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CEO Retention

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ARTICLES

CEO RETENTION

Lee Harris[*]

Abstract

Again and again, economists, corporate law scholars, and Congress have turned to reforms, such as executive compensation reforms, as a solution to executive misbehavior. The root of the evil, they muse, is sky-high pay with only a flimsy connection to managerial performance. If CEO pay can only be rejiggered on the front end and tied to performance, the argument goes, executives can be expected to pursue shareholder interests and put aside egos, and firms will prosper. This Article argues that such reforms are, despite the best of intention, fool's gold. The fallacy is not in thinking that CEOs and other executives who have abused their position and have failed to live up to expectations should be paid less—they should. However, this Article argues that when CEOs and other executives fail, they should be out of a job altogether. This Article goes on to describe how to create a right of retention by drawing the analogy to the public sphere. Specifically, one way to check CEO conduct is through periodic up-or-down votes, the same kind of retention-style elections a plurality of states use to give voters a say in whether judges should be ousted. Importantly, in states that use them, retention elections have treaded lightly—they have created a monitoring device to hold in check the worse abuses without undermining the authority of public officials (governor and judicial nominating committees) from making their selections about whom should be appointed. Thus, I suggest that retention elections provide a useful path, after bad conduct occurs, to checking corporate executive abuses. Incidentally, as I have suggested in the past, this approach demonstrates that, once again, a solution from the public sphere might mitigate another long-standing problem in the private sphere—this time, CEO accountability. Finally, this Article proposes a new classification scheme for efforts to rein in CEO misbehavior and promote accountability. The expected success of efforts to rein corporate leadership abuses depends, crucially, on timing. Reforms have a higher chance of achieving their goals if the focus is on actual (or past) performance, not anticipated performance. Thus, this Article makes some initial claims about when to create prospective incentives for good behavior versus retrospective punishments for bad behavior.

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INTRODUCTION

Executives at major U.S. firms are paid too much,[1] and their

1. *See, e.g.*, Richard A. Posner, *Are American CEOs Overpaid, and, if So, What if Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1041–42 (2009) ("Theory and evidence suggest that there is indeed overcompensation of the CEOs of American publicly held corporations."); Randall S. Thomas, *Explaining the International CEO Pay Gap: Board Capture or Market Driven?*, 57 VAND. L. REV. 1171, 1183 (2004) (finding that American CEOs are paid significantly more than CEOs in other countries). *See generally* Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 323 (2009) (noting that sky-high executive pay has generated headlines for at least the last fifty years). As an absolute number, CEOs are paid astronomical sums. *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 9 (2004) (reporting that aggregate pay for top executives in a sample of 1500 companies totaled roughly $100 billion); Lucian Arye Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency*

performance is often lousy.[2] At the expense of the firm's long-term health, they train their sights on short-term goals, like stock price pops and other clever tricks to monetize their stock options.[3] The recklessness of firm leaders caused the global financial system to collapse,[4] and they will likely do it again. This line of thinking has led to a raft of attempts by public authorities to regulate the behavior of firm CEOs and other executives, particularly through executive compensation proposals.[5] Unfortunately, these reform attempts have generally failed.[6]

Nonetheless, reformers continue to re-dip their chalices in the same well. Despite previous flops, economists, corporate law scholars, and Congress have turned repeatedly to reforms, such as executive compensation reforms, as the solution to executive misbehavior.[7]

Problem, 17 J. ECON. PERSPS. 71, 88 (2003) (noting that CEO compensation was almost eight percent of profits at many large public companies). Relative to other rank-and-file employees, chief executives pay has skyrocketed in the last few decades. *See* William W. Bratton, *The Academic Tournament Over Executive Compensation*, 93 CALIF. L. REV. 1557, 1559 (2005) (reviewing BEBCHUK & FRIED, *supra*) (noting that CEOs made thirty times the salary of an average production worker in 1970 and 210 times the same worker in 1996). For a discussion of the elements of executive compensation, see Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. REV. 299, 312–13 (2009); Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1028–30 (1999). As mentioned, not everyone agrees. A small minority of observers have argued that executive pay reforms only interfere with efficient market outcomes. *See, e.g.*, John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1142 (2005) (reviewing BEBCHUK & FRIED, *supra*) (noting that the belief of the need to reform executive compensation is "widespread" and offering a counterargument to "an increasingly one-sided debate); *see also* Jie Cai & Ralph A. Walkling, *Shareholders' Say on Pay: Does It Create Value?*, J. FIN. & QUANTITATIVE ANALYSIS 299, 305–06 (summarizing the "interference hypothesis").

2. *See generally* Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. ON REG. 359, 359 (2009) (noting the claim that typical executive compensation schemes led to "reckless conduct").

3. *See, e.g.*, *id.* at 363 (proposing that executive compensation focus on restricted stock options that can be exercised two to four years after the executive departs in order to create incentives for executives to focus on long-term goals); Posner, *supra* note 1, at 1026 (noting that stock options create incentives to manipulate and take too much risk); Judith F. Samuelson & Lynn A. Stout, *Are Executives Paid Too Much?*, WALL ST. J. (Feb. 26, 2009), http://online.wsj.com/article/SB123561746955678771.html (arguing that part of the reason for the economic failure is because executives were paid significant amounts to focus on "short-term thinking").

4. Posner, *supra* note 1, at 1027, 1040–41 (comparing CEO compensation practices to factors causing the savings and loan crash of the 1980s and explaining the indirect connections between the current recession and financial crises and executive compensation); Simmons, *supra* note 1, at 306 (noting that "[l]awmakers often link executive compensation . . . to broader economic turmoil, such as plant closings, unemployment, outsourcing domestic jobs, and income inequality").

5. *See* Simmons, *supra* note 1, at 304 (noting various legislative attempts to rein in executive compensation).

6. *See infra* Part I.

7. *See* Bebchuk & Fried, *supra* note 1, at 71 (noting that executive compensation reforms are focused on helping to "alleviate the agency problem in publicly traded companies"); Thomas &

According to these reformers, the problem begins with sky-high pay that is barely connected to managerial performance.[8] The argument is simple: if CEO pay can only be adjusted on the front end and tied to performance, executives can be expected to pursue shareholder interests, put aside egos, and firms will prosper.[9]

When Governor Bill Clinton ran for the White House in 1991, his campaign planted its flag on this theme.[10] Once he took office in 1992, President Clinton delivered. In fact, President Clinton ushered in one of the biggest reforms to date to encourage firms to make a strong link between CEO pay and performance.[11] Specifically, Congress approved changes to the tax code that created preferential tax treatment for firms that make CEO (and other executives') compensation a function of their performance.[12] Those changes to the tax code led to a sea change in how companies compensate their executives (and later many of their employees), with firms shifting to stock- and stock-option-based compensation and away from fixed compensation.[13]

Judging by the levels of CEO pay today and the hand-wringing about CEO performance, the Clinton-era reform attempt has failed miserably.[14] Yet, policy makers and academics continue to turn to executive compensation and related measures to monitor and police CEO conduct.[15]

Martin, *supra* note 1, at 1032 (discussing pay as a method of creating accountability according to economists).

8. *See, e.g.*, James E. Heard, *Executive Compensation: Perspective of the Institutional Investor*, 63 U. CIN. L. REV. 749, 751 (1995) (arguing that institutional investors are concerned about the connection of pay to performance).

9. *See, e.g.*, Bhagat & Romano, *supra* note 2, at 361 (summarizing an approach to executive compensation reforms that will provide managers of publicly traded corporations with the proper incentives).

10. *See* Ryan Miske, Note, *Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code*, 88 MINN. L. REV. 1673, 1686 (2004) (describing the campaign pledges of then-Governor Bill Clinton and his statement that "[i]t's wrong for executives to do what so many did in the 1980s. The biggest companies raised their [CEOs'] pay by four times the percentage their workers' pay went up and three times the percentage their profits went up" (second alteration in original)).

11. David Leonhardt, *Why Is This Man Smiling?; Executive Pay Drops off the Political Radar*, N.Y. TIMES (Apr. 16, 2000), http://www.nytimes.com/2000/04/16/weekinreview/ideas-trends-why-is-this-man-smiling-executive-pay-drops-off-the-political-radar.html (chronicling the tax code changes ushered in by President Clinton and the disappearance of executive compensation as a political hot-button issue).

12. *See* Simmons, *supra* note 1, at 303–04 (discussing President Bill Clinton's promise to end excessive executive compensation by using the tax code).

13. *See* Miske, *supra* note 10, at 1688–89 (reporting staggering growth in the use of stock options after 1992 and the tax changes that year).

14. *See, e.g.*, Simmons, *supra* note 1, at 306 (suggesting that executive compensation reforms have failed as judged by the marked increase in executive compensation levels).

15. *See* Posner, *supra* note 1, at 1045–46 (suggesting a slate of reforms including disclosure and taxation).

Just recently, Congress limited executive compensation at bailed out firms.[16] Next, as part of the Dodd-Frank Act—a behemoth financial industry overhaul—Congress gave shareholders an advisory vote on whether the CEO and other executives are paid too much, a so-called say-on-pay.

This Article makes several contributions. First, this Article argues that these types of reforms are, despite their best intentions, fool's gold. They have done little to create any accountability among executives and there is little reason to expect things to change. At their very best, reforms based on executive compensation are a second-best solution to curb corporate leadership abuses. The problem is not in thinking that CEOs and other executives that have failed to live up to expectations should be paid less. They should. More importantly, though, is that when CEOs and other executives fail, they should be out of a job altogether. CEO leadership is too important.[17] Good CEOs promote the firm's interests, manage and inspire employees, make savvy product decisions, and lead the firm into new markets.[18] But bad leaders, if not held accountable, can harm the firm's interests, shirk responsibility, and entrench themselves away from the glare of any oversight.[19] Shareholders at public companies should have a limited, but still effective, say-so in whether CEOs are retained, not how well they may be compensated. This Article describes how to create a right of retention by drawing the analogy to the public sphere.

Second, this Article demonstrates that giving shareholders a new right to remove firm executives does not have to be drastic or clumsy. While I argue for shareholder power to remove firm executives, the move in this direction should be tactful and limited. After all, if shareholders are given too broad a right to remove unwanted executives, the change in dynamics would undermine one of the core tenants of corporate law—the centralization of power in the hands of the board.[20] Reform should not

16. *Id.* at 1014 (noting limits on salary for bailed-out firms).

17. *See* Mark R. Huson et al., *Internal Monitoring Mechanisms and CEO Turnover: A Long-Term Perspective*, 56 J. FIN. 2265, 2266 (2001) (noting that the decision to bring in a new CEO is one of the most important decisions of the board); Simmons, *supra* note 1, at 311 (noting the attributes of a good executive leader).

18. *See* Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 762 (2002) (noting some of the key attributes of a successful firm leader).

19. *See* Bebchuk & Fried, *supra* note 1, at 71–72 (noting several examples of managerial misconduct).

20. *See, e.g.*, Heard, *supra* note 8, at 749 (noting the benefits of centralized authority). For a discussion of the pay-setting process and the board of directors' role, see Thomas & Martin, *supra* note 1, at 1025–28; see also Randall S. Thomas et al., *Dodd-Frank's Say on Pay: Will it Lead to a Greater Role for Shareholders in Corporate Governance*?, 97 CORNELL L. REV. 1213, 1215–16 (2012) (discussing the view that enhancing shareholder voting power might undermine board authority).

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careen the apple cart.[21] As shall be shown, a perfect analogy from the public sphere can guide corporate law in orchestrating this delicate pas de deux—centralization of power in the hands of an authority while creating real accountability.[22]

Specifically, this Article argues that one way to curb executive misconduct is through periodic up-or-down votes, the same kind of retention-style elections some states use to give voters a say in whether judges should be ousted. In states that use them, retention elections have treaded lightly—they have created a monitoring device to hold in check the worst abuses without undermining the authority of public officials (the governor and judicial nominating committee) in making their selections about whom should be appointed. In states that have used retention elections, voters do not have the power to choose judges.[23] Importantly, that power is reserved to special judicial nominating commissions, along with approval of the governor. But when judges steer too far afield, voters can remove them.[24] Thus, this Article suggests that retention elections provide a useful path, *after* bad conduct occurs, to check corporate executive abuses. Incidentally, as I have suggested in previous work, this approach demonstrates that, once again, a solution from the public sphere might mitigate another long-standing problem in corporate law—this time, CEO accountability.[25]

Third, this Article proposes a new theory for classifying and understanding efforts to check CEO misbehavior and promote accountability.[26] Current reforms hinge on decisions revolving around CEO

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21. *See* Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 148 (2009) (noting the long-standing concern that reforms that empower shareholders would create serious problems, including permitting the corporation "to take opportunistic advantage of other stakeholders").

22. *See* Michael R. Dimino, *The Futile Quest for a System of Judicial "Merit" Selection*, 67 ALB. L. REV. 803, 803–04 (2004) (describing retention elections as the "middle ground" in attempts to balance independence and accountability); *see also* Joanna M. Shepherd, *Money, Politics, and Impartial Justice*, 58 DUKE L.J. 623, 625–27 (2009) (suggesting that the struggle in crafting judicial selection is between the judicial independence model of appointment and the accountability model of elections).

23. *See* Shepherd, *supra* note 22, at 637.

24. As a consequence, this Article also makes a contribution to the wide-ranging debate about judicial selection. The debate on judicial selection has raged for decades, if not centuries. *See, e.g.*, Shirley S. Abrahamson, *The Ballot and the Bench*, 76 N.Y.U. L. REV. 973, 973 (2001) (noting that the subject of selecting judges is "now in its fourth century of debate in this country").

