. Moreover, at about the time the contract was made, the company loaned substantial sums of money to the chairman without interest, and, as of the time of the court’s decision two years later, the loans had not been repaid.

Prior to *Zapata*, the court would have dismissed plaintiff’s case. Although there was much in the arrangement to suggest that the company was not getting full value for its money, the court would have deferred to the business judgment of the directors. Moreover, the court would have had to dismiss the case if it had stayed within a strict reading of *Zapata*. *Zapata* only applies in demand-excused cases. The plaintiff had not made a pre-litigation demand on the board of directors. He argued that it would have been futile to make

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395. See 466 A.2d at 379.
396. See id. at 379-80.
397. The board can always offer some justification for the contract. It might say that the chairman’s special experience and expertise are extremely valuable to the company and, in the board’s judgment, worth the compensation. It might contend that it is not necessary for the chairman to work long hours to give the company the benefit of his advice. It might say that it is in the best interest of the company to ensure that the chairman does not resign and accept a position with a competitor. It may also argue that it is just as reasonable to promise the chairman reduced compensation if he becomes disabled as it would be, for example, to give him disability insurance. So long as the test is whether the directors had a rational belief in their decision (see supra notes 345-47 and accompanying text) or whether any person of ordinary sound business judgment would deem the contract appropriate (see supra note 353 and accompanying text), the board can always successfully defend its decision.
a demand because all of the directors were named defendants, because the chairman had allegedly chosen all of the directors and because the chairman controlled a near-majority of the company stock. The court rejected all of those arguments, yet it excused plaintiff's failure to make a demand nonetheless. It did so by focusing on the compensation arrangement itself. The complaint "describes a transaction that can be reasonably inferred to be wasteful," said the court, and therefore it "call[s] the [board's] business judgment . . . into question and mandate[s] further judicial scrutiny." In a sense, the court reasoned backwards: it proceeded first to the second step of the Zapata's analysis and—finding that the underlying transaction was sufficiently suspicious to warrant judicial review—held that there was adequate reason to excuse not making a pre-litigation demand on the board.

If the court had rigidly followed Zapata, it first would have found this to be a demand-required case and, having done so, held the Zapata methodology to be inapplicable and granted the company's motion to dismiss the action. As this case illustrates, however, Zapata is not going to be confined within its literal boundaries. Its overriding spirit is that courts should not dismiss actions that appear to have merit; and courts are likely to find ways to scrutinize the substance of the underlying actions.

The most prominent case that stands in opposition to Zapata is Auerbach v. Bennett, a 1979 case decided by the New York State Court of Appeals. A shareholder sought to bring a derivative action on behalf of General Telephone & Electronics Corp. (GTE). The plaintiff alleged that—with the personal knowledge and involvement of some members of the board—GTE made more than $11 million in illegal payments. The board established an SLC composed of three new disinterested directors, and the SLC determined that the litigation was not in GTE's best interests. The court held that "the responsibility for business judgments must rest with the corporate directors," and that "absent evidence of bad faith or fraud . . . the courts must and properly should respect their determina-

398. See 466 A.2d at 382-83.
399. Id. at 384.
400. Id.
401. Although the court does not describe the board's procedure, it appears that the board did not appoint an SLC. See id. at 380. Plaintiff alleged that the directors approved and were personally liable for the contract, and the court used this to deny a motion for reargument, noting that the directors were, at least allegedly, biased because of their potential liability. See id. at 386. However, this portion of the court's opinion is in the nature of a postscript that presents support for its finding and clearly did not drive the court's reasoning. The court seems principally interested in the balancing of competing interests described in Zapata. See id. at 385.
Its focus was entirely process-oriented. It held that the business judgment rule “shields the deliberations and conclusions of the chosen representatives of the board only if they possess a disinterested independence and do not stand in a dual relation which prevents an unprejudiced exercise of judgment.”

