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EXECUTIVE COMPENSATION AND INCOME INEQUALITY

Dan Morrissey
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I. Introduction

Executive compensation has reached scandalous levels at many public companies, making it the number one problem in corporate law. And as a major factor in the growing income inequality in America, it is even more significantly a threat to the economic well-being of our nation. Things were not that way during the widespread prosperity that followed the Second World War. During the last several decades, however, as the living standards of most Americans have remained stagnant or gone backwards, top corporate pay has grown to outrageous proportions.

This Article will first present statistical evidence on this soaring remuneration and its consequences on the general quality of life in our country. It will then discuss the classic legal

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1 See infra notes ** and accompanying text.

2 See infra notes ** and accompanying text.

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5 See infra notes ** and accompanying text.
treatment of this problem under both state corporate law and the federal securities laws\textsuperscript{6} and describe why leading scholars and public commentators believe it is inadequate.\textsuperscript{7}

The Article will then address the most current legislative response to this problem, the Say-on-Pay provision of the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank).\textsuperscript{8} That requires all public companies to afford their shareholders a non-binding advisory vote on the compensation they pay to their top officials. The Article will then present the results of those plebiscites during 2011, the measure’s first year of operation. They have disappointed a number of corporate critics since the majority of shareholders at only a few firms disapproved of their executives’ pay packages.\textsuperscript{9}

Yet more than 50\% of the shareholders did cast negative ballots at some firms whose officers were afforded lush compensation despite poor performance. When boards did not rescind those awards, stockholders at several of the companies brought derivative suits citing their “No” votes as evidence that there was no justification for those pay hikes. They therefore alleged that the directors should be held liable for waste of corporate assets and breach of their fiduciary duties. As of early 2012 one federal court has sustained such a claim by placing the allegations of excessive pay in the context of the exorbitant income inequality that it fosters.\textsuperscript{10}

The Article will conclude by pointing out the beneficial effects of such a judicial decision.\textsuperscript{11} It will not only restrain outlandish corporate remuneration that is virtually theft from

\textsuperscript{6} See infra notes ** and accompanying text.
\textsuperscript{7} See infra notes ** and accompanying text.
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\textsuperscript{10} See infra notes ** and accompanying text.
\textsuperscript{11} See infra notes ** and accompanying text.
shareholders, but it can also benefit our society in other ways. If those payments to executives, along with other sizeable amounts that corporations are now hoarding, were either distributed to shareholders or put to other productive uses they would expedite our country’s recovery. The economy would then promote prosperity for the large part of our citizens by expanding output and creating good paying jobs.

II. Economic Disparities and Wealth Concentration in America

The gap between wealthy Americans and the rest of our citizens is now a daunting reality. Study after study confirms that the disparity of wealth in America is frightening--much more of a factor than at any time since the Great Depression. As this gulf has continued to widen in the last several years, it has become increasingly apparent that a large part of it is a result of exorbitant compensation paid to top corporate officials.

Things were not always that way, particularly in the immediate post-war era. Throughout the 1950s and 60s the American economy was growing at a rapid clip and the incomes of all families increased on average by about 3%. Yet a recent study by economists from M.I.T. and the Federal Reserve shows that the pay of top corporate executives during those decades remained steady, increasing by less than 1% per year. Business leaders then didn’t have to be overpaid to lead their companies to larger profits.

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See infra notes ** and accompanying text.


In about 1970 however things began to change. In the next three decades, earnings of the top 1%, the “working rich,” increased by three times, while the average family’s real income during those thirty years grew by only 15%. Corroborating that was a study by the Congressional Budget Office that showed the after-tax income, adjusted for inflation, of the top 1% of American families jumped 139% from 1979 to 2001. By contrast the income of the middle fifth rose by just 17%, while the income of the poorest quintile increased by only 9%.

By 2007 even President George W. Bush was acknowledging that stating: “The fact is that income inequality is real—it has been rising for more than 25 years.” In that year the top 10% of American earners garnered almost 50% of the country’s total wages, a level higher than any times since the start of World War I. Statistics on wealth distribution from then were even more alarming. As of 2007, the top 1% owned 34.6% of America’s assets and the next 19% held 50.5% of them. Just one-fifth of our citizens therefore controlled over 85% of the country’s wealth. The bottom two quintiles, by contrast, owned only .03%. The effects of that prosperity gap were harshest on children who were twice as likely as adults to be poor.

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15 That term is borrowed from Robert H. Frank, Gauging The Pain of the Middle Class, N.Y. Times, Apr. 3, 2011, at 7.
18 See Michael Abramowitz & Lori Montgomery, Bush Addresses Income Inequality, Wash. Post, Feb. 1, 2007 at AO4
19 The Voice Reporter, supra note *.
Yet social scientists were unsure of what was driving that growing gap because until recently they didn’t have the data to determine who really comprised the upper echelon of America’s earners. But a new study by leading economists has established that most of the income gain during those decades was reaped by corporate executives and financiers. Today the top tenth of one percent of that group earns on average about $1.7 million.\textsuperscript{22}

The current Great Recession has finally put this disturbing situation in the public spotlight.\textsuperscript{23} Average Americans have been hurt much more severely than the wealthy by the recent financial meltdown, thus making the mal-distribution of society’s resources even more acute. The net worth of the median family has dropped an “astounding” 36.1% since 2008 whereas the asset values of the top 1% have fallen off by only 11%--widening the prosperity gap even more.\textsuperscript{24}

Even though most Americans may not know the full extent of income inequality in our country,\textsuperscript{25} economists, pundits, and bloggers are now writing and commenting at length on this injustice.\textsuperscript{26} Comparing America to other countries with stratified social classes, New York Times columnist Nicholas Kristof writes, “Maybe that’s why the growing inequality in America pains me so. The wealthiest 1% of Americans already have a greater net worth than the bottom 90% based on Federal Reserve data.”\textsuperscript{27} And Nobel Prize winning economist Joseph E. Stiglitz comments in the May, 2011 issue of Vanity Fair magazine, “Americans have been watching

\begin{footnotesize}
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\item Whoriskey, \textit{supra note *}.\textsuperscript{22}
\item 15 Facts about U.S. Income Inequality that Everyone Should Know, \newline \texttt{http://www.huffingtonpost.com/2011/04/05} (updated Apr. 5, 2011).\textsuperscript{23}
\item Domhoff, \textit{supra, note *}.\textsuperscript{24}
\item \textit{Id.}\textsuperscript{25}
\item Huffington Post, \textit{supra note *}.\textsuperscript{26}
\item Nicholas D. Kristof, \textit{Our Fantasy Nation?}, N.Y. Times, June 4, 2011, at WK9.\textsuperscript{27}
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protests against oppressive regimes that concentrate massive wealth in the hands of an elite few. Yet in our democracy, 1% of the people take in nearly a quarter of the nation’s income and own 40% of its wealth, the highest percentage since 1948.”

Contrasting the better productivity of American workers with those in European countries, labor lawyer Thomas Geoghegan notes, “Technically we seem far ahead, but don’t drool. The U.S. superrich gobbled up well over two-thirds of the increase. In 2005 the real hourly wage for production workers in America was approximately 8% lower than it was in 1973, while our national output per hour was 55% higher. So it’s dubious whether most Americans have gained even a penny in purchasing power since 1989.” In short, much of the gain in productivity by American workers has gone not to the folks who actually generated the wealth but to the upper echelon of the managerial class.