25. *See, e.g.*, Lee Harris, *The Politics of Shareholder Voting*, 86 N.Y.U. L. REV. 1761, 1765–66 (2011) [hereinafter Harris, *Shareholder Voting*] (arguing that shareholder voting dynamics can be analogized to citizen voting in political elections); Lee Harris, *Shareholder Campaign Funds: A Campaign Subsidy Scheme for Corporate Elections*, 58 UCLA L. REV. 167, 192 (2010) [hereinafter Harris, *Shareholder Campaign Funds*] (arguing for a campaign subsidy system for shareholder challengers along the same lines as campaign subsidy systems in presidential elections).

26. At least one scholar has made some earlier observations in this regard. In a previous article, Minor Meyers makes note that one of the reasons some executive compensation reforms are

compensation. These decisions, at bottom, are made before the CEO's performance can be observed, prior to CEO failures, and prior to any news of misconduct.[27] As shall be shown, the expected success of efforts to rein corporate leadership abuses depends, crucially, on timing. Reforms have more a chance of achieving their goals if the focus is on actual (or past) performance, not anticipated performance. In other words, this Article organizes previous reform measures in terms of timing. Thus, this Article makes some claims about when to create prospective incentives for good behavior versus retrospective punishments for bad behavior.

Part I summarizes government's main attempts to check corporate executive abuses, mainly by encouraging firms to tinker with their executive compensation schemes in the hopes that the changes will incentivize executives to perform well. Dodd-Frank, for instance, is one of the most significant pieces of financial services reforms ever passed by Congress.[28] The overhaul gives shareholders advisory voting rights on executive compensation schemes.[29] Although the votes are nonbinding, shareholders are entitled to vote on pay levels, how often executive compensation schemes ought to be presented to shareholder voters, and so-called golden parachutes or exit compensation for executives.[30] Part II presents a counterproposal for holding CEOs accountable: CEO retention elections. Retention elections are widely used in the public sphere to give voters a chance to decide whether state judges can return to office.[31] That is, in many states, after a state nominating committee appoints a judge,

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ineffective is because "it is impossible to know *ex ante* whether a new executive's performance will be so inadequate relative to her contractual entitlements that the payout . . . will later appear outrageous." Minor Myers, *The Perils of Shareholder Voting on Executive Compensation*, 36 DEL. J. CORP. L. 417, 449 (2011).

27. *See* Posner, *supra* note 1, at 1024 (noting that a compensation package is a function of the board's appraisal of the CEO's ability *ex ante*).

28. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 7 U.S.C., 12 U.S.C., and 15 U.S.C.). Dodd-Frank made a number of changes to financial services regulation beyond creating shareholder advisory votes on executive compensation. Dodd-Frank reforms several areas from derivative transactions to CEO compensation. For instance, Dodd-Frank creates a strong and mandatory clawback provision. Executive compensation is often tied to reported financial performance metrics. As it turns out, these metrics are often wrong. Under Dodd-Frank's clawback provision, firms would be required to seek the return of excess executive compensation after a restatement. In addition to reforms to executive compensation, Dodd-Frank includes reforms of how derivatives are traded, among other topics. *See* Jesse Fried & Nitzan Shilon, *Excess-Pay Clawbacks*, 36 J. CORP. L. 721, 731 n.47 (2011) (reporting that over 4,000 firms in recent years restated financial statements). For a brief discussion of the various provisions of Dodd-Frank and the policy rationales for the reforms, see generally BAIRD WEBEL, CONG. RESEARCH SERV., R41350, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: ISSUES AND SUMMARY (2010).

29. Dodd-Frank Wall Street Reform and Consumer Protection Act, § 951, 124 Stat. at 1899–90.

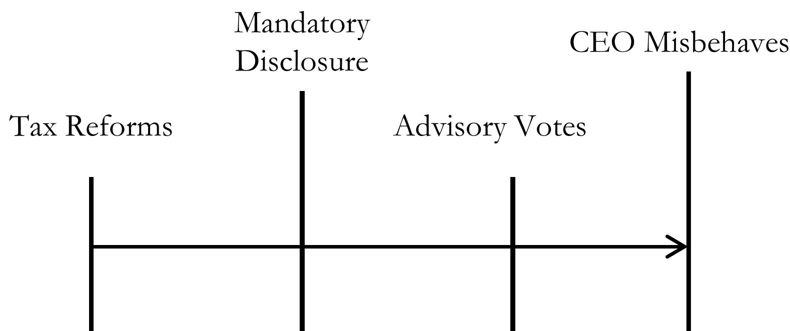
30. *See infra* notes 81–86 and accompanying text.

31. Abrahamson, *supra* note 24, at 976 (noting that the majority of state judges are elected).

citizens may periodically vote on whether the judge should be retained.[32] The same sort of system could be set for CEOs and other executives. Finally, Parts III and IV discuss the practical and political advantages of retention elections.

I. *Ex Ante* Approaches to Accountability

Imagine if one placed the current approaches to hold CEOs and other high-ranking executives accountable for misconduct on a timeline. Marks on the left side of the timeline would represent the various proposals by legislators, endorsed by corporate observers, to hold CEOs accountable. As illustrated below, such proposals primarily include ways to use CEO compensation to drive better performance and rein in misconduct—tax penalties for firms with CEO compensation packages not tied to performance objectives; broad disclosure to shareholders regarding pay



packages; and advisory votes on how much the CEO should be paid.

At one end of the timeline, one might put a mark for instances of managerial misconduct. If reform measures were visualized this way, almost all of the previous reform proposals would be to do something about CEO conduct *before* the misconduct occurs. For instance, tax code changes might incentivize firms to reform their compensation practices before any CEO misconduct has occurred and without an analysis of CEO performance. Such reforms, which are discussed in detail in this Part, might be said to be *ex ante* reforms, prior to CEO misconduct. Naturally, this Part is followed by my proposal for an *ex post* reform, after CEO misconduct.

A. *Tax Code*

As mentioned, the vast majority of reforms since at least the early nineties can be understood as a crusade to create accountability by toughening the links between pay and executive performance.[33] If CEOs'

32. Shepherd, *supra* note 22, at 637.

33. *See* Bhagat & Romano, *supra* note 2, at 361 (noting the "well-developed and widely

pay depends on their ability to enhance firm value, this will incent CEOs and other executives to perform well and in the shareholder's interest.[34] Proponents of enhanced CEO accountability have argued that changes in the tax code are a good way to spur firms to make their compensation structures more performance based.[35]

Proponents of using the tax code to create more accountability in the executive suite have focused on tax benefits, such as the deductibility of wages.[36] Normally, executive salaries, like wages and other employee costs, are deductible business expenses.[37] In order to hold CEOs and other high-ranking executives accountable, reformers proposed capping the usual deductibility associated with some executive salaries.[38] They proposed limiting deductibility with respect to fixed compensation.[39] At the same time, they proposed continuing to permit firms to deduct the cost of executive salaries as long as such salaries qualified as "performance-based compensation."[40] The thought was that, if used skillfully, limits on salary deductibility would encourage firms to reform their executive compensation schemes to make them more performance dependent. Firms could be expected to shift from large fixed compensation schedules (not deductible) to more performance-based alternatives, like stock and stock-based options (deductible).

Most famously, in 1993, Congress approved a flat $1 million tax deductibility limit on CEO pay.[41] Thus, firms paying executive salaries

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accepted economics literature on the fashioning of incentives to achieve consonance between managers' actions and shareholders' interest through the use of stock and stock-option compensation").

34. *Id.*

35. For instance, in 2004, Congress approved § 409A of the tax code, which threw cold water on in-the-money (discounted) options. Under this provision, discounted options would be taxed immediately and, more importantly, employees would pay a 20% penalty on those options. The goal, of course, was to encourage firms to avoid this type of compensation since discounted options obliterated the connection between pay and performance. *See* David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 VAND. L. REV. 611, 626–27 (2011) (noting the tax implications of discounted options).

36. *See, e.g.*, I.R.C. § 162(a)(1) (2012) (providing that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid . . . in carrying on any trade or business, including (1) a reasonable allowance for salaries or other compensation for personal services actually rendered").

37. *See, e.g.*, *id.*

38. *See id.* § 162(m)(1) (providing that "[i]n the case of any publicly held corporation, no deduction shall be allowed . . . with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds $1,000,000").

39. *See id.*

40. *See id.* § 162(m)(4)(C) (2012) (providing that the limits on deductibility "shall not include any remuneration payable solely on account of the attainment of one or more performance goals").

41. This does not mean that all previous attempts to regulate CEO pay through congressional action were unsuccessful or that 1992 was the first attempt at deductibility caps. As early as 1984,

above this amount would not be able to deduct the costs related to this expense.[42] Importantly, as part of the same change, Congress made performance pay in the form of stock options entirely deductible.[43] These tax changes only applied to top executives—the firm CEOs and the other four highest paid employees.[44]

In some sense, tax code changes were a stunning success. The response from firms was partially as predicted. As a consequence of these changes, firms began to rely less on fixed compensation that was unrelated to performance measures.[45] Firms adjusted CEO pay to make incentive compensation appear to be an increasingly substantial part of overall CEO compensation.[46] These changes have contributed to relatively significant growth in CEO compensation. In 1992, average CEO compensation, with the value of options granted added, was $3 million.[47] By 2005, average CEO compensation more than doubled to over $7 million.[48]

On the other hand, some have argued that tax code changes have failed in their principal objectives of creating accountability.[49] For one thing, savvy firm executives might easily outmaneuver the shift to stock-based compensation changes, effectively eviscerating any connection to performance. Professor Lucian Bebchuk and Professor Jessie Fried, two of

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reformers in Congress attempted to rein in high pay to departing executives—so-called golden parachutes—by tweaking the deductibility of these payments. David I. Walker, *The Challenge of Improving the Long-Term Focus of Executive Pay*, 51 B.C. L. REV. 435, 452–53 (2010) (noting that the rules on golden parachutes may have been ineffective). For a discussion of these tax code changes, see Miske, *supra* note 10, at 1676–84. Further, there were several unsuccessful attempts at using the tax code to create more accountability for executive action. In 1991, Congressman Sabo proposed taking away tax benefits for executive pay levels that were more than twenty-five times that of the lowest paid worker. *See* H.R. 3056, 102d Cong. (1991). A year later, Senator Harkin proposed taking away tax benefits for firms paying more than $500,000. *See* S. 2329, 102d Cong. (1992). Both of these attempts were unsuccessful.

42. *See* Bratton, *supra* note 1, at 1562 (noting the growth in top executive compensation over the last few decades, the lion's share of which was in the form of incentive pay).

43. *See* I.R.C. § 162(m)(4)(G).

44. *See id.* § 162(m)(3) (defining covered employees).

45. *See* Miske, *supra* note 10, at 1688–89 (reporting that between 1992 and 2000 stock options went from 27% of compensation to over 50%).

46. *See* Bhagat & Romano, *supra* note 2, at 365 (noting that equity incentive compensation mushroomed after congressional action to limit deductibility of fixed cash compensation).

47. Posner, *supra* note 1, at 1021.

48. *Id.* at 1022; *see also* Bebchuk et al., *supra* note 18, at 753 n.1 (noting the rapid rise in CEO compensation with the advent of stock options). The numbers for S&P 500 companies soared at an even more staggering clip. *See* Bratton, *supra* note 1, at 1562 (reporting that top executive compensation grew to $9.4 million by 2002).

49. The changes also failed in slowing the rate of pay increases. According to many at the time, the issue was one of fundamental fairness and the hope was that chief executives would earn less as a result of the changes. *See* Miske, *supra* note 10, at 1686 (noting the Senate Finance Committee reported that "excessive compensation will be reduced [by the $1 million cap]" (alteration in original)).

the most widely known critics of this trend, have argued that firms have been able to skillfully use changes to compensation design to ratchet up their compensation schemes without any serious corresponding enhancement to accountability.[50] For instance, they argued that most option-reliant compensation schemes overly reward the CEO for increases in the markets generally or a particular industry—increases that are unconnected to the CEO's performance.[51] Further, even when performance has been poor, the CEO and other leaders might convince the firm to reprice options—that is, set a new, lower exercise price.[52]

Finally, executive incentives based on stock and stock options might actually undermine firm value by, among other things, promoting disclosure manipulation and excessive risk taking.[53] In an effort to raise their firms' stock prices and to monetize their option compensation, firm leaders might be incentivized to strategically release information about their firms' well-being.[54] Managers may have incentives to hide or manipulate financial information reported to the public. This kind of strategic release might run the gamut from opportune disclosure of information all the way to outright fraud.[55]

Others have noted that, at the expense of the firms' long-term health, overreliance on stock options have incented CEOs (and other option recipients) to engage in shenanigans to create stock price pops and other risky gimmicks that might give them quick access to their stock options.[56] Options provide virtually unlimited upside if stock prices rise. However, there is limited consequence if the strategy fails to lift stock prices, since the CEO does not bear any additional loss for the downside, other than the loss of the options. Thus, firm leaders might take imprudent risks because

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50. *See, e.g.*, Bebchuk et al., *supra* note 18, at 757 (noting that firms fail to use option schemes that "filter out stock price rises that are . . . unrelated to the managers' performance").

51. Bratton, *supra* note 1, at 1564 (noting that market and industry movements account for a significant share of stock rise and "a payoff [for the CEO] is virtually guaranteed"); *see also* Bebchuk et al., *supra* note 18, at 796 (mentioning a couple of ways firms might handle undeserved windfalls, including indexing and vesting schedules).

52. *See* BEBCHUK & FRIED, *supra* note 1, at 127 (illustrating the issue of lowering executive targets with an example from Coca-Cola); Bebchuk et al., *supra* note 18, at 759–60, 821–24 (discussing how option repricing undermines *ex post* incentives to perform well); Posner, *supra* note 1, at 1027–28 (discussing repricing).