Over the past few years, courts have been choosing between the Auerbach and Zapata approaches. The ALI’s Principles essentially adopt Auerbach, but the strong trend is toward Zapata. Courts have become more savvy. Experience has taught them that boards of directors and their SLCs always want to terminate litigation against senior officers and directors, regardless of their merit. Consequently, the courts have lost faith in procedural safeguards. The theoretical model of outside directors exercising independent judgment has not worked in the real world. The Supreme Court of North Carolina put it this way:

We interpret the trend away from Auerbach among other jurisdictions as an indication of growing concern about the deficiencies inherent in a rule giving great deference to the decisions of a corporate committee whose in-

403. Id. at 1000.
404. Id. at 1001.


406. See supra note 405. The dates of the cases tell the story. The courts that followed Auerbach did so, in the main, in the early 1980s. As time went on, the trend toward Zapata gathered momentum.
stitutional symbiosis with the corporation necessarily affects its ability to render a decision that fairly considers the interest of plaintiffs forced to bring suit on behalf of the corporation.407

The court said that it would be difficult to protect the rights of shareholders “without looking at the proposed action substantively,”408 and it mandated a modified Zapata rule that required the trial court to review the merits in all actions—regardless of whether plaintiff would be excused from failing to make a pre-litigation demand on the board of directors409—and to exercise its own independent business judgment as to whether the case should continue.410 The court’s decision drew loud applause from academia.411

The principal problem with Zapata is the distinction between demand-excused and demand-required cases. The dichotomy is merely theoretical. In the real world boards of directors are not independent; they do not make objective, unbiased evaluations of shareholder demands. “Independent” boards (i.e., which have a majority of outside directors with no obvious relationships with management) are just as likely to support management in every case, regardless of the merits of a shareholder grievance.

The objective of the demand-excused/demand-required distinction is to provide a screening mechanism. Its goal is to allow only some derivative actions into court, thereby protecting boards of directors from second-guessing and preserving judicial resources. But it serves neither objective well. As Judge Frank H. Easterbrook of the United States Court of Appeals for the Seventh Circuit observed, “[t]he case reports overflow with decisions concerning the demand requirement . . . . As a way to curtail litigation, the demand rule is a flop.”412 All of this effort, moreover, is not devoted to separating the

407. Alford, 358 S.E.2d at 326.
408. Id.
409. Id. at 327.
410. Alford, 398 S.E.2d at 452-53 (N.C. 1990). In this opinion, known as “Alford IV,” the court delineated the discovery and trial procedures that should be followed during the trial court’s review.
411. See Cox, supra note 377.

A good illustration of how elaborate, time-consuming and meaningless this mode of analysis is, may be found in the case of Levine v. Smith, 591 A.2d at 194 (Del. 1991). In that case, shareholders challenged the arrangement whereby General Motors Corporation purchased all of the GM stock held by H. Ross Perot. Through a merger, Perot had become GM’s largest shareholder and a member of its board of directors. Perot became the exception that proved the rule: he was a director who refused to be loyal to management. He publicly criticized GM’s management, see id. at 198, and voted against its policies, see supra note 197 and accompanying text. This was so intolerable that GM bought out Perot for approximately $743 million. As part of the deal Perot resigned from the board and agreed to stop criticizing GM management. Levine, 591 A.2d at 198-99.
wheat from the chaff—from screening out frivolous claims and allowing truly meritorious claims to be heard.

It is more meaningful to focus on the substance of the dispute. Courts should ask whether the board action appears so unreasonable as to justify judicial review. Increasingly, that is what courts are doing. The Delaware Supreme Court has declared that the business judgment rule does not protect directors who violate either "procedural due care" or "substantive due care." When a complaint sets forth sufficient facts to make out a prima facie case of waste of corporate assets, courts will allow the action to proceed regardless of whether the board is independent or whether it exercised procedural due care.

The plaintiffs alleged that the transaction was not designed to benefit shareholders but rather to protect management (they called it "hushmail"). Id. at 206 n.4, 213.

The plaintiffs tried both paths through the screening mechanism: some filed derivative actions without making a prelitigation demand while one shareholder instituted a separate action after making a demand. The courts, therefore, had to wander through the mazes of both modes of analysis. The court held that the plaintiffs who argued that a demand would be futile because the board was not independent failed to plead, with sufficient particularity, facts that would establish a lack of independence. It therefore affirmed the lower court's dismissal of their claims. Id. at 208.

Meanwhile, the court held that the plaintiff who made a demand failed to plead facts sufficient to show that the board's consideration of the demand was unreasonable. Plaintiff alleged that the board "did nothing" to investigate his demand. But the board said the opposite. Its letter to plaintiff said that "following review of the matters set forth in your [demand letter], the Board . . . unanimously determined" that further action was not in the best interests of the company. Id. at 214. Plaintiff could not look beyond this bare statement; the board had denied him an audience and the court denied him any discovery. Indeed, the court held that generally no derivative plaintiff—i.e., neither a demand-made nor a demand-excused plaintiff—has a right to discovery. Id. at 208-10.