Along the same lines, Cornell University economist Robert H. Frank has created a “toil index” to measure the real costs of consumption such as paying the rent on a median priced home. The hours needed to be worked by the average American to meet that expense declined slightly from 1950 to 1970 to just 41.5 a month. But by 2000 they had risen to 67.4. So while the rise in Gross Domestic Product showed a general increase in wealth during the last several decades, average Americans were going backwards in the labor they had to expend to meet their basic needs.

By fall, 2011 the general discontent with this wide-spread unfairness gave rise to a spontaneous populist protest. It started with a few dozen demonstrators pitching tents on Wall

28 Joseph E. Stiglitz, Of the 1%, by the 1%, for the 1%, Vanity Fair, Apr. 5, 2011, at 1.
30 Frank, supra note 4, at 7.
Street in front of the New York Stock Exchange. Soon hundreds that included union activists joined them in a nearby park and the movement spread to a number of cities around the country. One organizer in Los Angeles said the protesters were united in their desire for “a more equal economy.” If the Occupy Wall Street Movement accomplished nothing else, it has brought that stark unfairness to the full attention of the American public.

III. The Reasons for the Rise in Wealth Concentration

One academic commentator observing this situation put it aptly, “...the rising tide of economic growth no longer lifts all the boats.” There seems to be a consensus among economist and others why this is so. As President George W. Bush himself explained, “The reason is clear. We have an economy that increasingly rewards education and skills because of that education.”

As a report on National Public Radio put it, “New technology has made many jobs obsolete, while creating dramatic opportunities for wealth in computers, finance, and media and

31 George Packer, All the Angry People, New Yorker, Dec. 5, 2011, at 32.
32 Erick Eckholm & Timothy Williams, Anti Wall Street Protests Spreading to Cities Large and Small, N.Y. Times, Oct. 4, 2011 at A18.
33 Packer, supra note 18, at 32.
35 Abramowitz & Montgomery, supra note *, at AO4.

entertainment.”  

A study on world trade also concluded, “[I]nnovations…have favored workers with greater skill and reduced the value of unskilled labor…Liberal trade with the newly industrialized countries of the world has certainly played a part in worsening the job prospects of America’s unskilled workers.”

Professor Stiglitz thus summed up similar conclusions by a number of his colleagues in the dismal science, “…laborsaving technologies have reduced the demand for ‘good’ middle-class, blue-collar jobs. Globalization has created a worldwide marketplace, pitting expensive unskilled workers in America against cheap unskilled workers overseas. Social changes have also played a role—for instance the decline of union, which once represented a third of American workers and now represent about 12 percent.”

But Stiglitz was also quick to add another, less excusable cause. “But one big part of the reason we have so much inequality is that the top 1 percent want it that way…wealth begets power, which begets more wealth.” Stiglitz went on to cite low tax rates, particularly on gains from investments, as a principal reason why America’s rich have got richer while most of their countrymen have stagnated or slid lower in economic well-being.

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38 Stiglitz, *supra* note *, at 3.

See also, Davidson, *supra* note *, who puts it, “[Because of] the double shock we’re experiencing now—globalization and computer-aided industrial productivity…income inequality is growing, as the rewards for being skilled grow and the opportunities for unskilled Americans diminish.”

39 *Id.*

See also Editorial, *The 1% and That 15%, Mitt Romney’s tax returns will show how much the tax code favors the rich*, N.Y. Times, Jan. 19, 2012.
As the NPR report noted, wealthy people own stocks and upper echelon corporate employees often get a good portion of their compensation in stock options. Since the Bush tax changes of 2003, share appreciation, which has been substantial during the past ten years, has been taxed at only 15%—20% lower than the top bracket on earned income.

As Professor Stiglitz also noted, corporate wealth evidenced in share prices has been augmented by lax anti-trust enforcement and by international competition for businesses which has weakened environmental laws and labor rights. And he also points out how much of the recent, immense wealth has been generated by manipulation of our financial system. The government, through lax regulation, condoned much of that, and then came in to rescue banks like Goldman Sachs and Morgan Staley with expensive bailouts that were deemed necessary to ward off an even greater recession.

IV. Vanishing Economic Mobility

Hand in hand with this concentration of wealth and decline in the living standards of most Americas has gone the demise of one important part of the American dream, the promise of rising social and material benefits for the next generation. As two New York Times reporters described that traditional belief, “There are poor and rich in the United States, of course, the

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40 Berliner, supra note *.


42 Stiglitz, supra note *, at 5.

43 For the author’s description of how that fraudulent conduct brought about the economic debacle of 2008 see Daniel J. Morrissey, After the Meltdown, 45 Tulsa L. Rev. 393, 399-400 (2010).

44 See Paul M. Barrett, reviewing In Goldman We Trust, N.Y. Times, May 1, 2011, at BR13.
argument goes, but as long as one can become the other, as long as there is something close to equality of opportunity, the differences between them do not add up to class barriers." 45

The renowned social historian Francis Fukuyama has recent made much the same point, "Inequality per se has never been a big problem in American political culture, which emphasizes equality of opportunity rather than outcomes. But the system remains legitimate only as long as people believe that by working hard and doing their best they and their children have a fair shot at getting ahead, and that the wealthy got theirs by playing by the rules." 46

Professor Fukuyama continues however with this chilling assessment, "The fact is, however, that rates of intergenerational social mobility are far lower in the United States than many Americans believe them to be, and lower than in many other developed countries that traditionally have been regarded as rigid and stratified. Over time elites are able to protect their positions by gaming the political system, moving their money off-shore to avoid taxation, and transmitting these advantages to their children through favored access to elite institutions." 47

Studies of inheritance patterns and elite colleagues bear out this disappointing conclusion about the lack of social and economic mobility. According to the Federal Reserve Bank of Cleveland, only 1.6% of Americans receive more than $100,000 in inheritance. Another 1.1% receive $50,000 to $100,000 but an astonishing 91.1% have older relatives who can leave them nothing. 48 And a 2010 study by Georgetown University of the country’s most selective colleges

45 Scott & Leonhardt, supra note *, at 2-3.
46 Fukuyama, supra note *, at 8-9.
47 Id. at 9.
48 Domhoff, supra note *, at 4.
found that only 15% of the entering freshman came from the bottom half of income earners whereas over 2/3 came from the wealthiest quarter of households.\textsuperscript{49}

V. The Consequences of Inequality

There may be some debate about the ramifications of this situation. One author comments that the possibility of disparate economic results can motivate people to work harder.\textsuperscript{50} If everyone were compensated the same amount regardless of what they did for society, many folks might not feel compelled to be productive. And another supposed benefit of lower wages, at least in the global economy, is that they allow Americans to purchase goods cheaper which can contribute to a higher standard of living.\textsuperscript{51}

From the perspective of psychology and cognitive science Professor Tyler Cowen adds this insight about the causes of inequality. It results less, he says, from lower paid workers at the bottom of the economic ladder than from brilliant inventors and business people at the top. “The root cause of income inequality, viewed in the most general terms,” he says, “is extreme human ingenuity, albeit of a perverse kind. That’s why it’s so hard to control.”\textsuperscript{52}

\textsuperscript{49} Scott & Leonhardt, \textit{supra} note *, at 2.

\textsuperscript{50} Catherine Rampell, \textit{Thy Neighbor’s Wealth}, N.Y. Times, Jan. 28, 2011 at BR17.