53. *See* Bebchuk & Fried, *supra* note 1, at 72, 88 (arguing that poorly designed pay structures of managers dilute incentives and hurt corporate performance).

54. *Id.* at 89 (noting that managers may have incentives to hide or manipulate financial information reported to the public).

55. *See* Miske, *supra* note 10, at 1690–91 (arguing that stock options incent executives to "adjust accounting methods" and take other manipulative actions to lift stock prices in the short term and access their compensation).

56. *See, e.g.*, Posner, *supra* note 1, at 1026 (noting that stock options create "an incentive to manipulate the stock price, and there is evidence that this incentive has been responsible for a number of financial debacles").

of the prospect of stock and stock options. They hope to revel in the upside, which is virtually unlimited, but are ensconced in the safety that their downside exposure is limited to the value of the options.[57] For instance, in a previous paper, Professor Bebchuk suggested that inaptly designed compensation structures can create incentives for managers to make acquisitions that add little to firm value.[58] They may pursue a path of so-called empire building since they expect that helming a larger firm will ultimately lead to higher pay, regardless of the firm's performance.[59]

It is important to note that relying on the tax code to create accountability in the executive suite attempts to incent good behavior beforehand, or *ex ante*—that is, prior to any specific misconduct on the part of executives at firms. Board decisions to change pay structures are at bottom tax driven, rather than based on the performance of their executives. In order to take advantage of tax benefits, boards of directors would remake their compensation structure, shifting from a fixed-salary structure to one more reliant on option-based compensation. Before CEO performance is observed, the tax changes drive boards of directors to rework their pay structures. At some firms, the new incentives might be warranted. At others, they may lead to sky-high pay with little connection to actual performance.

B. *Mandatory Disclosure*

In addition to tax code changes, reformers have argued that broadening the required disclosures that firms make to shareholders can drive accountability in the executive suite.[60] Broad disclosures, such as disclosures regarding CEO pay, alone would not directly rein in potential CEO misconduct. Rather, broad disclosure might help shareholders and other observers learn information and make more informed decisions. For instance, the media might report on broad disclosures regarding CEO pay, which, when unmeritorious or extravagant, might stir public outrage.[61] In short, reformers hope that disclosure will help actuate external monitors (mainly, media) and internal ones (here, shareholders) to take action to

57. *Id.* at 1026–27 (noting that stock-option compensation creates "no ceiling on the potential gain, but the loss is truncated at the value of the options").

58. *See* Bebchuk & Fried, *supra* note 1, at 89.

59. *See generally* Thompson & Edelman, *supra* note 21, at 147 (noting the ever-present allure of empire building).

60. *See* Heard, *supra* note 8, at 752; *see also* BEBCHUK & FRIED, *supra* note 1, at 192–94 (advocating for broader disclosure and improved transparency). For a brief discussion of the history of disclosure requirements, see Simmons, *supra* note 1, at 342–43; see also Thomas & Martin, *supra* note 1, at 1040–43. For a review of the latest set of disclosures as approved by the SEC, see Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 53,158 (Sept. 8, 2006) (to be codified at scattered parts of 17 C.F.R.).

61. *See infra* note 250 (briefly describing the role of media as monitor).

hold CEOs accountable.[62]

However, some evidence suggests that shareholders see little value in additional firm disclosures. According to a recent paper by Professor Randall Thomas, Professor James Cotter, and Professor Alan Palmiter, disclosure-type proposals have generated little support from shareholders.[63] Their paper found that shareholder proposals related to disclosure and additional reporting obligations were rare.[64] Further, in the rare instances when such proposals were put to shareholders for a vote, they received extremely low levels of support, frequently in the single digits.[65] In fact, in the Thomas, Palmiter, and Cotter eight-year study, no shareholder proposals related to disclosure were approved.[66] The authors speculated that the findings were relatively unsurprising, since shareholders already have sufficient information.[67]

Ironically enough, broadening disclosures may actually exacerbate the difficulty of holding CEOs accountable for their performance. While this information may be of little value to shareholders, broad disclosures do give CEOs and other firm leaders a glimpse into the pay at other firms, information that might have run-up CEO pay disconnected from performance.[68] As firms made more information publicly (and easily) available, the various disclosures created benchmarks.[69] Managers are able to use the released information to lobby boards of directors to increase their compensation. The dissemination of the information begets a vicious cycle, where firms set pay rates based on what other firms are doing, not strictly on performance and incentives.[70] Thus, another potential problem is that broad disclosures may have had the perverse effect of possibly

62. *See* Bebchuk & Fried, *supra* note 1, at 75–76 (suggesting that disclosure might be an effective tool to tamp sky-high pay).

63. *See* Thomas et al., *supra* note 20, at 1238 (reporting support of approximately 10% or less).

64. *Id.* (noting that over the eight-year study period, "proposals—asking boards to compile reports on executive pay, [or] to make additional disclosures about executive pay . . . were relatively few in number and attracted low levels of average voting support (often less than 10% of votes cast)").

65. *Id.*; *see also* Thomas & Martin, *supra* note 1, at 1061 (reporting that disclosure proposals are less successful than other types of proposals).

66. *See* Thomas et al., *supra* note 20, at 1238.

67. *Id.* at 1239 (explaining that "shareholders already receive voluminous disclosures about the levels and composition of pay for the top five executives at public companies and so they do not see the need for more information or reports from the company").

68. Bratton, *supra* note 1, at 1579 (discussing the "ratchet effect" of pay as firms gauge their success by reference to the pay of top executives at other firms).

69. Walker, *supra* note 41, at 454 ("[F]uller disclosure of pay appeared to lead more often to pay increases than decreases, as low-pay firms sought to bring pay levels up at least to the average of the relevant peer group.").

70. *See generally* Posner, *supra* note 1, at 1024 (noting the board's desire to pay CEOs at a level commiserate to the seventy-fifth percentile of comparable firms).

increasing undeserved CEO pay.

Recall that the previously discussed tax code changes create *ex ante* incentive effects for the board to take early and premature action, prior to any observed conduct on the part of executives. Like tax code changes, broad disclosures can also be described as an *ex ante* accountability tool. However, in contrast to tax code changes, which call on boards to hold executives accountable, disclosure reforms work their "magic" on shareholders and external observers, such as the media. Both shareholders and external groups play an important monitoring role in the structure of the firm.[71] Shareholders have important monitoring tools—namely, the right to vote (for directors, among other important votes), inspect the books, and sue—and thus, an established place in corporate governance.[72] Meanwhile, the press reports on firm performance and instances of misconduct, which can have a real effect on other actors. The issue, nonetheless, is whether disclosure reforms actually enhance firms' current abilities to hold executives accountable.

On the one hand, broad disclosure reforms incentivize shareholders to take action in holding executives accountable, but on the other, structure accountability prior to observing actual conduct. In most cases of disclosure of CEO compensation, for instance, prior to any observable misconduct, shareholders would be given information about levels of pay. As a matter of timing, disclosure requirements are usually made part of periodic reporting, such as delivery of the firm's annual proxy statement, and are not obviously connected to performance. In short, disclosures may drive accountability indirectly, as shareholders and other stakeholders fulminate about the information as they learn it; however, this information will likely be routinized and digested prior to any actual misconduct.

C. *Advisory Voting*

Recently, reformers have turned to shareholder advisory voting, so-called say-on-pay, to create more accountability in the executive suite.[73] Advisory voting reforms give shareholders a chance to vote on top executive pay levels. Even though the vote is typically nonbinding on the firm, the thinking is that these votes will give shareholders a new conduit for registering their satisfaction or dissatisfaction with the performance of top executives.[74]

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71. LEE HARRIS, MASTERING CORPORATIONS 179–201 (2009) (describing the rights of shareholders in firm governance).

72. *Id.* (describing the right to vote, inspect the books, and sue).

73. *See, e.g.*, Cai & Walkling, *supra* note 1, at 304 (explaining the legislative gap filled by "say-on-pay" reforms); *see also* BEBCHUK & FRIED, *supra* note 1, at 197–98 (advocating for more voting rights, including binding votes).

74. *But see* Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368,

Enchantment with advisory voting as a cure-all for managerial performance issues probably began abroad and migrated to the United States.[75] The United Kingdom has required advisory voting for shareholders since 2003.[76] Other countries, like Australia and the Netherlands, began to require firms to hold advisory votes on top executive pay in 2004.[77] In the United States, advisory voting began on a company-by-company basis. Beginning as early as 2006, shareholders began offering proposals at annual firm meetings to amend the bylaws to permit shareholder advisory votes.[78] Relatively high levels of shareholders voted to give shareholders say-on-pay. For instance, Thomas, Palmiter, and Cotter find that shareholder votes on whether shareholders should have a say on compensation receive broad support and are frequently approved by shareholders.[79] In fact, the topic of advisory voting eventually became the most oft-sponsored subject of shareholder proposals.[80]

In 2009, Congress responded. Congress mandated advisory votes for shareholders at firms receiving bailout funds under the Troubled Asset Relief Program (TARP).[81] A few months later, proponents of advisory voting secured a watershed victory with the financial services reform known as "Dodd-Frank." Dodd-Frank required all public companies to give shareholders periodic advisory votes on top executives pay levels.[82] In particular, Dodd-Frank provides that shareholders are entitled to an advisory (or nonbinding)[83] vote on the levels of executive compensation for

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376 (2007) (noting that in only 28.38% of cases did the incumbent board take action after a majority-supported shareholder proposal).

75. Thomas et al., *supra* note 20, at 1233 (noting that one of the goals of advisory voting is to "create a stronger relationship between 'pay and performance' and reduce the incidence of 'pay for failure'").

76. *Id.* at 1217.

77. *Id.* at 1227.

78. *Id.* at 1217. Of course, shareholder proposals related to advisory votes on pay to executives was only one type of shareholder proposals during this period. For instance, shareholders also made proposals that covered topics like disclosure of compensation and hard limits on the levels of executive compensation. *See* Thomas & Martin, *supra* note 1, at 1073 (noting several categories of shareholder pay proposals). For an example of the language of shareholder proposals regarding advisory voting, see Thomas et al., *supra* note 20, at 1219.

79. *See* Thomas et al., *supra* note 20, at 1238, 1240–42 (noting that "approve proposals" and shareholder-sponsored say-on-pay proposals received consistently high levels of support across the eight-year study period).

80. *Id.* at 1244.

81. *See generally* 12 U.S.C. § 5221(e) (2006) (providing that TARP recipients "shall permit a separate shareholder vote to approve the compensation of executives"); *see also* Thomas et al., *supra* note 20, at 1218.

82. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of 12 U.S.C.); *see also* WEBEL, *supra* note 28, at 3–21 (discussing various provisions of Dodd-Frank reforms).

83. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 951(c) ("The shareholder vote . . . shall not be binding on the issuer or the board of directors of an issuer, and

high-ranking employees.[84] In addition, Dodd-Frank provides that firms shall give shareholders a chance to vote on the frequency of say-on-pay votes. These "frequency votes" give shareholders a chance to say how often they want to have advisory votes—for instance, once every six months, once a year, or perhaps even less frequently. Third, Dodd-Frank requires firms to give shareholders an advisory vote on CEO exit compensation—golden parachutes, in certain circumstances. In the past, corporate executives were able to make tremendous sums from the firm as they made their exit.[85] These new advisory votes would be required beginning in 2011 for larger companies and 2013 for smaller ones.[86]

Supporters of the Dodd-Frank reforms argue the advisory votes are likely to incentivize managers to create pay packages that align manager and shareholder interests.[87] For instance, though the say-on-pay votes are nonbinding, the idea is that any significant level of no-votes will generate negative media attention, which may persuade directors into realigning their compensation schemes. Dodd-Frank will also have a second effect. Because of say-on-pay, firms will tend to scale back CEO pay on the front end because firms will be hesitant to propose large pay scales they will have to circulate to shareholders. In short, the point of Dodd-Frank (not to mention previous attempts at reforms like it) appears to be to tamp down too high and unwarranted CEO compensation, preserve firm resources, and improve firm value for shareholders.

Dodd-Frank's approach to advisory voting attempts to strike a balance between accountability and centralization. As to accountability, the votes, though not binding on the board of directors, are concrete evidence of shareholder dissatisfaction with firm leaders' performance. Even before Dodd-Frank, nonbinding voting was considered by several reformers as a way to hold corporate leaders accountable. For instance, Joseph Grundfest

may not be construed—(1) as overruling a decision by such issuer or board of directors; (2) to create or imply any change to the fiduciary duties of such issuer or board of directors; [or] (3) to create or imply any additional fiduciary duties for such issuer or board of directors . . . ."); Securities Exchange Act of 1934 § 14A(c) (codified as amended at 15 U.S.C. § 78(a) (2012)) (providing that the vote "shall not be binding on the issuer or the board of directors").

84. The SEC provides an example of the type of language firms should use. "RESOLVED, that the compensation paid to the company's named executive officers, as disclosed pursuant to Item 402 of Regulation S–K, including the Compensation Discussion and Analysis, compensation tables and narrative discussion is hereby APPROVED." *See* 17 C.F.R. § 240.14a–21a (2013).

85. *See* BEBCHUK & FRIED, *supra* note 1, at 134 (noting that severance payments were often as large as three years salary).

86. Shareholder Approval of Executive Compensation and Golden Parachute Compensation, 76 Fed. Reg. 22 (Feb. 2, 2011) (to be codified at 17 C.F.R. pts. 229, 240, 249); Dodd-Frank Wall Street Reform and Consumer Protection Act § 951; *see also* Thomas et al., *supra* note 20, at 1218; Securities Exchange Act § 14A(b).