Even assuming the logic behind the demand-excused/demand-required rubric, these analyses are empty. They proceed without facts. The court did not examine whether the directors were independent or whether the board reasonably considered the shareholder's demand. It merely constructed a game: what can a plaintiff plead without access to facts?


414. See, e.g., RCM Sec. Fund, Inc. v. Stanton, 928 F.2d 1318 (2d Cir. 1991). In that case, the founder of a public corporation died, leaving his estate (the Rhodes estate) with about 40% of the company's stock. Another estate (the Lerner estate) held nearly 11% of the company's stock. The Rhodes estate informed the board of directors it was negotiating to sell its stock to a third party who wanted to control the company. The company had its employee stock ownership plan (ESOP) purchase both blocks of stock, paying $28 per share for the Rhodes stock and $25 per share for the Lerner stock. The stock was trading between $14 and $20 per share at that time. In order to raise the necessary cash, the company depleted its cash reserves and borrowed heavily, mortgaging its facilities. Plaintiffs alleged that the company had disposed of more than one-third of its net worth and shareholder equity in order to complete the transaction.

The court found that plaintiffs failed to show whether the directors were not disinterested or independent. A majority of the board consisted of outside directors, and the
The courts make this analysis within the context of the demand-excused/demand-required rubric (e.g., when directors waste corporate assets they violate their duty of substantive due care, which provides a basis for excusing plaintiffs from making a prelitigation demand). The route is unnecessarily circuitous, but the essence of the reasoning is returning to Rogers.\textsuperscript{415} The trend of an increasing concentration on the substance of the underlying transaction is likely to continue.

E. Structural Bias

The courts find themselves in a bind. Scholars have been telling judges that boards of directors suffer from an innate "structural bias"—that members of boards of directors have deep psychological and institutional loyalties to management and their fellow directors.\textsuperscript{416} Scholars have warned that it is not only inside directors who are loyal to management, but outside and "independent" directors as well.\textsuperscript{417} The courts have been understandably reluctant to accept this proposition. After all, it threatens the very foundation of corporation law.

The legal model of the corporation presupposes a competent, conscientious and autonomous board of directors that is loyal only to the company's shareholders. Although the model has not worked, the hope has long remained that it could be made to work. If boards of directors could be made truly independent, by appointing more independent members, the model could be saved. It has, however, not worked out that way. The proof is in the pudding. At the courts' behest, boards of directors have established SLCs that, by objective measurement, appear to be independent. Yet even when SLCs are comprised entirely of new, independent directors—i.e., people who court believed that the annual director fee of $2,250 was too small to plausibly support an entrenchment motive. \textit{See id.} at 1330. Yet, the court still held that plaintiffs were entitled to maintain a derivative action.

The court used the concept of substantive due process to examine the underlying transaction. The company argued that the transaction was justified to fulfill its long-term goal of ultimately placing control of the company in the hands of the ESOP. It argued that the company's employees would be more productive if their ESOP owned a controlling share of the firm. The court held, however, that "any reasonable person must conclude that there is more than a reasonable doubt as to whether increased productivity caused by vesting control in the ESOP can even begin to offset the financial harm to the corporation" resulting from the transaction. \textit{Id.} at 1334. The court held that the complaint had stated a prima facie case of waste, and that plaintiffs had, therefore, made a sufficient showing that the directors violated their duty of substantive due care. \textit{Id.} at 1331.

\textsuperscript{416} \textit{See supra} notes 171-216 and accompanying text.
\textsuperscript{417} \textit{See supra} notes 202-25 and accompanying text.
join the board after the challenged events are over and have no visible ties to management—the results are always the same. Litigation that attacks directors or senior officers is invariably dismissed.418

Courts therefore face a dilemma. They no longer can pretend to believe in independent directors, but they are apprehensive of declaring that corporate democracy is myth. The ramifications may be too great. If boards of directors cannot be trusted to supervise the management of America's corporations, who is to take over that role? It is easy to envision chaos—shareholders filing innumerable lawsuits challenging virtually every aspect of corporate management. If the courts have declared that boards of directors are incapable of settling those disputes, will they not be required to do so themselves? If they turn their backs on these cases, will they not admit that there is no real oversight of corporate management?