\textsuperscript{51} Huffington Post, \textit{supra} note *.

\textsuperscript{52} See Tyler Cowen, \textit{The Inequality That Matters}, The American Interest, Jan. /Feb., 2011.

Two other commentators sum this up well:

\textbf{Before the creation of the corporate structure, there were few opportunities for individuals to make dramatic changes in status and wealth. However, corporate history is filled with people like Henry Ford, Walt Disney, Bill Gates, Steve Jobs, and Facebook’s Mark Zuckerberg, who changed the world and made themselves and their investors rich. The American system has provided opportunity for immigrants from Andrew Carnegie to Google’s Sergey Brin to create almost unimaginable wealth. Robert A.G. Monks & Nell Minow, Corporate Governance (5\textsuperscript{th} ed.) at 10.}
Yet one does not have to be a radical egalitarian to see the adverse consequences that such a state of affairs will ultimately have for American society. Professor Fukuyama notes “…the rising levels of populist anger on both the Right and Left contribute to a polarization that reflects a social reality at odds with the country’s own legitimating principles.”\footnote{Fukuyama, supra note *, at 8.}

The title of Professor Stiglitz’s recent piece, \textit{Of the 1%, by the 1%, for the 1%},\footnote{Stiglitz, supra note *, at 6.} is a play on that point. And columnist David Brooks cites Richard Wilkinson and Kate Pickett for this finding. “Inequality and a feeling of exclusion causes social pain, which leads to more obesity, worse health outcomes, fewer social connections, more depression and anxiety.”\footnote{David Brooks, The Social Animal, (2011) at 330.}

Others see a similar threat to the general welfare. Conservative former Federal Reserve chairman, Alan Greenspan, has recently noted that our unequal economy is “very distorted.”\footnote{Chrystia Freeland, \textit{The Rise of the New Global Elite}, the Atlantic, Jan. /Feb., 2011, at 1.}

And another commentator has noted the disturbing lack of empathy among its winners for those who are less fortunate. The plutocrats, she says, who have emerged from this winner-take-all system are now increasingly a global class to themselves, without any particular allegiance to citizens from their homeland. Many seem to suggest that the trials of the American working class are their own fault.\footnote{Id. at 10.}

Caveats about the corrosive effects of great wealth are as old as the Scriptures. And there is a corresponding lesson that we are all in this together. As Dr. Stiglitz writes, “looking out for
the other guy isn’t just good for the soul—it’s good for business. Consumer demand and purchasing power drive our economy and make it possible for businesses to flourish.

Along those lines, fears abound about the rise of a new, very large underclass comprised of white men. This group has grown in the post-industrial economy as wages for working people have been going down since 1983 and longer than that for blue collar males. That startling decline has only been compounded by the Great Recession in which 75% of the 8 million jobs lost were by men. As David Brooks summed up this alarming state of affairs, “The American working class—those without a college degree—is being decimated, economically and socially.”

VI. Soaring Executive Compensation

Contrast that stark reality with the current good fortune enjoyed by business leaders. In 1965 the typical American CEO made twenty-four times the average worker. By 2007 that differential had increased by more than ten-fold to two hundred seventy five and it has continued to grow. According to a study by the AFL-CIO, the compensation of CEOs at America’s 300 largest companies in 2010 was 343 times the average worker’s pay.

58 Joseph E. Stiglitz, Of the 1%, by the 1%, for the 1%, Vanity Fair, (May 2011), available at http://www.vanityfair.com/society/features/2011/05/top-one-percent-201105
60 For a study which attributes this more to the breakdown of values that to economic concerns, see Charles Murray, Coming Apart, (2012).
62 Hanna Rosin, The End of Men, the Atlantic, July/Aug., 2010, at 4.
63 Brooks, supra note *.
64 David Owen, What's to be Done about CEO Compensation, New Yorker, Oct. 12, 2009, at 1.
average American worker earned $46,742 in 2010, a 2% rise, and unemployment remained shockingly high, the compensation of S&P 500 CEOs was $12 million, up 18%. Commenting on this huge pay differential Eleanor Bloxham from the Values Alliance stated, “It’s insane. Corporate boards have bought into the idea that they have to pay up for performance. There’ll be more of the same until institutional investors decide CEOs aren’t worth what they’re being paid.”

As has been said, executive pay has not always surged so far beyond with the wages of working people. Even during the fast growing post war decades, it remained level. But since the 1980s, it has zoomed upward fueled in large part by the increased use of incentive pay comprised of stock options and bonus awards allegedly tied to firm performance. Those mechanisms for compensation became dominant in 1992 when Congress, alarmed that the average CEO’s pay had risen to what today seems a very modest $750,000, capped the deductibility of executive compensation at $1 million. Then according to Nell Minow, the

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65 Lorraine Mirabella, Legg Mason Investors Vote for Executive Pay Package, Baltimore Sun, July 27, 2011 at 14A.


67 Quoted in Straus, Stock Options Help CEOs Cash In, U.S.A. Today, July 8, 2011, supra note *.

Outrage over exorbitant executive pay is not limited to the United States. Recently the conservative prime minister of Great Britain David Cameron said that large pay packages awarded to executives there during a time of general austerity, “made people’s blood boil.” Julia Werdigier, In Britain, Rising Outcry over Executive Pay that Makes ‘People’s Blood Boil.’ N.Y Times, Jan. 23, 2012 at B5.

68 See supra note * and accompanying text.

69 Fryman & Saks, supra note 3, at 3.

70 Id.

71 Fryman & Saks, supra note 3, at 14.

leader of a research firm dedicated to improving corporate governance,\textsuperscript{73} “The first thing that happened was that everyone got a raise to a million dollars. The second was that companies started issuing bazillions of options.”\textsuperscript{74}

Minnow continued her critique: “Options are intended to reward executives for increasing their company’s market capitalizations—a benefit to all shareholders. But executives have turned out to be ingenious at eliminating any personal risk, turning options into corporate play money, and helping to inaugurate the ongoing proliferation of American billionaires.”\textsuperscript{75} That form of compensation has been easy to game, most notoriously by the widespread practice of executives backdating the grant dates of their options.\textsuperscript{76} But even if we leave aside that patently illegal practice, there are plenty of other ways that corporate officials can manipulate those awards to engineer exorbitant compensation for themselves.

For instance they need only have their firms issue them stock and options when the prices of those financial instruments are historically depressed. Just recently during the market’s low point in late 2008 and early 2009 more than 90% of the CEOs at Standard and Poor’s top 500 companies received large amounts of those securities. When stock prices rebounded in spring, 2011, those awards netted them $3 billion.\textsuperscript{77} In addition, that surge gave American executives

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\textsuperscript{73} She is the co-author of a fine book on that subject. Monks & Minow, Corporate Governance (5\textsuperscript{th} ed. 2011).

\textsuperscript{74} Owen, supra note *, at 2.

\textsuperscript{75} Id.

\textsuperscript{76} For an article by the author on this pernicious practice, see Daniel J. Morrissey, The Path of Corporate Law: of Options Backdating, Derivative Suits, and the Business Judgment Rule, 86 Or. L. Rev. 973 (2007).