87. *See, e.g.*, Lucian Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 GEO. L.J. 247, 276–77 (2010) (noting that shareholder advisory votes might reduce excessive, undeserved compensation arrangements).

famously argued that shareholders dissatisfied with the firm performance should "withhold" their vote for directors up for reelection.[88] Although these withhold campaigns would not be binding on the firm, Grundfest conjectured that the votes would express dissatisfaction and lead to changes in corporate governance.[89]

Additionally, since the votes are not binding on the boards of directors, they do not directly damage the principle of centralization of power. Even after an advisory vote expressing disfavor with the compensation schedule, the board of directors can modify compensation levels or ignore the vote altogether or even increase CEO compensation.[90] Predictably, the fact that boards of directors can ignore votes has been an easy target of critics.[91]

Perhaps as a consequence, the hopes for advisory voting were high. Proponents of advisory votes suggested that the new law would, among other things, "limit excessive risk taking,"[92] and "compel corporate boards to align pay with the corporation's financial performance."[93] According to one Treasury official at the time, advisory voting would "empower[] shareholders with the ability to have stronger oversight."[94] In fact some empirical evidence tended to bear out this optimism. For instance, Professor Jie Cai and Dr. Ralph Walkling found some positive market reaction as Congress made legislative progress on creating advisory votes for shareholders.[95] They reported that the market viewed positively the prospect of advisory voting at some firms—firms with signs of excessively high CEO compensation and poor corporate governance structures, namely.[96]

However, other evidence suggests that the cold reality is that advisory votes, like tax changes and disclosure reforms, turn out to be more a tempting mirage than oasis.[97] It should be noted at the outset that the evidence is hardly conclusive at this point, since Dodd-Frank's advisory voting scheme has not quite reached all firms. Nevertheless, the evidence

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88. *See* Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 865 (1993); *see also* Thomas & Martin, *supra* note 1, at 1053 (noting the symbolic success of "Just Vote No" campaigns).

89. Grundfest, *supra* note 88, at 866 (explaining that "vote no" campaigns might send a signal to management that shareholders are unhappy with the firm's performance). *But see* Cai & Walkling, *supra* note 1, at 306 (noting the general theory that there is little market impact from purely symbolic voting).

90. *See* Thomas et al., *supra* note 20, at 1220 (noting that boards, for a time, ignored shareholder proposals on advisory votes).

91. *See, e.g.*, Simmons, *supra* note 1, at 345 (arguing that say-on-pay may be feckless since the vote is nonbinding).

92. Thomas et al., *supra* note 20, at 1236.

93. *Id.* at 1235.

94. *Id.* at 1236.

95. *See* Cai & Walkling, *supra* note 1, at 314 (reporting positive market reaction).

96. *Id.* at 314, 324 (finding that say-on-pay creates some firm value).

97. See text accompanying notes 99–107.

so far indicates that shareholders rarely use advisory votes as a conduit for oversight. The evidence suggests that once shareholders actually get their say-on-pay, in the vast majority of cases, shareholders defer to management, approving whatever pay package management puts in front of them.

For instance, though there has been little research on firms under the recently approved Dodd-Frank mandate, there has been some research on the firms receiving TARP funds, since they were required to have their advisory voting much earlier. At these firms, the current reported findings are that shareholders approve management-recommended payment schemes in an overwhelming majority of cases.[98] For instance, Thomas, Palmiter, and Cotter found approval in 88.7% of their sampled cases.[99] They rightly noted that result surprising, since firm performance at those firms holding advisory votes was likely poor.[100] The sampled firms were, after all, firms that had been forced to ask for TARP bailout funds.[101] Yet, Thomas, Palmiter and Cotter found that when called to vote on pay packages, shareholder support frequently tops ninety percent and these pay packages were rarely rejected.[102] In explaining their findings, the authors concluded that shareholders appear "not too concerned about overall pay levels."[103]

Similarly, studies of the United Kingdom experience show that advisory voting has not necessarily led shareholders to take an active role in firm governance. According to Gordon, shareholders in the United Kingdom have approved virtually every pay package, only voting down pay packages in eight cases over roughly six years.[104] Gordon also noted that the advisory votes have not stopped the rate of pay increase.[105] Thus, as it turns out, advisory voting may not create the kind of oversight proponents had hoped for. Regardless of firm performance, in the vast majority of cases, shareholders have unceremoniously approved CEO compensation schedules. These preliminary findings make sense, as

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98. Pay packages are recommended by management and, in most cases, are endorsed by advisory firms, such as ISS. *See, e.g.*, Thomas et al., *supra* note 20, at 1244 (reporting that ISS endorsed 77.2% of management pay proposals).

99. Thomas et al., *supra* note 20, at 1224.

100. *Id.* (noting that the results were "interesting given that most mandatory say-on-pay votes in 2010 were held largely at financial firms receiving TARP money").

101. *Id.*

102. *Id.* at 1243 (noting that shareholder support for proposals asking for approval of executive pay packages "is extremely high—around 90% for 2008, 2009 and 2010—and only a small handful—three in 2010—did not receive majority support by shareholders"); *see also* Cai & Walkling, *supra* note 1, at 306 (explaining that advisory voting might have little impact since the voting is purely symbolic).

103. *Id.* at 1239.

104. *See* Gordon, *supra* note 1, at 341.

105. *Id.* at 324 (noting the increasing gap between pay for top executives and average line workers over the last five decades).

shareholders have weak incentives to spend time digesting and understanding executive compensation decisions.[106] For one thing, shareholders frequently have small stakes in individual firms and a fully diversified portfolio. For another, executive compensation plans typically only represent a small share of total firm spending. As such, how the CEO is paid will only affect shareholders' portfolios indirectly—and then only in a very small, almost imperceptible way.

Based on this early track record, there is little reason to be optimistic about Dodd-Frank as an accountability tool. In fact, some corporate law scholars, such as Thomas, Palmiter, and Cotter, have already begun to speculate that after Dodd-Frank, advisory votes are likely only to affirm management pay practices.[107] Thus, Dodd-Frank is not likely to empower shareholders, much less precipitate a shareholder revolt. In fact, one might argue that advisory voting has actually created *less* oversight for managers. For instance, one corporate law observer recently suggested that the advisory votes merely provide cover for managers with compensation packages that are undeserved and would otherwise be subject to criticism.[108] Managers can point to the vote results as evidence that their compensation package must be fair and that their job performance is, according to the vote, satisfactory. If not for advisory voting, some would argue that given lackluster performance, managers would have a tough time justifying pay packages to external watchdogs such as the media.

As to timing, advisory voting is similar to other reforms, particularly disclosure reforms. With advisory voting, shareholders make a prediction about how they expect the CEO to perform.[109] If the shareholders expect the CEO to do well, they might be happy to "approve" a lavish compensation package. If the shareholders expect the CEO to do poorly, they might vote the opposite. Either way, shareholders are making a reasonable guess about something that they previously had no opportunity to observe: the CEO's performance at the relevant firm.[110] Since shareholders have not directly observed the CEO's performance, it is

106. *See* Thomas & Martin, *supra* note 1, at 1034 (noting that shareholders have little incentive to invest time to understand compensation plans).

107. *See* Thomas et al., *supra* note 20, at 1244 (concluding that, based on the evidence of shareholder votes prior to Dodd-Frank, "we would project that management-sponsored say on pay after Dodd[-]Frank would be likely to attract high levels of shareholder support and that only a relatively small fraction of such proposals would likely fail to attract majority support").

108. Minor Myers, *The Perils of Shareholder Voting on Executive Compensation*, 36 DEL. J. CORP. L. 417, 436 (2011) (criticizing say-on-pay reforms by arguing that they diffuse responsibility for pay packages and insulate directors); *id.* ("While shareholders cannot be held responsible for initiating the compensation package, their approval can absorb some portion of future criticism. This potential consequence of shareholder voting on executive compensation has gone unnoticed.").

109. *Id.* at 422 (noting that advisory voting asks shareholders "to vote on—and legitimize—a compensation scheme before they can know whether it is outrageous in relation to the executive's future performance").

110. *See id.* at 449–50 (discussing timing of the say-on-pay vote).

difficult to evaluate whether the CEO is worth the compensation package.[111] Moreover, in contrast to previously mentioned reforms, one might also expect a relatively high and costly error rate associated with advisory voting. Shareholders will approve high compensation packages based on an expected performance that never pans out. They might also erroneously reject low compensation packages when the CEO's actual performance turns out to be stellar.[112] Thus, as a reform, advisory voting may be mistimed and costly—this approach to reform gets shareholders involved too early, before CEOs have actually performed.

II. AN *EX POST* APPROACH TO ACCOUNTABILITY

For years, scholars and regulators have argued about whether government should get involved in managerial failures; once involved, how government should respond to managerial failures; and, having responded, whether government reforms worked.[113] Based on the available evidence, previous attempts at holding executives accountable have generally failed.[114] One of the problems of previous reforms is largely in the mode of thinking. Previous reformers focused almost exclusively on *ex ante* checks on managerial misconduct: tax code changes that incentivize firms to create performance-based compensation plans; disclosure of compensation plans in hopes of empowering shareholders; advisory voting that gives shareholders a chance to express their opinion in matters of compensation. All of these reforms have at least one feature in common: They each seek to create accountability before the actual misconduct occurs. Put another way, previous reforms focused on creating incentives for good conduct, before any managerial conduct could be actually observed.

However, as shown, these types of reforms have generally failed. For instance, one of the problems with executive compensation is that it often

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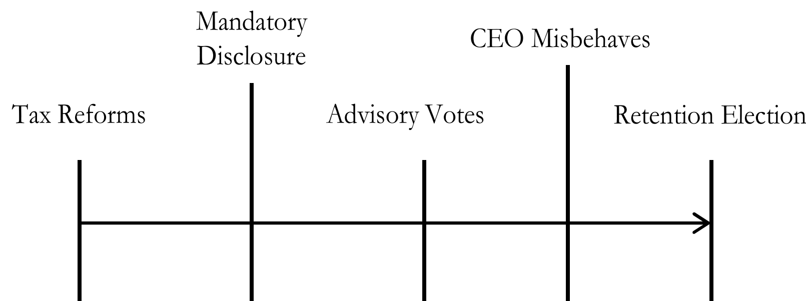
111. *Id.* at 449 (noting that shareholders are not in a position to "determine what constitutes 'good compensation' before the CEO has completed her term of service").

112. This might be costly, since the CEO might leave the firm.

113. On a theoretical level, according to some observers, executive compensation reforms have also failed. A general theoretical critique of these reforms made by some scholars is that the government should not be in the business of regulating executive compensation at all. In this view, executives at firms are not overpaid. Rather, their pay is a function of market forces. *See* Myers, *supra* note 108, at 424 (reviewing literature suggesting that "rising pay for CEOs and other executives is simply a function of the growing demand for their services"); Simmons, *supra* note 1, at 306 (suggesting that executive compensation reforms have failed as judged by the marked increase in executive compensation levels); Walker, *supra* note 41, at 439 ("The bottom line is that regulating the term of executive pay is no less challenging than regulating the amount and may not be worth undertaking.").

114. *See* BEBCHUK & FRIED, *supra* note 1, at 189 (noting that their research aims "to improve understanding of the problems that have plagued executive compensation" and arguing that "the problems of executive compensation can be fully addressed only by adopting reforms that would confront boards with a different set of incentives and constraints").

gives managers profound incentives to pursue short-term gains, such as a pop in the stock price, even though such gains may be fleeting or even detrimental to the firm's long-term health. What is stunning is that despite the failures of the current reform menu, current corporate scholars continue to propose more of the same. In response, scholars have not suggested that policy makers try shifting away from regulating executive compensation as the main strategy. Unimaginatively, instead they have suggested more fine-tuning to executive compensation reforms.[115] Thus, while well-intentioned, the previous set of reforms all relied on creating prospective incentives for managers to perform well, in particular through executive compensation. This Part attempts to shift the mode of thinking relating to reform and managerial accountability and, further, proposes erecting *ex post* accountability for managerial conduct. An *ex post* approach to accountability would focus on punitive responses to bad conduct after it occurs. That is, *ex post* reform would focus on how a punitive retrospective reform is better suited to manage managerial accountability. It is largely a question of timing. For instance, consider the illustration below.



The dividing line between *ex ante* and *ex post* approaches to accountability is CEO behavior. *Ex ante* approaches to accountability are activated before CEOs can demonstrate their capacity to lead. *Ex post* approaches to accountability empower stakeholders to do something after the CEO has performed and failed. Thus, *ex ante* reforms are hopeful; they imagine and hope for good conduct going forward, and they rely on the firepower of theoretical incentives. But *ex post* reforms are realistic; they exact punishment for bad conduct when it happens, and are based on observed conduct. Thus, this Article proposes a retrospective approach to drive managerial accountability. Specifically, periodic retention votes for

115. For instance, no less than the eminent Roberta Romano of Yale and Richard Posner of the Seventh Circuit have proposed recently that regulation of executive compensation should attempt to create incentives to pursue long-term firm value objectives, versus short-termism. *See* Bhagat & Romano, *supra* note 2, at 359 (proposing that long-term incentives will create executive accountability); Posner, *supra* note 1, at 1045–46 (suggesting a slate of reforms like broad disclosure and tax code changes).

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CEOs (and other high-ranking executives) are one *ex post* approach to creating managerial accountability. Retention votes are used in the public sphere all the time.

For example, in the public sphere, state court judges are frequently subject to an up–down vote by citizens. In a similar way, retention elections could be utilized in the private sphere. CEOs (and other high-ranking executives) would be subject to periodic up–down retention votes. Shareholders might get a say on whether these managers are retained. Importantly, also, retention elections have limits on the role of stakeholders in holding their agents accountable. Shareholders would not get a chance in deciding who ultimately is to become the executive officer. In fact, shareholders' opinion about CEO salary (say-on-pay) may become moot. This approach to accountability is comparable to how judicial elections in many states operate. In these states, the public does not have the initial say-so on who is appointed to the bench, nor, of course, their salary. Most judges are initially appointed, some through a nomination committee, much like the nomination committee that operates at many public companies.[116] But judges are subject to periodic retention elections. Thus, through retention elections, the selection process for executives would not change. Similarly, CEOs and other high-ranking executive officers would continue to be appointed by the board of directors.