Comfort can be taken in the fact that some courts have subscribed to the notion of structural bias without dire consequences. The Supreme Court of Iowa has declared that it can no longer ignore the possibility that SLCs are plagued by structural bias. The court has held that a corporation must apply to the court for the appointment of a special panel to determine whether litigation is in the company's best interest.419 In a case under Massachusetts law, the Sixth Circuit reached the same conclusion.420 It wrote:

The delegation of corporate power to a special committee, the members of which are hand-picked by defendant-directors, in fact, carries with it inherent structural biases.

... .

418. See supra notes 376-77 and accompanying text.
419. Miller v. Register & Tribune Syndicate, 336 N.W.2d 709, 717-18 (Iowa 1983). The court wrote:

We believe that the potential for structural bias on the part of a litigation committee appointed by directors who are parties to derivative actions is sufficiently great and sufficiently difficult of precise proof in an individual case to require the adoption of a prophylactic rule. We conclude that we should prevent the potential for structural bias in some cases by effectively limiting the powers of such directors in all cases.

In this case of first impression in this jurisdiction we hold that directors of Iowa corporations . . . who are parties to a derivative action may not confer upon a special committee . . . the power to bind the corporation as to its conduct of the litigation.

Id. at 718.

The court went on to hold that the corporation could apply to the court for the appointment of a special panel to determine whether the litigation should be dismissed. Id. Presumably, the court would select the members of the panel and its determination would be binding on the parties.

The problems of peer pressure and group loyalty exist a fortiori where the members of a special litigation committee are not antagonistic minority directors, but are carefully selected by the majority directors for their advice. Far from supporting a presumption of good faith, the pressures placed upon such a committee may be so great as to justify a presumption against independence. 421

It is not only the SLCs that demonstrate structural bias. The excessive compensation that America's largest corporations pay their senior executives also shows the true loyalty of boards of directors. The experience of these two board activities—setting compensation and evaluating derivative litigation—confirm each other.

IV. CONCLUSION

America's largest companies are in the hands of a homogeneous group of men who are able to exercise total control over these great institutions. These are not evil people; but they are people, subject to human foibles and frailties. One of our society's most fundamental principles is that power must never be unchecked. We are ever mindful of Lord Acton's warning that power tends to corrupt and absolute power corrupts absolutely. 422 When, in 1932, Berle and Means pondered how the new form of absolutism in the modern corporation would inevitably create a caste of "economic autocrats," 423 they told us that because there would be no effective check on top executives, it would be necessary to inculcate a form of self-restraint. 424 Greed was the enemy. It was therefore necessary to make managers aspire to higher goals. If their principal reward was money, they would learn to crave money, and Mammon would be their god. Berle and Means' solution was to honor them for their professionalism, their skill, their responsibility. 425

Perhaps Berle and Means had too idealized a vision for a capitalistic society. We may never know because we did not follow their advice. We have rewarded top executives with enormous sums of money, or—put more accurately—we have permitted them to enrich themselves. The runaway compensation of America's top executives is beyond rhyme or reason. Its lavishness and irrationality demonstrate that it is neither the product of sound business judgment by
boards of directors nor of arms-length bargaining between employer and employee. Executive compensation provides a barometer that measures how well corporate democracy works, and a reading of the barometer tells us that there is serious dysfunction.

The dysfunction cannot be cured internally. That has been tried by increasing the number of independent directors and by establishing audit, nominating and compensation committees that are largely, and often entirely, composed of independent directors. Those efforts have failed. Nor is it likely to be cured by regulatory reform. The SEC has proposed rules to require clearer disclosures of executive compensation, and similar measures are pending in Congress. As desirable as that may be, it will not cure the disease. Although corporations often try to make the information pertaining to executive and director compensation as abstruse as possible (prompting Professor Crystal to make an annual “proxy obfuscation award”), the business press does a good job of deciphering the information. Shareholders have not failed to stem the tide because they don’t have the facts. Justice Brandeis may have been generally right when he said that sunlight is the best disinfectant, but for many top executives, disclosure may be more limelight than sunlight. One wonders whether CEOs cringe from, or bask in the glow of, the annual issues of Fortune, Forbes or Business Week that rank the highest paid executives.