\textsuperscript{77} Scott Thurm, Options Given During Crisis Spell Large Gains for CEOs, Wall St. J. Apr. 27, 2011.
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more billions in gains on the stocks and options they already held. Commenting on that remuneration, Paul Hodgson, a compensation expert, said “Some of the gains are humongous” and predicted that they would continue in 2011.78

Companies that issue huge amounts of stock and options to their executives dilute the wealth left over for their shareholders. As one astute investment adviser put it, “Stock-based compensation plans are often nothing more than legalized front-running, insider trading and stock watering all wrapped into one package. When compensation is excessive, that should be a red flag. Does the company exist for the benefit of shareholders or insiders?”79

By that standard, shareholders and the investing public are particularly ill-served today by the stewards of their wealth. While many businesses that were hard hit by the recession have been doing better lately, top corporate officers seem to be raking off a larger and larger share of that increased wealth, getting hefty raises and multi-million dollar paychecks. Phillippe P. Dauman of Viacom, Ray R. Irani of Occidental Petroleum, and Lawrence J. Ellison of Oracle were near the top of that list with compensation last year of $84.5 million, $76.1 million, and $70.1 million respectively.80 John Hammergren the CEO of McKesson Corp., a health care services firm, was at its head taking down $150.7 million.81

the companies paid out no actual cash. According to the New York Times, “This tax break will deprive the federal government of tens of billions of dollars in revenue over the next decade.” David Kocieniewski, Tax Benefits from Options as Windfall for Business, N.Y. Times, Dec. 29, 2011.

78 Gary Strauss, Stock Options Help CEOs Cash In, USA Today, July 8-10 at 1A.


80 Daniel Costello, The Drought is Over (at Least for CEOs), N.Y. Times, Apr. 10, 2011, at BU1.

81 Strauss, supra note *. 
In addition, these outrageous annual payments are compounded by almost obscene severance arrangements. The aforementioned Mr. Hammergren will get $469 million from his company if there is a change in managerial control.\(^{82}\) In September, 2011 Leo Apoktheker Hewlett-Packard’s CEO resigned after serving just 11 months. Even though the company’s stock dropped 50% during his tenure,\(^{83}\) he took with him a $13.2 million in severance pay on top of a signing package worth $10 million.\(^{84}\) But that was chump-change compared to golden parachutes in excess of $200 million each for Hank McKinnell of Pfizer and Robert Nardelli of Home Depot in the last decade\(^{85}\) and a $46 million bonus in advance of $3.4 million in severance awarded to Adam Metz last year after just two years at GGP, a land trust. This past year that company collapsed in one of our country’s largest real estate bankruptcies.\(^{86}\)

Nor can the lush perquisites these emperors of industry receive be overlooked. Most notorious there were $700,000 worth of unreported corporate jet usage by Eugene Issenberg, the CEO of Nabors, Industries during 2009-10. The Wall Street Journal discovered that he often flew on the corporate plane to his homes in Palm Beach, Florida and Martha’s Vineyard, Massachusetts.\(^{87}\)

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\(^{82}\) Id.


\(^{85}\) Id.

\(^{86}\) Lublin and Worthern, supra note 71

VII. Legal Responses before Say-on-Pay

a. **Caselaw**

Opponents of excessive executive compensation scored an early victory at the U.S. Supreme Court in the celebrated case of Rogers v. Hill. There during the Depression the president of the American Tobacco Company was paid salary and bonuses over $1 million per year based on a provision in the company’s by-laws that entitled him to 2½% of the firm’s profits. While the compensation arising from that formula had not been excessive when it was adopted two decades earlier, in subsequent years there had been what the court called an “enormous increase in the company’s profits” that resulted in what for that time was exorbitant remuneration.

Because the top executive’s pay had gotten so large, the Court found that the complaining shareholder had stated a claim of waste. In justification for that holding it quoted these remarks from Judge Thomas Swan, a distinguished jurist of that era, who dissented in the lower court’s opinion. “If a bonus payment has no relation to the value of services for which it is given, it is in reality a gift and the majority stockholders have no power to give away corporate property against the protest of the minority.”

A later case arising out the same situation however set quite a different tone for those actions and proved, until recently, to be the more influential. There the Court called those same payments “…munificent. To the person of moderate income they would be princely—perhaps something unattainable; to the wage earner eking out an existence they would be

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88 289 U.S. 582 (1933).

89 *Id.*

fabulous and the unemployed might regard them as fantastic, if not criminal. To others they would seem immoral, inexcusably unequal and an indictment of our economic system.”

Yet noting that a majority of the shareholders had recently ratified the payments, the Court cited its “reluctance…to interfere with the internal management of a corporation.” Stating that “Courts are ill-equipped to solve or even to grapple with these entangled economic problems,” it dismissed the action.

In the post-World War II era the influential Delaware Supreme Court followed this approach showing little interest in overturning a compensation plan that had been approved by disinterested and independent directors as beneficial to the company and ratified by its shareholders. And in the 2006 Disney case that High Court refused to set aside a lucrative severance deal for the dismissed president of the company, Michael Ovitz. Disney however involved payments made under an employment contract entered into before Mr. Ovitz went to work for the company, not big jumps in pay given to an already-employed corporate official.

By contrast in a more recent case from Delaware Chancellor Chandler refused to dismiss a waste claim against Citigroup’s CEO Charles Prince who was responsible for billions of dollars of losses by that company during the financial meltdown. After stating the general authority of boards to set executive compensation, the Chancellor made this telling comment, “It is also well settled in our law, however, that the discretion in setting executive compensation is not unlimited. Indeed, the Delaware Supreme Court was clear when it stated that there is an

91 Id. at 669.
92 Id. at 679.
93 See e.g., Beard v. Elster, 160 A.2d 731 (Del. 1960).
94 In re Walt Disney Co. Derivative Litig., 906 A2d 27 (Del. 2006).
95 In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009)
outer limit to the board’s discretion to set executive compensation, at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."  

The Chancellor went on to examine the allegations that Mr. Prince had been paid $67 million upon departing from his top position at Citigroup in 2007 after the housing market had crashed. It found that they raised a reasonable doubt that Citi’s board was well-informed, careful, and rational in approving that compensation plan.

b. SEC Disclosure Requirements

On the federal front since its beginnings in the 1930s the Securities and Exchange Commission (SEC) has used its regulatory power under the securities laws to compel disclosure of executive and director compensation by public companies. Acting on its mandate to provide helpful information to investors, the Commission has amended those requirements periodically in response to changing forms of corporate remuneration.

In 2006, shortly after the options-backdating scandal became public, the SEC issued another revision of its compensation rules. To promote annual and intercompany comparisons the Commission had for the first time in 1992 had mandated a tabular format for that disclosure. The 2006 standards refined that approach and required that company officials explain their

96 Id. at 138.

97 Section 7(a) of The Securities Act of 1933, 15 U.S.C.A §77g, and §§12(b), 12(g) and 14(a) of the Securities and Exchange Act of 1934, 15 U.S.C.A §§ 78 l(b), 78 l(g), and 78n(a).

remuneration policies in a narrative analysis called Compensation Discussion and Analysis (CD&A).\textsuperscript{99}

Other new SEC provisions called for tabular presentations of senior executive compensation over a three year period, which must include equity-based awards and amounts realized from those holdings as well as potential post-employment payments. When publishing them, the Director of the SEC’s Division of Corporate Finance gave this reason for those rules. “Investors will be provided with one number for total annual compensation for each named executive officer. The clarity and comparability of this one number will be complemented by the principles-based narrative disclosures in our new Compensation Discussion and Analysis section and by the requirement that these disclosures be made in plain English.”\textsuperscript{100}

Some commentators thought these more extensive disclosure requirements for compensation would shame corporate officials into showing some restraint but that hardly seems to have been the result.\textsuperscript{101} Rather greedy executives now appear to be using that disclosure as a benchmark to ratchet up their own pay by arguing that their remuneration should be at that level or better.\textsuperscript{102} As one commentator put it: “Chief executives tend to view themselves as residents of Lake Wobegon, ‘where all children are above average’…The compensation details of their

\textsuperscript{99} \textit{Id.} at §§228, 229.