A. *Retention in the Public Sphere*

An *ex post* approach to corporate accountability might be based on the approach many states have turned to for holding judges accountable: judicial retention elections. In the judicial setting, these retention elections have managed to balance two potentially competing objectives—giving citizens a chance to hold nonelected judges accountable, while protecting the independence of judges.[117]

1. Judicial Retention Votes

With at least eighteen states utilizing them, judicial retention elections are already the most popular method of imposing accountability on the judiciary.[118] However, judicial retention elections are only one of several

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116. Joseph A. Colquitt, *Rethinking Judicial Nominating Commissions: Independence, Accountability, and Public Support*, 34 FORDHAM URB. L.J. 73, 73 (2007) (noting that "most judges, even those in states utilizing judicial elections, initially take the bench through appointment").

117. *See* Laura Denvir Stith & Jeremy Root, *The Missouri Nonpartisan Court Plan: The Least Political Method of Selecting High Quality Judges*, 74 MO. L. REV. 711, 717 (2009) (noting that in retention elections held for judges, accountability and judicial independence go hand in hand).

118. *See* Michael S. Kang & Joanna M. Shepherd, *The Partisan Price of Justice: An Empirical Analysis of Campaign Contributions and Judicial Decisions*, 86 N.Y.U. L. REV. 69, 79 (2011) (noting widespread adoption of retention elections). In fact, some version of retention elections may

options states have utilized to select judges, including partisan elections and nonpartisan elections.[119] In partisan elections, judges run for office in much the same way as candidates for any other political office. They raise money, they run campaign commercials, and the major political parties endorse and help procure a victory. As seen in the chart below, eight states use partisan elections to select their judges.

State Supreme Court Selection by Retention			
State	Length of Probationary Term (if any)	Length of Full Term	Citation
Alaska	3 years	10 years	ALASKA CONST. art. IV, § 6.
Arizona	At least 2 years	6 years	*Methods of Judicial Selections: Arizona*, AM. JUDICATURE SOC'Y, http://www.judicialselection.us/judicial_selection/methods/selection_of_judges.cfm%20?state=AZ (last visited Oct. 16, 2013).
California	Up to 4 years	12 years	CAL. ELEC. CODE § 9083 (West 2013).
Colorado	At least 2 years	10 years	*Methods of Judicial Selections: Colorado*, AM. JUDICATURE SOC'Y, www.judicialselection.us/judicial_selection/methods/selection_of_judges.cfm?state=CO (last visited Oct. 16, 2013).
Florida	At least 1 year	6 years	*Methods of Judicial Selections: Florida*, AM. JUDICATURE SOC'Y, http://www.judicialselection.us/judicial_selection/methods/selection_of_judges.cfm?state=FL (last visited Oct. 16, 2013).
Illinois	N/A	10 years	ILL. CONST. art. VI, § 10.
Indiana	2 years	10 years	IND. CONST. art. VII, § 11.

be becoming more popular as states turn away from partisan elections. *Id.* at 127–28 (noting a movement toward retention elections in Nevada).

119. For a brief and accessible discussion of the main judicial selection methods and their historical origins, see Rachel Paine Caufield, *In the Wake of* White*: How States are Responding to* Republican Party of Minnesota v. White *and How Judicial Elections Are Changing*, 38 AKRON L. REV. 625, 626–29 (2005) (discussing the tension between the values of democratic accountability and judicial independence).

Iowa	1 year	8 years	IOWA CODE § 46.16 (2013).
Kansas	1 year	6 years	KAN. CONST. art. III, § 5 (c).
Maryland	1 year	10 years	MD. CONST. art. IV § 5A(c).
Missouri	1–3 years	12 years	MO. CONST. art. V, § 19; MO. CONST. art. V, § 25(C)(1).
Nebraska	3 years	6 years	NEB. CONST. art. V, § 21 (3).
New Mexico	Remainder of unexpired term	8 years	N.M. CONST. art. VI, § 33.
Oklahoma	1 year	6 years	OKLA. CONST. art. VII-B, § 5.
Pennsylvania	N/A	10 years	PA. CONST. art. V, § 15.
South Dakota	3 years	8 years	S.D. CONST. art. V, § 7.
Tennessee	Until the next general election at least 30 days after vacancy occurs	8 years	*Methods of Judicial Selections: Tennessee*, AM. JUDICATURE SOC'Y, http://www.judicialselection.us/judicial_selection/methods/selection_of_judges.cfm?state=TN (last visited Oct. 16 2013).
Utah	3 years	10 years	UTAH CONST. art. VIII, § 9.
Wyoming	At least 1 year	8 years	*Methods of Judicial Selections: Wyoming*, AM. JUDICATURE SOC'Y, http://www.judicialselection.us/judicial_selection/index.cfm?state=WY (last visited Oct. 16, 2013).

If the goal is to strike a good balance between accountability and judicial independence, partisan elections creates uneven results. On the one hand, partisan elections are compelling in terms of accountability. The upside of partisan elections for judicial officers, after all, is that judges are held accountable by popular will.[120] On the other hand, partisan elections for judges do a poor job of creating a basis for judicial independence. In partisan judicial elections, political parties, interest groups, and donors have an outsized influence on the electoral process, which could undermine judicial independence.[121]

120. *See* William K. Hall & Larry T. Aspin, *What Twenty Years of Judicial Retention Elections Have Told Us*, 70 JUDICATURE 340, 341 (1987) (discussing the influence of progressives and their interest in expanding voting rights in order to increase the accountability of public officials).

121. *Id.* at 341 (noting that reformers sought to change judicial selection method in order to "break the grip of the political machines on judicial selection"). *But see* Kang & Shepherd, *supra*

For instance, Professor Michael S. Kang and Professor Joanna M. Shepherd recently conducted an empirical analysis of the influence of campaign contributions on judicial decisions.[122] They reported that judges selected in partisan elections (as opposed to judicial selection through nonpartisan elections or retention elections) are more likely to support business interests in their decision making.[123] By contrast, the authors reported that judges that face retention election show no obvious bias in favor of business interests. In fact, the authors suggested that judges selected through the retention method are as independent as judges with lifetime tenure.[124] In short, in a job that calls for impartial justice, judges selected through methods such as partisan elections may be biased to support the causes of those who supported their candidacy for office.[125]

As a consequence, some states have introduced nonpartisan judicial elections. In these elections, judges also end up running for office, like other candidates. However, in an effort to remove the overly political nature of these elections, judges do not run under the banner of a political party. Thus, judicial candidates in nonpartisan elections are less likely to make the kind of campaign promises, receive benefits from parties and party loyalists, and, importantly, owe favors once the election is over. Nonpartisan elections remove some of the taint of ordinary politics from judicial elections and restore at least the prospect of judicial independence.[126]

However, nonpartisan judicial elections might do some damage in terms of accountability. An advantage of partisan elections is that they create opportunities for voters to have a say in judicial selection. If voters have little information about prospective judicial candidates, then their voting is under-informed or, worse, random. Party identification, or party label, is shorthand that helps citizens sort through candidates and make a (somewhat) informed selection. Thus, in nonpartisan elections, one could argue that voters are less likely to make informed decisions. Without the party label, voters may make decisions on the basis of things that are

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note 118, at 73–74, 120 n.186 (noting the potential benefits associated with partisan judicial selection methods).

122. *See* Kang & Shepherd, *supra* note 118, at 69 (testing the influence of campaign donations on judicial decision making).

123. *See id.* at 73 ("Campaign contributions from business groups are associated at statistically significant levels with judicial decisions for business interests *only under partisan elections*, but not under nonpartisan ones.").

124. *Id.* at 102 (reporting that "judges facing retention elections do not systematically vote differently from judges facing gubernatorial or legislative reappointment and judges with permanent tenure").

125. *See id.* (reporting that campaign contributions influence judicial decision making).

126. *See* Stith & Root, *supra* note 117, at 721 (noting, for instance, the outsized influence of political parties on elections in Missouri at the turn of the twentieth century). *But see* Dimino, *supra* note 22, at 805 (noting the importance of party label for informed voting).

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irrelevant. As seen in the table above, thirteen states use nonpartisan elections to select judges.

With these defects in mind, states began turning to judicial retention elections in 1940, beginning in Missouri.[127] In 1940, the state, through popular initiative, instituted a plan to select judges under what was called a "merit system."[128] By the 1960s, a significant number of states had adopted retention elections similar to Missouri's.[129] The merit system would usually have two important component parts.[130] The first part of the Missouri plan called for a judicial nominating commission to vet candidates for the judiciary and narrow the pool.[131] Once this was done, the governor would appoint a candidate from the pool.[132]

The second part of the plan gave voters a chance to vote on whether to retain the judge selected by the governor and nominating commission. In some states, these retention votes would take place soon after the initial appointment, as in a probationary vote, and much later, after the judicial officeholder had served a full term.[133] Voters would not get information about party affiliation and judges would not run against other candidates. Voters would simply be asked to vote on whether the incumbent judge should continue in office. The hope of reformers was that voters would cast their ballot based on the judges' record in office.[134] Thus, poorly performing judges would be ousted in retention elections. If a judge was ousted in a retention election, the judicial nominating commission would reconvene and appoint a replacement to the bench.[135] As mentioned, a plurality of states relies on judicial retention elections.[136] In the states that have them, judicial retention elections seem to strike a good balance between the twin goals of judicial independence and public

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127. For a detailed history of judicial elections, see generally Caleb Nelson, *A Re-Evaluation of Scholarly Explanations for the Rise of the Elective Judiciary in Antebellum America*, 37 AM. J. LEGAL HIST. 190 (1993) (explaining judicial elections beginning in 1832).

128. *See* Stith & Root, *supra* note 117, at 712.

129. *See* Hall & Aspin, *supra* note 120, at 340 (noting that judicial retention elections were used sparingly until the 1960s and 1970s).

130. *See* Kang & Shepherd, *supra* note 118, at 78 (discussing the Missouri plan).

131. *See* Hall & Aspin, *supra* note 120, at 341 (describing briefly the work of judicial nominating commissions).

132. *Id.*

133. *See, e.g.*, Stith & Root, *supra* note 117, at 725 (noting probationary votes in Missouri).

134. *See* Hall & Aspin, *supra* note 120, at 341 (noting that since judges run unopposed, voters would cast their ballots based "only on the record compiled [by the incumbent while] in office").

135. *Id.* at 341.

136. *See* Kang & Shepherd, *supra* note 118, at 79 (reporting that eighteen states rely on retention elections; fourteen states use nonpartisan elections; nine states appoint judges; six states use partisan elections; and three states give judges lifetime tenure); *see also* Brian T. Fitzpatrick, *The Politics of Merit Selection*, 74 MO. L. REV. 675, 678 (2009) (noting that merit selection, which usually features a retention vote, is "the most prevalent system of judicial selection in use in the United States today").

accountability.[137]

2. Independence

To begin with, one of the chief advantages of judicial retention elections is that they protect the independence of judges. The importance of judicial independence is straightforward enough. Judges should be free from public pressure that would make it hard to make tough, potentially unpopular decisions. Judges should feel emboldened to resist the will of the majority and protect the minority. Judicial independence can mean a great deal in the annals of history. Regarding the school desegregation trend beginning in the 1960s, one commentator has gone so far as to posit that judicial independence meant that judges were free to resist "racist threats and public hatred to integrate public schools."[138]

Retention elections appear to sustain judicial independence. Significantly, in those states that utilize judicial retention elections, judges generally run unopposed, do not raise money, and only face retention elections infrequently.[139] Because judicial retention elections do not have the usual features of a campaign, judicial candidates, once retained, owe few favors.[140] The U.S. Supreme Court held that judges who have to campaign for office can give off the sense of bias in favor of those who supported them.[141] However, with judicial retention elections, judges seem free from any whiff of bias in favor of those who supported them during the campaign.[142] Recent empirical evidence backs up these claims. In her study on how judicial decision making, Professor Shepherd reported virtually no evidence that judges who run in retention elections are biased in favor of political interest groups.[143] This is in contrast to stronger

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137. *See* Hall & Aspin, *supra* note 120, at 342 (noting the often conflicting goals of judicial independence and democratic accountability and the advent of judicial retention elections).

138. Shepherd, *supra* note 22, at 625.

139. *See* Kang & Shepherd, *supra* note 118, at 94 (noting that judges in retention elections are prohibited from campaigning); *see also* James J. Alfini & Terrence J. Brooks, *Ethical Constraints on Judicial Election Campaigns: A Review and Critique of Canon 7*, 77 KY. L.J. 671, 684 (1989) (noting the prohibition against campaigns in unopposed races, like retention elections).

140. *See* Stith & Root, *supra* note 117, at 736 (noting that in Missouri, retention elections sidestep partisan politics).

141. Caperton v. A.T. Massey Coal Co., 556 U.S. 868, 870 (2009) (observing that judicial independence is compromised "when a person with a personal stake in a particular case had a significant and disproportionate influence in placing the judge on the case by raising funds or directing the judge's election campaign"); *see also* N.Y. State Bd. of Elections v. Lopez Torres, 552 U.S. 196, 212 (2008) (Kennedy, J., concurring) (noting that partisan judicial elections raise the question of "whether that process is consistent with the perception and the reality of judicial independence").