In 1983, Professor Detlev Vagts of Harvard Law School studied the issue of executive compensation and concluded that, in the face of outrageous CEO salaries, the courts would have to act as the forum of “last resort.” The courts have not yet acted, and the needle on the barometer has continued to rise.

Nevertheless, some of the groundwork for judicial action has

426. Executive Compensation Disclosure, 57 Fed. Reg. 29,582 (1992) (proposed rules for modifying 17 C.F.R. §§ 229 and 240). The proposals would require that the compensation for a company’s CEO, and the four other most highly compensated executives, be set forth in a series of tables. The board or its compensation committee would be required to describe the factors on which executives’ compensation was based and to explain how their compensation relates to company performance. The company would also be required to publish a five-year graph comparing its cumulative returns to shareholders to the Standard & Poor’s 500 Stock Index. In some instances (e.g., when a company does not have a compensation committee composed entirely of outside directors), expanded disclosure of business relationships between directors and the company would be required. See also Robert D. Hershey, Jr., S.E.C. Acts On Behalf of Holders, N.Y. TIMES, June 26, 1992, at D1.

427. Senator Carl Levin (D-MI) has proposed legislation along these lines. S. 1198, 102d Cong., 1st Sess (1991). His bill has two objectives. One objective is to facilitate shareholder action, but, as previously discussed, concerted shareholder action may not be feasible in any event. See supra notes 226-58 and accompanying text. The second objective is to require clear disclosure of senior executive compensation.

428. Vagts, supra note 22, at 275.
been laid. The courts now know that they cannot blindly accept the judgment of an SLC, and since Zapata, they have moved increasingly to provide for judicial evaluation of shareholder derivative actions. There is at least as much reason to be suspicious of the determinations of compensation committees, and courts should not grant them greater deference under the business judgment rule than they would give an SLC. This is not to suggest that the Zapata revolution is complete; it is not. The courts are in the process of reconsidering the business judgment rule and striking a new balance that would allow corporate management to manage and protect shareholder rights. Meanwhile, the ALI is pulling in the opposite direction, and it is too early to tell whether its Principles will derail the current trend.

It is, of course, not an easy task for judges to review compensation decisions. There is no formula for determining how much the CEO of one of the nation's largest corporations should be paid. But there is nothing magical about it, either. There are, at least, some straightforward principles that provide a framework for analysis. Compensation is excessive whenever it is higher than necessary to (1) hire or retain the executive, (2) provide the optimum incentive to the executive, or (3) be fair.429 Notwithstanding the size of the companies, the celebrity status of the executives or the incantations of compensation experts, judges430 should want to know how much the executive made in his last position; how mobile the executive is realistically; whether he has been offered other positions and, if so, for how much.431

How should courts evaluate incentive compensation programs? When, during a Senate hearing, it was suggested that it was appropriate to give executives special payments to make them want to perform well, Senator John Chafee (R-RI) said, "[n]onsense! Why should executives be offered lucrative [incentives] to do what they are generously paid to be doing anyway? Directors had best look for new executives if they have to be bribed to stiffen their spine and do their duty."432 A New York court voiced a similar thought many

430. Because these cases will be heard under the court's equity power, there is no right to a jury trial and all determinations will be made by the judge.
431. What of that argument that—to the company that currently engages him—the CEO is not worth what others are willing to pay him? This analysis would accept the board's business judgment that the CEO should be retained "at any cost," so long as the company can prove that what it is paying is genuinely necessary to retain the CEO. The board may believe that the CEO is irreplaceable; that there is no one else who has the same knowledge of the company, the same experience in the industry and the same managerial acumen as the CEO. The court should not substitute its judgment for the board's on this matter although, as someone once quipped, the cemeteries are filled with irreplaceable people.
432. See GREEN & TENNERILLO, supra note 19, at 30. Senator Chafee was speaking
years ago when a CEO of a closely held company argued that he was entitled to large salary increases because the company had done better under his leadership. "To do well what one is employed to do is commendable," wrote the court, "but I do not see how it has any bearing on the issue of this litigation." That may be overly harsh. Companies have a right to have incentive payments programs, but judges should evaluate them skeptically. Does a company that claims to believe in incentive compensation provide incentives to more than a few senior executives? If the CEO is rewarded for good performance, is he also penalized for bad performance? When bonuses are discretionary, is there an attempt to distinguish an executive's performance from the company's performance?