\textsuperscript{100} \textit{Id.}


\textsuperscript{102} See Richard A. Posner, \textit{Are American CEOs Overpaid, and, if so, What if Anything should be Done about it?}, 58 Duke L.J. 1013 (2009).
countersparts provides them with the leverage to request a high amount from boards. The result: each year executive pay rises ever higher and the industry average is reset.”

**c. Comments by Scholars and Public Officials**

Two prolific and renowned scholars of business law, Professor Lucian Bebchuk and Judge Richard Posner, have of late also weighed in with very critical comments on the current state of corporate remuneration, as has the respected TARP Special Master, Kenneth Fineberg. In a 2004 book with Professor Jesse Fried, *Pay Without Performance*, Bebchuk attacked what he called the “official view” that directors fix executive pay in arms-length negotiations with executives to provide incentive for those officials to increase shareholder wealth. In reality corporate leaders set their own pay through captured boards.  

While Bebchuk declined to pass judgment on the high levels of executive pay, he levied heavy fire on their failure to provide any real incentives to corporate management. They are, he said, “compensation practices that obscure the amount and performance insensitivity of pay.”

His point was thus a modern restatement of economist John Kenneth Galbraith’s famous dictum, “The salary of the chief executive of the large corporation is not a market award for

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104 Cite to Bebchuck & Fried

As two other corporate scholars have recently put it with mild understatement, “In light of the recent deluge of academic and popular criticism of executive pay as well as recent legislation in this area, the belief that the American executive compensation system works well is a distinctly minority position. Far more popular is the well-worn Board Capture theory of American corporate governance, which claims that corporations’ executives—particularly the chief executive officer (CEO)—dominate their boards of directors and, in essence, set their own pay.” Randall S. Thomas and Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers Fiduciary Duties*, 95 Minn. L. Rev. 846, 847 (2011)

achievement. It is frequently in the nature of a warm personal gesture by the individual to himself."106

In 2008 the country suffered a devastating financial meltdown brought on by the collapse of debt obligations collateralized by inflated real estate values. The federal government stepped in with an enormously expensive bail-out of banks that had created and dealt in those speculative securities. In October, 2009, Kenneth Fineberg, the special master appointed to oversee executive compensation for banks receiving those so-called TARP funds, ruled that the 25 most highly paid executives at those institutions would have their pay capped at $500,000.107 When asked if he anticipated that his ruling would more broadly change the practices of executive pay, Fineberg replied, “I hope so.”108 That advice however has not been heeded by corporate America.

In the wake of the financial crisis, Bebchuck and co-authors presented evidence that executive pay arrangements such as stock options encouraged excessive risk taking that ultimately had deleterious effects on the economy.109 Executives at two large financial firms that collapse in the meltdown, Bear Sterns and Lehman Brothers, cashed out and kept large, so-called

106 Owen, supra note *, (citing Galbraith’s famous comment).


109 Another commentator made the same comments even more bluntly. “An officer with stock options has an incentive to move corporate assets from stable, low-volatility investments into high-risk investments because that enhances the value of his options. An option holder does not participate in losses although the underlying assets of the corporation collapse. A corporation that has given its managers substantial options has given them incentives to invest in highly volatile, even suicidal investments, which should scare the pants off shareholders. Calvin H. Johnson, Corporate Meltdowns Cause by Compensatory Stock Options, Tax Notes, May 16, 2011.
performance-based compensation that they garnered in the decade before the crash.\textsuperscript{110} Bebchuck and Fried followed up with another article discussing ways that executives’ compensation can be genuinely tied to the long-term performance of their firms by generally requiring that management hold equity grants for the long-term. Another commentator suggested that the same result is currently being achieved by firms that substitute grants of restricted stock for options.\textsuperscript{111}

Judge Posner, the father of Law and Economics, made similar critical comments recently stating, “The problem of executive compensation is not only real; it is more serious than I believe it to be.” First he saw it as a problem of agency costs, that is, excessive amounts paid by owners of a business to those who manage it. With the “uncertainty that surrounds success in the business world,”\textsuperscript{112} it is very difficult, said Posner, to evaluate the performance of a CEO and therefore to say that she has really earned her pay.

And even if there were a reliable method of sizing up the work of a top corporate official, Posner said, boards would generally be unable to apply it to the CEO at their firms. Directors generally come from the ranks of executives at other companies and thus have a vested interest in keeping the compensation of like-situated officials high. In addition, since CEOs influence the choice and pay of directors, “there is evidence of mutual back scratching—the directors authorizing generous compensation for the CEO and the CEO supporting generous fees for directors.”\textsuperscript{113}


\textsuperscript{112} Posner, \textit{supra} note * at 1018.

\textsuperscript{113} \textit{Id.} at 1024.
Posner also found that so-called incentive compensation for executives such as stock options are not well aligned with the CEO’s performance because “many things move a company’s stock besides the decisions of its CEO.” He also cited the common practice of re-pricing executive options when a company’s stock has fallen and compared it to back-dating which, he said, is only a clandestine approach to achieve the same result. Both allow the recipients to reap large gains from stock appreciation.

Judge Posner concluded that the social costs of excessive compensation are very disturbing. “The redistributive effects are obvious and are troubling from an ethical standpoint because, by definition, overcompensation is theft from shareholders.”114 Another current commentator echoed those sentiments and expressed these like doubt about the validity of top corporate pay in whatever form it takes.

I believe that interactions between executives and companies can be characterized as struggles between hyper-interested and very well organized minorities, i.e. the executives, and relatively disinterested and extremely disorganized minorities, i.e. the shareholders represented by boards of directors. Executives will prevail in such struggles every time. Inevitably the end product of such struggles will be contracts that have more to do with optimal looting than with optimal incentive creation.115

VIII. The Coming of Say-On-Pay

Since at least the famed study of Professors Berle and Means was published in the 1930s it has been well established that control of public companies is effectively separated from its far-flung shareholder-owners and lodged in a self-perpetuating managerial class.116 And from at least the Watergate scandals of the 1970s, there have been wide-spread movements to reform

114 Id. at 1042.
116 William R. Bratton, Berle and Means Reconsidered at the Century’s Turn, 26 J. Corp. L. 737-770 (2001)
corporate governance practices so that officers and directors might be held more accountable to their shareholders and the public. Yet those efforts seem to have produced little success. As one leading corporate critic put it, “It is one of the great anomalies of our ownership society: shareholders own companies, but executives can easily slap them down. The hired help, in other words, holds the cards.”

As public awareness grew of this exorbitant compensation, however, investor groups and other activists began demanding shareholder input on those decisions. Under pressure, a few firms voluntarily afforded stockholders a say-on-pay vote and Congressional action to mandate it at all public companies began with a bill that was introduced by Congressman Barney Frank in 2007. In 2009, that morphed into a law requiring that all firms receiving TARP assistance be required to hold such a vote. Finally after a lengthy legislative process to address the causes of the financial meltdown, Congress included a provision in the omnibus Dodd-Frank Act giving shareholders in all public companies a non-binding vote on the compensation received by their executives. With President Obama’s signature it became law in July, 2010.