142. *See* Stith & Root, *supra* note 117, at 740 (discussing the perception of bias associated with large campaign donations); *see also* Shepherd, *supra* note 22, at 680–81 (reporting that the absence of campaign donations in judicial retention elections removes bias).

143. *See* Shepherd, *supra* note 22, at 681 (noting that the "empirical results show that retention

findings by the same author that judges might bias their decision making following partisan elections.[144]

Also, since judicial candidates have little reason to build a campaign apparatus, successful judicial candidates have little incentive to ingratiate themselves to donors, political parties, interest groups, and others who might support campaigns in hopes of winning future elections. Recall that in the Kang and Shepherd study, the researchers concluded that partisan elections do a poor job of keeping judges independent.[145] In order to preserve independence, the authors recommended nonpartisan and retention elections since these elections do not rely on the usual features of campaigning.

Furthermore, judicial retention elections only occur infrequently. As a consequence, judges are not always making decisions weighed by the prospect of an intervening (and potentially career-ending) vote by the public.[146] For instance, in Missouri, the first state to adopt retention elections, Missouri Supreme Court justices face retention votes every twelve years.[147] In states that use them, the minimum is six years. The infrequency of the elections insulates judges from the risk of distraction associated with the prospect of removal.[148] Judges are empowered to make decisions free from excessive worry about future voter whimsy.[149] Thus, judicial retention elections seem specially suited to preserve the ability of judges to make decisions, even unpopular ones.

Finally, retention elections allow judges to maintain independence, since judicial officeholders can almost always expect to return to office. In fact, one researcher found that in retention elections, judge candidates are returned to office nearly ninety-nine percent of the time.[150] Another suggests that in fifty years of these elections around the country, only around fifty trial court judges have ever been ousted in retention

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politics have almost no influence on the voting of judges under merit plan systems”).

144. *Id.* at 662 (concluding that “to keep their jobs, judges in partisan election systems must appeal more to their retention agents than judges under other systems”).

145. *See* Kang & Shepherd, *supra* note 118, at 73 (reporting judicial bias in partisan elections).

146. *See generally* Abrahamson, *supra* note 24, at 981 (defining judicial independence as, partly, the ability to make decisions free from fear of interference from citizens).

147. *See* Stith & Root, *supra* note 117, at 726 n.70 (noting the length of terms for retention votes).

148. *See* Shepherd, *supra* note 22, at 634 (noting that long judicial terms are meant to “reduce any dangers of excessive popular influence”).

149. *See* Stith & Root, *supra* note 117, at 744 (arguing that a benefit of lengthy terms for a judge is avoiding “voter caprice”).

150. Hall & Aspin, *supra* note 120, at 343. By contrast, in partisan contested elections, judges are more often turned out, sometimes regularly turned out. *See, e.g.*, Shepherd, *supra* note 22, at 628 (noting that in more recent partisan elections incumbents lost approximately 45% of the time); Stith & Root, *supra* note 117, at 722 (noting that only twice were Supreme Court justices returned to office in Missouri in the two decades between 1920 and 1940).

elections.[151] One author found that judges in retention elections received on average about 77.2% of the vote to retain.[152] The infrequency of ouster is likely intentional in light of the historical perspective. It represents another of the many design features that states used to ensure that judges would be independent from the whims of voters.[153] The infrequency of ouster staves off regular upheaval in the judiciary and makes some level of consistency possible.[154]

3. Accountability

As mentioned, almost never has a judge been thrown out in a retention election. But the fact that few judges are recalled during a retention election is not necessarily a failure of accountability. For one thing, a low turnover rate could be a sign that nominating commissions are selecting high-quality judicial candidates, which would preclude any reason to turn out judges.[155] Regardless, retention votes still give constituents a voice in monitoring their elected officials. For instance, though judges are almost always returned to office, the cases where judges are not returned to office are particularly salient to court observers and are widely covered by the media.[156] Judges, one would expect, will want to avoid such a public embarrassment.[157] Thus, the presence of voting, even if voters seldom oust the officeholder, represents a credible monitoring function.[158]

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151. *See* Hall & Aspin, *supra* note 120, at 342.

152. *Id.* at 343 (discussing vote percentages to retain and defeat judges across 1,864 trial judge elections).

153. *See* Kang & Shepherd, *supra* note 118, at 78 (pointing out various historical features of judicial elections designed to maintain judicial independence).

154. *See* Stith & Root, *supra* note 117, at 725 (noting the value of consistency in the judiciary).

155. *See id.* at 745 (noting that judicial commissions select high-quality candidates and the vote merely confirms the wisdom of those choices).

156. *See id.* at 744 nn.141–42 (noting two examples of state supreme court judges losing retention elections); *see also* Abrahamson, *supra* note 24, at 986–87 (discussing the ouster of Tennessee Supreme Court Justice Penny White over her decision in a death penalty case, *State v. Odom*); Shepherd, *supra* note 22, at 625 (calling the ouster of California Supreme Court Justice Rose Bird over her decision in a death penalty case and other similar incidents "[t]ragedies").

157. *See* Kang & Shepherd, *supra* note 118, at 94 (noting empirical analyses that show that the prospect of elections, any kind of elections, incent judges to avoid unpopular decisions); Nelson, *supra* note 127, at 224 (noting that elections "keep judges honest once they reach[] the bench").

158. *See* Stith & Root, *supra* note 117, at 744 (arguing that retention elections serve as a final backstop and make it clear that "the people are in charge"). Incidentally, also, retention votes seem especially suited for informed voting, an important feature of accountability. Turnout in judicial retention elections is lower than for other electoral contests. *See* Hall & Aspin, *supra* note 120, at 342 (noting the low turnout rates). The lower turnout is usually associated with more informed voting, as uninformed voters are more likely to avoid voting, particularly on down-ballot races. Also, because judges run unopposed in retention elections, it means that judges need not worry too much about uninformed voting for a seriously unqualified candidate, a possibility that exists only when there is an alternative on the ballot. Furthermore, it is likely that the design features of retention elections help voters focus on substantive criteria when they cast their vote. In judicial

B. *Retention in the Private Sphere*

In the same way voters in many states get a retention vote on state judges, shareholders might be given an up–down vote on whether the CEO and perhaps other high-level executives are retained.

1. CEO Retention Votes

There is a range of options for implementing retention votes at public companies. For instance, retention votes might be modeled on early advisory voting reforms—that is, shareholder-sponsored proposals on a company-by-company basis. Before Dodd-Frank, shareholders at targeted firms submitted proposals to amend firm bylaws and create advisory votes. In some of these cases, these shareholder proposals were approved by a majority vote of shareholders and became part of the targeted corporation's corporate governance structure.

In a similar way, shareholders might propose a periodic shareholder vote on whether the CEO should be returned to office.[159] Shareholder proposals are virtually costless to their proponent, since corporations are required to disseminate shareholder proposals on the proponent's behalf.[160] Proposals are typically nonbinding on the corporation.[161] Thus, if shareholders in a retention vote approve an ouster, the board might be expected, but is not obligated, to follow shareholder wishes.[162] The shareholder-proposal approach to creating retention elections can be characterized as a "soft" regulatory approach. Firms are reformed, if at all, on a case-by-case basis after a shareholder–proponent pitches a proposal regarding retention votes and the proposal is approved by a majority of shareholders. Reform is piecemeal. Not all firms would be affected at once. The advantage of this approach is that reform can be specifically tailored to the needs of each firm. Firms can also learn from one another. Early adopters of the reform would serve as models for firms that adopt the

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retention elections, judicial candidates are typically prohibited from campaigning. In this way, voters likely make up their mind whether the judge has performed satisfactorily, not on the basis of whether the judge has a sufficient number of campaign commercials, or other irrelevant variables.

159. *See* 17 C.F.R. § 240.14a-8 (2012) (describing the procedure to make a shareholder proposal).

160. *See* Harris, *Shareholder Voting*, *supra* note 25, at 1770 (discussing shareholder proposals and noting that "[s]hareholders . . . can piggyback the firm's proxy statement at virtually no cost to the shareholder and present a proposal to the other members of the shareholder community").

161. One of the core features of the firm is the centralization of authority. As a consequence, shareholders are forbidden from introducing proposals that undermine the board's authority. Thus, securities regulations have been interpreted to only permit shareholder proposals that are advisory or nonbinding. *See* Stephen Choi, *Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms*, 16 J.L. ECON. & ORG. 233, 241 (2000) (reporting study results that show that shareholder proposals were almost always advisory).

162. *See* Thomas & Cotter, *supra* note 74, at 379 (reporting that the board took action with respect to advisory proposals in only twenty-five percent of sampled cases).

reform later. Later adopters might modify and improve the earlier models. However, broad reform might be a long, tedious slog, as reformers submit proposals to corporations one by one.[163]

Alternatively, corporations could be required by law to hold retention votes. This style of reform would be similar to the approach of Dodd-Frank on advisory voting, which, as mentioned, requires that all public companies hold advisory votes on compensation schemes.[164] This style of reform, where reform is required by law and broadly applicable, might be referred to as a "hard" regulatory approach. In contrast to the shareholder proposal approach, arguably the most important advantage of this regulatory approach is that the reform would apply to all corporations at once. On the other hand, a disadvantage of a Dodd-Frank-style approach to retention elections is that this approach eliminates opportunities to learn and make adjustments. Shareholder proposals can be analogized to a pilot program wherein, through successive iterations at one firm at a time, reformers might get a chance to observe what works and make changes. Also, hard regulatory reform would require intervention from lawmakers, which creates the potential for unpredictable outcomes and depends on the reform's political appeal. A soft approach, by contrast, does not depend completely on the political appeal of the reform, since any shareholder may make a proposal to adopt retention elections at any corporation in any given year.[165]

2. Independence

One advantage of retention elections for firms is that this reform would not unduly undermine the ability of directors and executives to make decisions and take risks. Corporate law scholars agree that business leaders should be independent of influences that would chill decision making.[166] Recall that in the judicial sphere, independence means that judges should be free to resist the will of the majority in the interests of justice.[167]

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163. Further, it is uncertain whether shareholders at each firm would approve these proposals, which might require proponents to return a second year, extending their slog.

164. *See* Thomas et al., *supra* note 20, at 1218.

165. However, a disadvantage of a case-by-case approach is that the process of selecting the individual cases may be co-opted by special interest groups. This could lead to misidentification of potential targets for reform. Consider, for instance, case-by-case targeting with respect to shareholder-sponsored proposals regarding say-on-pay. The firms that ended up being targets, according to one study, were not necessarily the firms that would benefit from reforms—e.g., firms that had excessive pay structures or weak corporate governance reforms. Instead, the firms that ended up being targeted were simply large, high-profile firms. *See* Cai & Walkling, *supra* note 1, at 329 (reporting that the "primary factor driving the decision to target these firms appears to be their large size" and noting that labor unions were frequent sponsors of proposals on say-on-pay); *id.* (reporting a negative market reaction to proposals sponsored by labor unions regarding say-on-pay).

166. HARRIS, *supra* note 71, at 129–32 (describing the powers of the board of directors).

167. *See*, *e.g.*, Shepherd, *supra* note 22, at 625 (noting that it is an "assumed truth" that judges

Corporate leaders should be able to lead into new markets, make changes in personnel, and devote time to refining their product without undue second-guessing. Freedom to take risks and make tough decisions is one of the keystones of centralized authority and the core rationale for the corporate form in the first place.

On the face of the matter, if implemented, retention votes would represent an important new power to shareholders.[168] Importantly, however, retention elections would not significantly damage corporate leaders' ability to make tough decisions. In fact, retention votes would be generally consistent with the emphasis on the board's central authority. By comparison, in judicial retention elections, voters do not get to select who is appointed to the bench—only who stays. Recall that, like in the corporate sphere, in many jurisdictions a central authority selects judges. The judicial nomination commission (along with the state governor) retains that power. Similarly, retention elections for firm executives would continue to rely heavily on the board of directors. The board of directors would continue to select the firm's CEO and other high-ranking executives, as is currently the case. When it comes to the selection process, the status quo would be preserved. Significantly, also, in the event that the CEO or other executive is ousted in a retention election, the board of directors would select their replacement.

A related potential criticism of retention elections is that they take the power to remove a CEO away from the board of directors. As power is stripped from the board of directors, it undermines centralized management, one of the core tenants of corporate law.[169] However, according to recent analyses, the board rarely uses this power.[170] Currently CEOs (and likely other high-ranking officials) retain their office for significant periods of time, even in the face of middling performance.[171] In one recent study, researchers found that just over two percent (2.25%) of CEOs are terminated in a given year.[172] Thus, nearly ninety-eight percent

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should be protected from public influence).

168. *See* Thomas et al., *supra* note 20, at 1228–29 (discussing the view that enhancing shareholder voting power might undermine board authority).

169. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 121–122 (West 2013) (providing the general and specific powers of the board); *id.* § 141(a) (providing that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors"); MODEL BUS. CORP. ACT § 8.01(b) (2012) (providing that power resides with the board of directors).

170. *See generally* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 240 (1990) (reporting sample results that show that CEOs hold their jobs for over ten years, on average, and that most leave at retirement age). However, the trend may be changing slightly. *See* Bebchuk et al., *supra* note 18, at 773 (discussing findings that outside-director dominated boards are more apt to terminate a CEO).

171. *See, e.g.*, Posner, *supra* note 1, at 1022 (noting that there is greater CEO turnover in Europe than at U.S. firms).

172. Dirk Jenter & Fadi Kanaan, CEO Turnover and Relative Performance Evaluation 1, tbl.1 (Aug. 2010) (unpublished manuscript) (on file with Stanford University), *available at*

of CEOs are retained. According to other research, average CEO tenure is between six and seven years.[173] Also, there is no reason board action should operate as the exclusive method for removing a CEO. The power of removal would simply be shared. In other words, shareholders might remove a lackluster CEO, but so might the board of directors. Thus, executive retention elections would continue to preserve the power of the board of directors to make executive appointments and thus reaffirms the importance of the board's authority and the notion of centralized authority.