The courts enter this arena with considerable resources. They have much experience—and have already developed a rich body of law—in compensation cases involving closely held companies.

about golden parachutes, but his thought is applicable to all special forms of payment.


434. For example, are scientists working in the company's research and development department given incentives to invent valuable new products? Are the executives who directly manage the research and development division given incentives? One of the key factors that distinguished the compensation plans of the American and R.J. Reynolds tobacco companies is that the American Tobacco plan gave bonuses to six executives while more than 2,000 employees benefitted from R.J. Reynolds plan. See supra note 288 and accompanying text. Because a large company's success depends on the efforts of many people, a court should expect that a company that truly believes in contingent compensation will develop a program that gives incentives to more than a handful of senior executives.

435. Some argue that this is the most important single criterion. See, e.g., Colvin, supra note 361.

436. The two are certainly related but they are not identical. A program that gives the compensation committee the discretion to award bonuses (rather than providing for an automatic calculation of bonuses from objective data) assumes that a subjective evaluation of the executive's performance is important. Under this type of plan, therefore, a bonus is not justified merely because the company has performed well. Some effort should be made to determine whether the company did well because of special managerial skill. A court should examine, for example, how other companies in the industry performed; and it should expect the compensation committee to be able to articulate a relationship between the executive's managerial decisions and the company's performance.

437. See, e.g., Fendelman v. Fenco Handbag Mfg. Co., 482 S.W.2d 461 (Mo. 1972) (drawing upon a basic corporate treatise and IRS cases to list factors to consider in determining an executive's compensation and evaluating an executive's compensation against those standards); Soulas v. Troy Donut Univ., Inc., 460 N.E.2d 310, 313 (Ohio Ct. App. 1983) (listing primary factors to consider in determining an executive's compensation and holding that the employees have the burden of showing the reasonableness of their compensation); Berman v. Meth, 258 A.2d 521 (Pa. 1969) (acknowledging that excessive compensation cases are always difficult because courts must consider intangible as well as objective factors, id. at 523, and because "it is almost impossible to assign a dollar figure to an individual's worth to a company," id. at 522, but making the determination nonetheless); Lynch v. Patterson, 701 P.2d 1126, 1133 (Wyo. 1985) (listing estab-
Courts have also reviewed many cases in which the IRS determined that executive pay was unreasonable and disallowed the company's deduction of those payments.\textsuperscript{438} The courts can apply the same standards in reviewing the compensation of senior executives at large companies that they have applied to closely held companies. The companies are larger and the numbers are bigger, but the basic principle is the same: the court should try to discern how much the executive would be paid if his compensation were truly established through arms-length negotiations. That is how everyone's services are properly valued in a free market system.

\textsuperscript{438} A company may not deduct more than "a reasonable allowance for salaries and other compensation" as an ordinary and necessary business expense. 26 U.S.C. § 126(a)(1) (1992). For a sampling of such cases arising under this section, see, e.g., RTS Inv. Corp. v. Commissioner, 877 F.2d 647, 651 (8th Cir. 1989) (listing factors the tax court considered in determining whether an executive's salary was reasonable); Rutter v. Commissioner, 853 F.2d 1267, 1271 (5th Cir. 1988) (listing factors a court should consider in determining the reasonableness of an executive's salary); Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315 (5th Cir. 1987) (considering complex factors to determine whether executive compensation—including contingent compensation and incentive and discretionary bonuses—were reasonable, including the company's dividends, total return on equity, compensation paid by similar companies and the question of whether the amount of compensation might be unreasonable even if the manner of determining it were reasonable); Kennedy v. Commissioner, 671 F.2d 167 (6th Cir. 1982) (considering, inter alia, the reasonableness of an incentive compensation plan and the CEO's civic and charitable activities).

Legislation was recently introduced in the House of Representatives to limit the amount of an executive's compensation that could be deducted from corporate taxes to one million dollars. The proposal was included in the unemployment bill that passed the House, but at this writing its ultimate fate is uncertain. Like Professor Reich, see supra note 257, Professor Crystal is reported as believing that this approach would be a "dismal failure." See Alison Leigh Cowan, A Corporate-Tax Approach to Curbing Executive's Pay, N.Y. TIMES, June 11, 1992, at D1. Nevertheless, while the legislation may not be good at eliminating excessive executive compensation, it may be a reasonable way to generate tax revenue.