This Dodd-Frank Say-on-Pay measure added a new subsection to the Securities Exchange Act of 1934 entitled, “Shareholder Approval of Executive Compensation.” It requires that public companies hold shareholder advisory votes on the executive compensation described in their proxy statements at least once every three years. There is no special language

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118 Gretchen Morgenson, When Two-Thirds Isn’t Enough, N.Y. Times, at BY 1, June 12, 2011
that this resolution must take. The law also mandates that at the first annual meeting after its enactment the shareholders elect how frequently they will take these votes—at a one, two, or three year interval. This is the so-called “Say-when-on-Pay” vote. A separate advisory vote is also required on severance arrangements under a golden parachute provision.\textsuperscript{122}

The law also includes this “Rule of Construction.”\textsuperscript{123} It may not be interpreted (1) “as overruling a decision by such issuer or board of directors; (2) to create or imply any change to the fiduciary duties of such issuer or board of directors; or (3) to create or imply any additional fiduciary duties for such issuer or board of directors.”

The SEC followed up with its own regulations implementing Say-on-Pay.\textsuperscript{124} It requires that the results of those votes be reported promptly to the public on Form 8-K. It also mandates that each firm’s narrative disclosure in future proxy statements must explain when those results were taken into account in future compensation decisions.

A similar Say-on-Pay provision has existed since 2004 in the United Kingdom where it has constrained executive pay at poorly performing firms.\textsuperscript{125} This led one commentator to propose that such a vote would be more effective if taken \textit{ex ante}, that is, as a review of the pay package of a prospective CEO rather than \textit{ex post}, as a referendum on whether an already awarded pay package was warranted.

Shareholders under the regime established by Dodd-Frank, he argued, also might be reluctant to cast a negative vote on exorbitant compensation at a well-performing firm for fear of

\begin{itemize}
\item \textsuperscript{122} Securities and Exchange Act of 1934, 15 U.S.C. §14A(b) (1934)
\item \textsuperscript{123} Securities and Exchange Act of 1934, 15 U.S.C. §14A(c) (1934)
\item \textsuperscript{124} JoAnn S. Lublin and Ben Worthen, H-P to Limit Severance Payouts for Ousted Executives, Wall St. J. December 15, 2011 \textit{available at} http://online.wsj.com/article/SB10001424052970204844504577099023075898992.html
\item \textsuperscript{125} Lund, \textit{supra} note *, at 123 (2011)
\end{itemize}
offending its management. The commentator also surmised that in its present form as an after-the-fact advisory vote, the principal harm to directors of a negative say-on-pay would be reputational, although it could also signal an implicit threat to remove them at their re-elections or through a proxy contest.126

IX. Say-on-Pay: The First Year and Beyond

When Say-on-Pay went into effect in early 2011, one commentator assessed some of its early votes and predicted that the measure would have “a transformative impact on the relationship between chief executives and institutional investors.”127 After a full year’s operation, however, the results are more mixed. By June, at the end of the spring proxy season in which a large majority of public companies held their annual meetings, shareholders casting say-on-pay votes had overwhelmingly approved the executive compensation at their companies. Institutional Shareholder Services, (ISS) a leading shareholder advocate, had recommended a negative vote at 293 companies.128 Yet a majority of voting shareholders from almost 2,500 firms signaled their approval of the pay packages at all but 39.129 This amounted to a “yes” vote at 98.5% of the companies.130

An editorial therefore called Say-on-Pay “a disappointment” and cited this comment on the process from Robert A.G. Monks, a corporate governance expert, “You have only the

126 Id. at 124-25.
128 John Helyar, Investor ‘Say on Pay’ is a Bust, Bloomberg Businessweek, June 18, 2011.
appearance of reform and it’s a cruel hoax. In the same vein, another commentator said, “The latest “say on pay” endeavor has turned into a costly exercise that validates almost every company’s pay practices.”

Yet the same expert noted that the reforms were not futile. Some companies foresaw shareholder criticism and changed their pay arrangement ahead of the votes. Almost 80% of companies on the Russell 3000 index endorsed annual votes rather than every 2 or three years and there was also evidence that instead of “the old country club back-slapping of earlier years” pay scales were being more closely tied to company performance.

Other observers cited similar promising outcomes. Some companies like General Electric that had originally gotten negative recommendations from ISS changed their compensation policies and secured its approval and many companies generally made changes in their compensation programs in anticipation of the first round of Say-on-Pay votes. Additionally Lynn Turner, the former chief accountant for the SEC, explained the positive ballots by noting that many mutual funds that hold 70% of the stock in American companies also have contracts with them to manage their employees’ 401(k) plans. As such, said, Turner, they “won’t vote against management on compensation unless they’re really bad.”

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132 Davidoff, supra note *.
133 Id.
136 Id.
Another observer counseled firms not to take the wrong message from this first year of voting because “…institutional investors said they reserved their ‘No’ votes for particularly egregious compensation practices. They felt that too many ‘No’ votes would ‘dilute the effectiveness of voting against the plans.’”\(^{137}\)

Along the same lines, at least one careful observer expects the number of companies with majority “No” votes to increase in 2012.\(^{138}\) With that in mind, he said, a large majority of companies are reviewing the results of 2011’s vote to see if changes should be made in their compensation plans in anticipation of the 2012 ballot.\(^{139}\) He counseled that firms learn from particular concerns that caused negative say-on-pay votes in 2011 such as “cherry picking” performance metrics from year to year, “make-up” awards when plans did not pay out because performance targets were missed, executive perquisites, and compensation levels that are “facially too high.”\(^{140}\)

Negative votes may also increase in 2012 because of new SEC disclosure rules expected to go into effect then. Chief among them will be a requirement that companies state the ratio of their CEO’s pay to that of their median-employee.\(^{141}\) This will quite bluntly mandate that firms “put in black-and-white that the CEO makes umpteen times more than the median total compensation for all employees in the organization.”\(^{142}\)

\(^{137}\) Id. quoting Steven Slutsky, a consultant from PricewaterhouseCoopers.

\(^{138}\) Id.

\(^{139}\) Id.

\(^{140}\) Id.


\(^{142}\) \textit{Why it’s Good at the Top: Shareholder had a say on Executive Pay Increases at many Public Companies. Almost all the Votes were in Favor}, Philadelphia Inquirer, Aug. 14, 2011 at WEB
Republicans in Congress, however, and their allies who lobby for Wall Street, have made a strong push to repeal or cut back the reforms of Dodd-Frank. One former Senator called their spending “the most uneven battle since Little Big Horn.”143 Business groups, emboldened by a judicial decision in July, 2011 striking down the SEC’s proxy access rule, may also bring Court challenges to all or parts of Dodd-Frank.144 By contrast a senior Obama official, speaking of the upcoming presidential election, has said that the President will staunchly defend the legislation. “One of the main elements of the contrast will be that the president passed Wall Street reform and our opponent and the other party want to repeal it.”145

X. Say-on-Pay Votes as Evidence of Breach of Fiduciary Duties

a. Preliminary Considerations

Under the internal affairs doctrine, officers and directors owe their shareholders duties set by the states where their firms are incorporated.146 In addition, all states place the power to manage corporations under the supervision of their boards.147 Therefore unless Congress wanted

144 Ben Protess, Court Ruling Offers Path to Challenge Dodd-Frank, N.Y. Times, August 17, 2011
145 Quoted in Mona Charen, Obama’s Tactics Court Few, Spokanesman Review, October 18, 2011.
146 CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 78 (1987).
147 See e.g. §8.30 MCBA, Del. Code Ann. tit. 8 §144 (2010).
to pre-empt this area of law, it had to make say-on-pay votes advisory or else it would be impinging on the prerogative of state jurisdiction.