Furthermore, retention votes, if implemented, would preserve the authority of executives to make tough decisions. Again, consider the analogy to judicial retention elections. In the public sphere, voters have the power to oust underperforming judges. However, they rarely do it. In the vast majority of cases, judges can expect to return to office.[174] One might expect the same thing to be true of CEO retention elections. One would expect that shareholders would only rarely use the power to oust through retention elections. Thus, though the proposed CEO retention elections would give shareholders a way to remove some of these underperformers, it is unlikely they would exercise this option very often. Absent rare cases of particularly slipshod performances, CEOs and other executives who might be subject to retention elections can expect to be returned to office. The peace of mind associated with the high probability that they will be returned to office will likely translate into wide latitude to make tough decisions.

Incidentally, also, other design features along the model of judicial retention elections could also be used in the private sphere in order to ensure CEOs' ability to remain independent and comfortable enough to make tough decisions. Recall that another design feature of judicial retention elections was their infrequency. The infrequency of the elections insulates judges from the risk of distraction associated with the prospect of an imminent vote for removal.[175] Similarly, CEO retention elections should

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http://www.stanford.edu/~djenter/CEO_Turnover_and_RPE_August_2010.pdf (finding 383 forced departures across 16,865 firm-year observations). *See generally* Lucian Bebchuk & Yaniv Grinstein, *The Growth of Executive Pay*, 21 OXFORD REV. ECON. POL'Y 283, 299 (2005) (noting that "even though the incidence of executive firing increased a bit, the risk of being fired remained quite small, hardly one that needs to be made up by a sharp increase in pay").

173. *See* Steven N. Kaplan & Bernadette A. Minton, *How Has CEO Turnover Changed?*, 12 INT'L REV. FIN. 57, 57 (2012) (reporting that annual CEO turnover was 15.8% from 1992 to 2007, which suggests an average tenure as CEO of less than seven years).

174. Hall & Aspin, *supra* note 120, at 343–44 (reporting that only twenty-two judges were defeated in 1,864 retention elections). By contrast, in partisan contested elections, judges are turned out more often, sometimes regularly turned out. *See, e.g.*, Shepherd, *supra* note 22, at 628 (noting that in more recent partisan elections, incumbents lost approximately forty-five percent of the time); Stith & Root, *supra* note 117, at 722 (noting that only twice were Missouri Supreme Court justices returned to office in the two decades between 1920 and 1940).

175. *See* Shepherd, *supra* note 22, at 634 (noting that long judicial terms are meant to "reduce any dangers of excessive popular influence").

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only be held infrequently. For instance, retention elections might be crafted to only occur from time to time after a triggering event, similar to how firm special meetings are already structured. Generally, a larger shareholder or group of shareholders (e.g., greater than ten percent) or the board of directors may call a special meeting.[176] By holding these votes infrequently, CEOs (and other firm leaders who are subject to retention) would have more leeway to make tough decisions, without the constant worry about the prospect of a potentially career-ending vote. In sum, retention votes offer at least two considerable benefits to independence. On the one hand, retention elections for the most part preserve independence, as most executives would have little to fear in terms of ouster. On the other hand, a move to retention elections would not upend the normal dynamics of corporate governance or the power of the board, since the board retains the power to make appointments.

3. Accountability

Another advantage of this reform is that retention elections create some level of accountability. As mentioned, it is likely that retention elections will rarely result in an ouster of executives. Yet the presence of retention elections still creates a check on CEO misconduct.

Recall that very few judges have been thrown out in retention elections. Given the low rates of turnover for CEOs in corporate firms, it is also unlikely that retention elections will result in much turnover. However, the turnover that does occur might increase firm value. Similarly, in a previous study, Professor David Ikenberry and Professor Josef Lakonishok found that turnover in firm leadership after a proxy contest reduced declines to firm value.[177] In another study, Professor Michael S. Weisbach found positive stock market reaction to announced CEO resignations.[178] Though it is largely an empirical question that goes beyond the scope of this Article, it stands to reason that the threat of turnover of other firm leaders through retention votes might also translate into firm improvements.

Further, like with judicial retention elections, the circumstances surrounding an ouster are likely to be powerfully vivid in the minds of

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176. *See* MODEL BUS. CORP. ACT § 7.02 (2012) (setting out requirement for special meetings).

177. It is worth noting that dissident victory after a proxy contest does not automatically lead to improvements in firm value. In fact, in some cases, dissident victory may presage negative returns. However, previous scholarship has noted that dissident victory, along with management turnover, improves dissident prospects for success. For instance, in some of these cases, the dissidents are able to markedly reduce the negative returns that can sometimes be associated with dissident victory. *See* David Ikenberry & Josef Lakonishok, *Corporate Governance Through the Proxy Contest: Evidence and Implications*, 66 J. BUS. 405, 424 (1993) (finding that dissident victories in proxy contests, in combination with management turnover, reduces the negative abnormal return normally associated with dissident victory).

178. *See* Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 456–57 (1988) (finding positive excess returns surrounding announcements of CEO resignations).

CEOs, particularly since both judges and CEOs value reputation. In fact, the circumstances of an ouster might be even more vivid in the case of CEOs.[179] For background, consider that cash incentives are not the only thing that makes being a CEO a desirable occupation. There is also prestige that flows from running a large company. CEOs, for instance, get to play a significant role in hiring others as top-level executives, serve as prominent members of the local community, and serve as important figures in the industry.[180] In fact, for some (although admittedly not all), the prestige of running a public company may be the most important motivation, even more important than the money.

Retention elections create accountability because they interact with prestige and reputation. A failure to be retained harms an executive's reputation. As mentioned, CEOs are rarely terminated and, even when they are fired, CEOs are able to preserve their public reputation. When CEOs are terminated, they are often allowed to gracefully exit the firm.[181] They are almost always given a seat on the board of directors[182] and a large severance package,[183] and the departure is referred to as a "retirement."[184] As such, dismissed CEOs preserve their reputation and may be able to find jobs elsewhere in the industry. Since public firings happen so rarely, a failure to win a retention vote can have new consequences. A failure to retain does not simply mean that the CEO loses one job—it may ruin reputation and mean that the CEO has to exit the industry altogether. Thus, another benefit of a retrospective response is that CEO retention elections create a way for shareholders to tap into the non-cash (reputational) incentives of leading a large U.S. public company. Thus, one would expect that presence of voting will have some positive incentive effects. CEOs and other executives subject to a vote will want to avoid public

179. By comparison, one commentator has said corporate directors are "the most reputationally sensitive people in the world." David A. Skeel, Jr., *Shaming in Corporate Law*, 149 U. PA. L. REV. 1811, 1812 (2001) (quoting Interview with Nell Minow, Editor, The Corporate Library, in Washington D.C. (Oct. 25, 2000)).

180. *See* Posner, *supra* note 1, at 1021 (noting briefly that power can serve as "a source of nonpecuniary income"); *id.* at 1031 (discussing non-cash benefits of being an American CEO).

181. *See* Jenter & Kanaan, *supra* note 172, at 10 (noting that "CEOs are rarely openly fired from their positions," which means that any study of CEO departures must be extremely careful); Weisbach, *supra* note 178, at 437–38 (finding that in only nine of 286 cases of "resignations" was performance mentioned as a reason, and noting that firms conceal the real reasons for CEO terminations).

182. *See* Jensen & Murphy, *supra* note 170, at 240 (reporting that the vast majority of exiting CEOs, eighty percent, remain on the board of directors and more than a third serve as chairman of the board).

183. *See* Posner, *supra* note 1, at 1027 (discussing severance payments); *see also* Bebchuk et al., *supra* note 18, at 760, 834–35 (noting payout related to acquisition transactions and discussing gratuitous payments to executives for facilitating acquisition transactions).

184. *See* Weisbach, *supra* note 178, at 439 (finding that a significant share of CEO changes are, allegedly, for retirement, while only a handful of changes are for performance-related reasons).

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embarrassment, even if the chances of that event are slim.

Incidentally, retention votes seem especially suited for informed voting, an important feature of accountability. In the judicial context, turnout in retention elections is lower than for other electoral contests.[185] The lower turnout is usually associated with more informed voting, as uninformed voters are more likely to avoid voting, particularly on down-ballot races. Also, because judges run unopposed in retention elections, it means that judges need not worry too much about uninformed voting for a seriously unqualified candidate, a possibility that exists only when there is an alternative on the ballot. Furthermore, it is likely that the design features of retention elections help voters focus on substantive criteria when they cast their vote. In judicial retention elections, judicial candidates are typically prohibited from campaigning.[186] In this way, voters likely make up their mind whether the judge has performed satisfactorily, not on the basis of whether the judge has a sufficient number of campaign commercials or other irrelevant variables.[187]

III. Other Benefits of an *Ex Post* Approach to Accountability

CEO retention elections are a good response to the deep disadvantages associated with trying to put a value on CEO performance before CEO performance can be observed. For instance, recall advisory voting. With advisory voting, shareholders make a reasonable guess about something that they have not had an opportunity to observe—the CEO's performance at the relevant firm.[188] Thus, advisory votes are mistimed. Shareholders are asked to vote on expected performance, rather actual performance. As a consequence, one might expect a relatively high error rate associated with this style of reform. Shareholders will often approve high compensation packages based on an expected performance that turns out to be subpar. On the other hand, shareholders might reject a compensation scheme when the CEO's performance turns out to merit it. By contrast, CEO retention votes capture the right moment in time. CEO retention votes would come *after* shareholders have had a chance to evaluate and weigh CEO performance. Shareholders will have ready facts to make this determination. It is reasonable to intuit that the likelihood of error would be lower. After all, with retention elections, shareholders are not asked to predict the future.

A. *Political Appeal*

Another potential advantage of retention elections relates to their

185. *See* Hall & Aspin, *supra* note 120, at 344 tbl.2 (noting the low turnout rates).

186. Kang & Shepherd, *supra* note 118, at 94 (citing Alfini & Brooks, *supra* note 139, at 684–85).

187. *Id.* at 87 (noting the importance of campaign commercials on election results in competitive (non-retention) judicial elections).

188. *See* Myers, *supra* note 108, at 449 (noting timing issues in advisory voting).

political appeal. On the face of the matter, retention elections for judicial candidates were created precisely because they gave voters what they wanted—a role to play in judicial selection.[189] Similarly, the prospect of voting in retention elections is likely to be popular as these elections give shareholders a role in CEO selection.

Furthermore, a retention election scheme matches up well with the kinds of reforms already popular among some shareholders. Consider for instance the most recent changes to director elections such as the shift to majority-voting rules.[190] The vast majority of directors run opposed. In fact, in a previous study, the author reported that out of thousands of director elections each year, directors faced opposition in about three dozen contests.[191] Because they run unopposed, at many firms the directors are reelected regardless of whether most shareholders are satisfied with their performance and regardless of how many votes are cast for the director. This is a consequence of plurality voting, which is the traditional voting scheme at most firms.[192] Under plurality voting, a director who runs unopposed is reelected when at least one vote is cast for that director.[193] Thus, even if the vast majority of votes are cast "no," a director is reelected with a single vote.[194] In a technical sense, the director received more votes than any other candidate—after all, there was no other candidate.

However, firms are increasingly updating their voting schemes to provide that directors that fail to receive a majority of the votes cast should offer their resignation. The move toward majority-voting rules for director elections has been something of a cause célèbre for shareholders, some states, and progressive corporate law observers.[195] At these firms, directors still run unopposed. However, if a majority of shares are cast "no," then the director agrees to resign. At these firms, therefore, director elections have

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189. *See, e.g.*, Shepherd, *supra* note 22, at 681 (noting briefly the political appeal of an accountability model that features elections of judges).

190. *See* William K. Sjostrom, Jr. & Young Sang Kim, *Majority Voting for the Election of Directors*, 40 CONN. L. REV. 459, 463 (2007) (examining majority-voting rules at 371 public companies); *see also* Jonathan R. Macey, *Too Many Notes and Not Enough Votes: Lucian Bebchuk and Emperor Joseph II Kvetch About Contested Director Elections and Mozart's Seraglio*, 93 VA. L. REV. 759, 765 n.21 (2007) (describing voting rules).

191. Lee Harris, *Missing in Activism: Retail Investor Absence in Corporate Elections*, 2010 COLUM. BUS. L. REV. 104, 120–21 (reporting the overall number of challenges over a ten-year period from 1999–2008).

192. *See, e.g.*, DEL. CODE ANN. tit. 8, § 216(3) (West 2013) (providing that "[d]irectors shall be elected by a plurality of the votes").

193. *See* Thompson & Edelman, *supra* note 21, at 138 n.31 (discussing the default rule of plurality voting); *see also* Harris, *Shareholder Voting*, *supra* note 25, at 1763 n.5 (explaining plurality voting).

194. *See* Harris, *supra* note 191, at 140–41 n.117.

195. *See* Thompson & Edelman, *supra* note 21, at 138 n.31 (noting that firms are under "sustained pressure from institutional shareholders" to adopt majority voting rules); *see also* Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 OHIO ST. L.J. 53, 61–70 (2008).

become, for all practical purposes, retention elections. Directors run unopposed and, if a majority of votes are not cast for the director, the director's relationship with the firm ends. This is exactly what is anticipated with retention elections—firm leaders would run unopposed and have to garner a majority of votes cast in order to be retained. Again, changes along a similar track with director elections have been relatively popular among shareholders and increasingly popular among firm boards. Thus, inferring from what we see in director elections, a functionally equivalent scheme for executives and high-ranking managers might be well-positioned to generate support among firm stakeholders.