One conservative legal scholar, Steven Bainbridge, thus went on the record with this dismissive view of potential lawsuits based on such negative votes.

In state law, executive compensation decisions by the board of directors are subject to the business judgment rule. This makes shareholder pay lawsuits extremely hard to win…The act (Dodd-Frank) and its legislative history make clear that the votes shall not be deemed either to effect or affect the fiduciary duties of directors….It will be interesting to see what legal theories these plaintiff lawyers come up with…Surely they won’t have the brass balls to claim that say on pay is binding, will they?148

Despite Professor Bainbridge’s comments doubting the resolve of shareholder lawyers, by September, 2011 at least seven derivative suits had been filed against senior executives, directors, and their compensation consultants over negative say-on-pay votes.149 They all alleged that the preliminary requirement for pre-suit demand on the board should be excused as futile because those directors had already approved the questionable compensation.150

The suits did not challenge the directors’ and officers’ duty of care which would be protected by the business judgment rule and exculpatory provisions such as Section 102(b)(7)


149 Dechert, LLP, DechertonPoint, Defending Against Shareholder “Say-on-Pay” Suits, September, 2011.

150 Id. See also, Aronson v. Lewis, 473 A.2d 805 (1984)
of the Delaware Corporate Code.\textsuperscript{151} Instead, they alleged that the “No” votes reflected the “independent business judgment” of shareholders that the pay was not in the interest of their firms and they attacked the compensation decisions as breaches of the duties of loyalty and good faith owed by corporate officials to their shareholders.\textsuperscript{152}

Astute commentators pointed out that recent Delaware decisions had laid the groundwork for such claims.\textsuperscript{153} In Gantler v. Stephens\textsuperscript{154} that state’s High Court ruled that corporate officers have the same fiduciary duties as directors.\textsuperscript{155} And a few years earlier the Chancellor had found that a CEO violated his duty of loyalty when negotiating a compensation agreement with his company.\textsuperscript{156} Unlike Mr. Ovitz in the Disney case who was bargaining for his first employment contract,\textsuperscript{157} the CEO there was already the top official of the firm and thus likely to receive a sweetheart deal.

b. Cincinnati Bell

Commentators therefore should not have been so quick to call these say-on-pay suits frivolous.\textsuperscript{158} On the contrary, it should have been apparent that they had the potential to really

\textsuperscript{151} Dechert, \textit{supra} note 137. Section 102(b)(7), is the so-called Delaware “raincoat” because by adopting it as a provision of a company’s certificate of incorporation it holds the officials of those firms harmless for any damage claims that they have breached their fiduciary duties of care. \textit{See also} 8.30 MCBA.

\textsuperscript{152} Dechert, \textit{supra} note *.

\textsuperscript{153} Thomas and Wells, \textit{supra} note * at 884-85.

\textsuperscript{154} 965 A.2d 695 (Del. 2009).

\textsuperscript{155} Gantler v. Stephens, 965 A.2d at 709.


\textsuperscript{157} Disney, \textit{supra} note *.
“shake up a boardroom.”

That was confirmed in September, 2011 when a U.S. District Court refused to dismiss one by automatically acceding to the business judgment of directors. Instead, the Court ruled that whether such deference was warranted would be a question for trial and also found the requirement that shareholders make a pre-suit demand would be excused.

The case involved $4 million dollars in bonuses given to the CEO of Cincinnati Bell, Inc. on top of $4.5 million in salary and other compensation. Cincinnati Bell’s board took that action despite a $61.3 million decline that year in the company’s net income, a drop in earnings per share from $0.37 to $0.09, a reduction in share price from $3.45 to $2.80, and a negative 18.8% annual shareholder return. In light of that poor performance it should have been no surprise that the Company’s shareholders registered a 66% “No” vote against the CEO’s increased pay package.

The shareholder plaintiff brought the suit alleging that the directors had breached their duty of loyalty in awarding the bonuses. To establish that liability, a stockholder has to meet a high standard of culpability under Ohio law. It requires a showing of “deliberate intent to cause injury to the corporation” or “reckless disregard for the best interests of the corporation.” And even though informed decisions on compensation by disinterested directors are presumed to be the product of a valid business judgment, the Cincinnati Bell


159 Id.

Court found that the plaintiff had adequately pled facts showing that protection might not be available in that case.

The Court justified its ruling by citing the Company’s own pay-for-performance policy. It held that there was therefore a plausible claim the “multi-million dollar bonuses approved...at the time of the company’s declining financial performance...were not in the best interests of Cincinnati Bell’s shareholders and therefore constituted an abuse of discretion and/or bad faith.”

In its lengthy first footnote, the Court gave an indication of how the negative Say-on-Pay suit impacted its decision. There the Court observed that some commentators have identified excessive executive compensation as the “No. 1 problem in corporate governance.”161 It then went on to cite various statistics describing how CEO pay has far outstripped average wages and how the mal-distribution of earnings and wealth in our country has grown to alarming proportions.162

It then found that Congress had passed Dodd-Frank with its say-on-pay provision “against this backdrop.” Next it noted that although Dodd-Frank says those votes “are not binding and do not alter the fiduciary duties of directors some commentators opine that ‘[a] negative vote gives the court evidence that there’s been a breach of duty.’ It doesn’t mean there’s been a breach of duty, but it can support a finding of breach.”163


162 Id.

Finally turning the fear of frivolous litigation on its head, the Court cited a report that as of June, 2011 shareholders had disapproved of executive pay in only 1.6% of public companies that took Say-on-Pay votes. In a terse following comment the Court stated, “Cincinnati Bell is one of those companies,” signally that it considered the shareholders’ negative vote there as evidence of misconduct.

c. Beazer Homes

A Georgia trial court however has dismissed a similar shareholder suit. The case involved Beazer Homes USA Inc. (Beazer) whose four most highly-compensated executives received pay raises even though the company suffered a $34 million loss and a -17.23% share price return for fiscal 2010. That continued a three year pattern of poor performance where Beazer lagged behind peer companies. Yet the firm's CEO received total remuneration of $6,893,362 in 2010, up approximately $450,000 from the previous year. That compensation package drew a 54% negative say-on-pay vote at the company's annual meeting of shareholders in February, 2011.

In reporting the vote Beazer stated: "Our core compensation objective continues to be that we will pay for performance--we believe that we should pay higher compensation when our management team succeeds and lower compensation when it does not.” Yet the company went on to justify the greater pay in 2010 by citing "the highly unique set of circumstances facing the Company at the start and during most of fiscal 2009." Beazer also explained the jump in pay by noting that the executives' compensation had been frozen for some time, their bonuses had been reduced in recent years, and no equity awards were made to them in the last two years.

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According to the Company's 2010 proxy however Beazer was under criminal and civil investigations by the Department of Justice that precluded it from offering such equity based grants. Since the company’s top officials were presumably responsible for those potential law violations, shareholders as evidenced by their negative vote may well have felt that Beazer’s leaders suffered no injustice in being deprived of those awards and there was no need that they be given now.

As such Beazer was an egregious situation of unearned compensation and management’s justifications for it were disingenuous. The company’s shareholders therefore quite logically signaled their disapproval. Yet in contrast to the Cincinnati Bell decision the Beazer Court refused to excuse pre-suit demand finding that the complaint failed to allege particularized facts raising doubt that "the challenged compensation decisions were made in good faith and in the directors' honest belief that the decisions were in Beazer's best interests." 165

In other words, according to the Court, the allegations had not raised "a reasonable doubt the Beazer directors' decisions reflected valid business judgment." 166 The Beazer Court also supported its decision by noting that Delaware law had long granted "wide discretion" to boards to set executive compensation and Dodd-Frank had specifically preserved that "fiduciary duty framework concerning directors' executive compensation decisions." 167

165 Id. at 3.
166 Id. at 2.
167 Id. at 6.


There each officer’s compensation increased from 60 to 160 percent in 2010 despite a negative 7.7% return to shareholders. That Magistrate Judge however declined to follow Cincinnati Bell and questioned whether it would remain viable legal authority because there could have been lack of subject
XI. Say-on-Pay’s Broader Impact on the National Economy

According to a recent survey of investors, executive pay continues to be one of their top concerns—particularly when that remuneration is significantly higher than peer levels and disproportionate to the company’s performance.\textsuperscript{168} Suits against boards for authorizing excessive compensation therefore will continue, bolstered by the Cincinnati Bell decision which cites negative Say-On-Pay votes as prime evidence of such a breach of fiduciary duty.

Facing such a specter of potential liability, one commentator starkly advised that directors might finally “sit down and do the math.”\textsuperscript{169} Up until now, he noted, they haven’t been evaluating what options awards might cost the company when the stock price goes up. Even more significantly directors, he said, “who typically owe their positions to CEOs”\textsuperscript{170} might finally have a countervailing incentive to do their job and check their top executives’ demands for exorbitant compensation.

Underlying this legal change is the moral sense that these huge executive pay packages are a grave injustice, a real theft of our productive resources. All religious traditions condemn the evil that results when great wealth is misappropriated. And American history is full of...
lessons that we all rise or fall together as a people. As President Kennedy put it, “If a free society cannot help the many who are poor, it cannot save the few who are rich.”171

Closely related to the misuse of corporate wealth by excessive compensation is the equally troubling phenomenon of corporations’ hoarding large amounts of cash and not distributing those funds to shareholders or putting them to other productive uses.172 $2 trillion of these funds currently lie in corporate treasuries, with firms showing little interest in spending them to create jobs for workers,173 which would spur economic recovery.174 In addition, the revival of the American manufacturing base requires expenditures in science, engineering and technology.175 With debt issues paramount in Washington, experts expect a 10% cut in federal grants for research and development,176 making private sector spending here even more imperative.

In short, this underuse of firm resources along with their blatant misuse by excessive executive compensation is robbing companies and their shareholders of funds that should be put to work expanding the profitable capacities of our nation and giving productive work to its citizens. As a leading treatise on corporate governance puts it when discussing the proper

171 President John F. Kennedy, Address at the Presidential Inauguration (Jan. 20, 1961).
172 Becky Yerak, Sitting Tight on Big Cushions, Chicago Tribune, Sept. 25, 2011, Sec. 2 at 1.
173 Rana Foroohar, Don’t Hold Your Breath, Time, June 8, 2011 available at http://www.time.com/time/nation/article/0,8599,2076568,00.html
purposes of those firms, “The accountability that we…seek…is that which is most likely to result in corporate choices that best benefit society over the long term.”

A prime example of that beneficial attitude comes from one of the great geniuses of American business, Henry Ford. By the second decade of the 20th century, Ford’s Motor Company had already become quite profitable. Ford planned to use some of those funds as a reserve so he could lower the price of his cars, but some of his early shareholders, the Dodge brothers, objected. They sued Ford charging that they were getting insufficient dividends. Ford offered this defense of his business plan. “My ambition is to employ still more men, to spread the benefits of our industrial system to the greatest number possible, to help them build up their lives and their homes. To do this we are putting the greatest share of profits back in the business.”

That was in line with Ford’s oft stated aspiration that everyone who worked at his plant should be paid well enough to purchase one of the cars they help make.

The Court however seemed to find Ford’s rhetoric too philanthropic. In holding that Ford must pay more dividends to the Dodge Brothers it stated, “There should be no confusion…a business corporation is organized and carried out primarily for the profit of the stockholders.” Yet the Court also acknowledged the discretion that the law would allow to directors to accomplish that purpose. If Ford had thus justified his price-reduction policies as a way of creating a permanent market for his product, the result would most likely have been different.

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177 Monks and Minow, page 14.


His statement about the broader corporate purposes would then have been very acceptable when seen as creating wide desire for a product that only well-paid consumers could satisfy.\textsuperscript{181}

The need for such broad based buyer demand is even greater today when our nation’s recovery staggers along. As economist Robert Reich stated, “The economy cannot get out of its current doldrums without a strategy to revive the purchasing power of America’s vast middle class.”\textsuperscript{182} Economic growth will thus come when corporate funds are used for job-creating investments, rather than hoarded or paid out lavishly to overcompensated executives.

XII. Conclusion

Cases like Citigroup and Cincinnati Bell are evidence of a renewed judicial willingness to find boards liable for breaches of their fiduciary duty if they have granted overly-generous pay hikes to their top officials. This may be particularly so when shareholders have stated their disapproval of those awards by negative Say-on-Pay votes, especially when those lush raises

\begin{quote}
\textsuperscript{181} Most recently a new business form has been established by the laws of several states, the Benefit Corporation. It allows a company to explicitly embrace a dual purpose, profitability and other more altruistic goals that further the public good. By thus putting potential shareholders on notice that it may have other motives in addition to profit maximization, a corporation can shelter its altruistic leaders from shareholder suits such as Dodge v. Ford. See Stephen J. Haymore, \textit{Public(ly Oriented) Companies: B Corporations and the Delaware Stakeholder Provision Dilemma}, 64 Vand. L. Rev. 1311 (2011); Rakhi I. Patel, \textit{Facilitating Stakeholder-Interest Maximization: Accommodating Beneficial Corporations in the Model Business Corporation Act}, 23 St. Thomas L. Rev. 135 (2010).

\textsuperscript{182} Along the same lines, former Vice-President and environmental activist Al Gore has recently created a blue-print for what he calls “sustainable capitalism” which would lead companies away from “irresponsible short-term investment.” Sinead Cruise, \textit{Al Gore takes aim at “unsustainable” Capitalism” Reuters, Feb. 16, 2012 at http://news.yahoo.com/al-gore-takes-aim-unsustainable-capitalism-164819308.html}

\textsuperscript{182} Reich, \textit{The Limping Middle Class}, N.Y. Times, Sept. 3, 2011.
\end{quote}
have been granted despite losses and in derogation of corporate policy that executive pay should be based on performance.

Although those negative resolutions are not legally binding on boards, they are nevertheless probative evidence that directors have violated their duty to act in the best interest of their shareholders. Courts can act on that with rulings that will send a much needed message to boards that they must curb excessive pack packages for their top management. Then by distributing those funds to shareholders or putting them to other productive uses business leaders can roll back some of the outlandish income inequality that is plaguing our nation.