B. *Practical Appeal*

A second benefit of retention elections relates to their practical appeal. For one thing, implementing retention elections does not require complicated rulemaking like the rules associated with other forms of shareholder voting. Recall that in judicial retention elections, the candidates are not permitted to campaign for votes. Judge candidates can neither raise money from outside interests nor spend their own. They make no appeals to voters through television, radio, or any pitch whatsoever. This means that retention elections are low-key affairs. The system is easy to organize and eliminates the need for the usual campaign-related rules surrounding fundraising, solicitations, and disputes that invariably arise over whether such rules were followed. For instance, in judicial retention elections, since there is no fundraising, candidates need not worry about donation limits and regulators need not worry about the content of campaign advertisements. In the corporate sphere, this aspect of retention elections would mean that an elaborate apparatus to regulate the campaign process would be unnecessary. As it stands now in the corporate sphere, director elections have led to a raft of complicated "solicitation" rules. Candidates for director seats, for example, cannot attempt to influence the shareholder vote without filing a complicated, lengthy disclosure document and following other strict solicitation rules. However, the intricate rules related to the soliciting of shareholder votes would seem unnecessary with retention elections.

Additionally, because retention elections do not depend on an opponent, the scheme is far less complicated than other frequently touted reforms designed to hold firm leaders accountable to shareholders, such as so-called proxy access. Proxy access is perhaps the most often debated reform for ensuring that shareholders have a way to hold firm leaders accountable.[196] Through proxy access, firms would help facilitate

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196. *See, e.g.*, Cynthia J. Campbell et al., *Current Perspectives on Shareholder Proposals: Lessons from the 1997 Proxy Season*, 28 FIN. MGMT. 89, 90 (1999) (noting that the SEC received a large number of public comment letters in response to proposed rule changes related to proxy access); Joseph A. Grundfest, *The SEC's Proposed Proxy Access Rules: Politics, Economics, and*

shareholder nominations to the board of directors. When the ballots or proxy cards are sent to those eligible to vote in director elections, firms would be required to include shareholders' nominees to the board alongside the incumbent nominees. If shareholders are able to make nominations to the board using the firm's proxy, they will be able to run shareholder challengers for board seats at little cost.

Yet, for proxy access to be successful, disenchanted shareholders have to find a challenger to run against the current slate of directors. This task is challenging. Many shareholders, particularly institutional shareholders, which represent the lion's share of the shareholder community, want to have a voice in firm operations, but want to stay relatively passive.[197] In proxy contests, as it turns out, these shareholders are willing to vote "no" against directors that they have not measured up, but they are unwilling to field their own nominees for board seats.[198] In fact, proxy access may be too blunt of an instrument for other reasons as well. If the status quo persists, the only way shareholders could accomplish the ouster of the CEO is by launching a contest to replace the board of directors and hoping that a newly installed board replaces the CEO. However, shareholders may not be inclined to call for the ouster of the board of directors. Shareholders may view the real problem as the CEO. Retention elections give them a conduit to make this change. Thus, retention elections create a more targeted solution than the current reform ideas, like proxy access. Because retention elections do not depend on shareholders fielding an opponent and taking an active role in firm operations or seeking the ouster of the board, retention elections are simpler. Retention elections sync well with the more passive role many shareholders want to play. Shareholders dissatisfied with the firm leadership need only vote "no" in corporate governance. They need not also launch a daunting proxy challenge.[199]

Finally, in some regards retention elections are better suited to accountability than schemes hinged to executive compensation such as advisory voting. When it comes to advisory voting, some shareholders use

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the Law, 65 BUS. LAW. 361, 386 (2010) (same); *see also* Harris, *Shareholder Voting*, *supra* note 25, at 1803–07 (summarizing the debate over proxy access).

197. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 876 n.91 (2005) (noting the disinclination of some investors to get involved with activism); *see also* Harris, *Shareholder Campaign Funds*, *supra* note 25, at 201 (discussing the passiveness of some institutional investors).

198. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 691 (2007) (remarking that "[r]unning a contest that demands . . . time and attention . . . does not sit well [with some investors]").

199. Incidentally, retention elections might sidestep the need for proxy access in the first place. That is, through retention elections, shareholders may have less desire to nominate alternatives to the board of directors. They might be content to rest on their ability to vote to recall poor-performing executives. Thus, retention elections relieve some of the pressure to push for proxy access.

those votes as an opportunity to vent frustration rather than assess performance. That is, some shareholder voters will use an advisory vote as a way to vent their frustration with high executive salaries, the politics du jour, without giving fair appreciation to managerial performance or the scarcity of managerial talent.[200] In other words, many will disapprove of high executive compensation, regardless of performance. They may do it because they believe high executive pay to be inequitable or un-American.[201]

However, with retention elections, shareholders might be more likely to turn their attention to performance issues. They are less likely to vote based on the politics of the moment, as with advisory voting. In a retention election, voters will not face the politically loaded issues of considering the appropriateness of a compensation schedule. From the perspective of some small segment of the shareholder population, the CEO's salary is always objectionable. Thus, these votes are disconnected from the CEO's performance. By contrast, with retention elections, shareholders will be asked to consider whether the executive is a good choice. To be sure, it is possible that some level of voters will still use this as an opportunity to be contrarian and vent frustration. Yet, the reframing of the question to target whether the CEO should remain in office likely trains the attention of the voter on the CEO's performance, rather than force more ideologically loaded questions regarding whether the CEO is too wealthy.

It is worth mentioning also that retention elections are flexible enough to deal with the unique circumstances of individual firms. Importantly, this reform proposes that firms be required to give shareholders a vote on whether the CEO is retained, but firms, at their discretion, can do significantly more using the same model. Firms might expand retention

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200. *See* Posner, *supra* note 1, at 1015 (noting two ways to define excessive compensation, but dismissing the concept of a just reward, "a concept that might be based for example on notions of an acceptable ratio between the compensation of the highest-paid and lowest-paid worker in an organization"). In fact, the unfairness rationale, not necessarily performance, has been the cause célèbre of many elected officials. For instance, President Obama, without making a qualification regarding performance, called Wall Street bonuses "shameful." Aaron Lucchetti & Matthew Karnitschnig, *On Street, New Reality on Pay Sets In*, WALL ST. J. (Jan. 31, 2009), http://online.wsj.com/article/SB123336341862935387.html; *see also* Kenneth R. Bazinet et al., *President Obama Caps Executive Compensation Limits at $500K for Firms Receiving Bailout Funds*, N.Y. DAILY NEWS (Feb. 4, 2009), http://www.nydailynews.com/news/politics/president-obama-caps-executive-compensation-limits-500k-firms-receiving-bailout-funds-article-1.388379 (reporting that on the topic of executive compensation, President Obama was the "shamer in chief"); Thomas McCarroll, *Executive Pay*, TIME (June 24, 2001), http://www.time.com/time/magazine/article/0,9171,159544,00.html (calling executive compensation reform "a populist issue that no politician can resist").

201. *See* Brian J. Hall & Kevin J. Murphy, *The Trouble with Stock Options*, 17 J. ECON. PERSP. 49, 63 (2003) (reporting that the average CEO of an S&P 500 firm made about thirty times the pay of the average production worker in 1970, but made about 360 times the pay of the average production worker by 2002).

elections to include other leaders and executive officers at the firm, like the CFO or general counsel. For instance, when tax code reforms, previously discussed, were implemented, the reforms referred to the firm's top five highest paid executives.[202] Similarly, some firms might expand retention votes to include other officers and high-ranking executives of the firm, not just the firm's CEO. Incidentally, firms may also amplify the penalties associated with retention votes. It is easy to imagine, for instance, that a retention vote to oust a CEO (or other leader) can be categorized as terminations "for cause." If a failure of a retention vote was classified as for-cause termination, it would give some firms a legal basis for avoiding paying the departing CEO (or other executive) expensive severance payments, golden parachutes, and other exit benefits.

IV. ALTERNATIVE *EX POST* APPROACHES TO ACCOUNTABILITY

Retention elections are not the only way to create *ex post* accountability for CEOs and other executives. In fact, there are already other mechanisms that hold CEOs and other executives accountable for misconduct. Executives at firms are held in check by already existing internal and external monitoring mechanisms, some of these to be considered in this Part. As for internal controls, the board of directors already has the power to remove ineffective officers like the firm's CEO. Shareholders also have indirect powers to influence executive conduct. Shareholders can vote for members of the board of directors and they can also file suit. Also, in theory, takeover markets serve as a check on CEO misconduct. That is, firms that are mismanaged become ripe for a takeover attempt and give rise to the specter that new owners will come in with plans to sack the underperforming managers. However, each of these existing checks on managerial abuse is ineffective, as discussed in more detail below.

A. *Internal Accountability*

The board of directors is one of the internal methods of checking CEO performance after misconduct has occurred.

1. Board of Directors

If the board acts as expected, additional corporate governance reforms are unnecessary and boards of directors would hold executives accountable.[203] If, based on observed performance, the CEO is paid too much, the board of directors would reduce compensation. Shareholders

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202. *See* 26 U.S.C. § 162(m)(3)(A)–(B) (2012) (applying the excessive remuneration provision to the "chief executive officer" and "the 4 highest compensated officers for the taxable year (other than the chief executive officer)").

203. *See* Weisbach, *supra* note 178, at 431 (describing boards as internal monitors of managers, at least in theory).

would not need an opportunity to "advise" on compensation packages or even vote on retention. More to the point, the board of directors might simply fire a CEO who underperforms relative to his or her peer group.[204] If boards of directors could be expected to live up to their responsibility, there would be little need for any reform.

In fact, the data suggests that, over time, the board of directors have all the features of an increasingly effective monitoring body.[205] First, the boards of directors of public companies have become smaller, and smaller boards tend to be more effective.[206] Median board size has decreased from fourteen in the late 1980s to twelve by the 1990s.[207] Second, boards have become increasingly populated by outsiders.[208] Again, this feature of board structure seems to also be correlated positively with the board's monitoring ability.[209] As the number of outside directors on the board increases, the

204. *See* Jenter & Kanaan, *supra* note 172, at 1–2 (discussing the predominant theoretical models on the CEO dismissal decision and stating that "[i]f the board's assessment of CEO quality falls below some threshold, often equal to the expected quality of a replacement, then the board dismisses the CEO").

205. *See* Hall & Murphy, *supra* note 201, at 65 ("Although corporate governance can surely improve further, changes over the last decade have strengthened board governance and seem inconsistent with an increased ability of executives to extract rents from captive boards.").

206. *See* Bebchuk & Fried, *supra* note 1, at 77 (discussing previous research finding that larger boards are less effective); Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233, 247 tbl.4 (2002) (reporting findings that show a negative relationship between board size and several firm's performance measures); Hall & Murphy, *supra* note 201, at 65; *see also* Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 865 (1993) (arguing that smaller boards are effective at monitoring the CEO); David Yermack, *Higher Market Valuation of Companies with a Small Board of Directors*, 40 J. FIN. ECON. 185, 189 (1996) (arguing that board size significantly impacts firm performance).

207. *See* Huson et al., *supra* note 17, at 2276–77 (noting that in their sample mean board size decreased over time).

208. *Id.* at 2277 (finding, over time, a significant increase in the number of outside directors on boards); *see also* Bebchuk et al., *supra* note 18, at 773 (noting the trend among firms to increase the number of outside directors); Bhagat & Black, *supra* note 206, at 238–39 (noting that in the last forty years, boards have transitioned from majority outsiders to majority insiders); Hall & Murphy, *supra* note 201, at 65 (noting that in modern corporations, as distinguished from earlier years, the compensation committee is typically composed of outside directors); Weisbach, *supra* note 178, at 456–58 (finding that outside boards are more successful at improving firm value after a CEO turnover event than boards dominated by insiders, particularly in cases where firm performance has previously been poor).

209. *See* Huson et al., *supra* note 17, at 2267 (noting previous literature on inside versus outside directors). *But see* Bhagat & Black, *supra* note 206, at 247–48 (reporting that board independence shows no relationship to positive firm performance and hinting that board independence might undermine firm performance); *see also* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (suggesting that independent boards are better boards); Posner, *supra* note 1, at 1024 (noting that "there is no persuasive evidence that corporate performance is positively correlated with the percentage of independent directors on the corporation's board"); Weisbach, *supra* note 178, at 431 (noting that outside directors are "widely believed to play a larger role in monitoring management than inside board members").

board's ability to monitor CEO actions also increases.[210] For instance, previous commentators have theorized that inside directors are less likely to discipline a CEO for poor performance, since they may owe their careers to the CEO.[211] Others have theorized that outside directors have a reputational interest in being good monitors.[212] Thus, they use board positions as a way to signal to the marketplace that they are tough-minded, no-nonsense directors.[213] According to some empirical evidence, outsiders have been more willing to terminate a CEO for poor performance.[214] They are also more apt to select an outside CEO as a replacement candidate, which, according to some studies over outside versus inside appointments, has positive firm value effects.[215]

Third, changes in the way members of the board are compensated to mimic the structure of pay for top executives also, theoretically, could give the board new reason to amplify their monitoring.[216] Some boards have turned to stock-based compensation for directors.[217] The thought is that the

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210. *See* Weisbach, *supra* note 178, at 432 (reporting that firms with "outsider-dominated" boards are more likely to remove CEOs for poor performance as measured by stock returns and earnings). *But see* Bhagat & Black, *supra* note 206, at 233 (arguing that the empirical evidence does not support the proposition that independent boards improve corporate performance).

211. *See* Huson et al., *supra* note 17, at 2267 (noting previous literature on inside versus outside directors).

212. *See* Weisbach, *supra* note 178, at 433 (theorizing that insiders are unwilling to discipline managers because of their own career interests).

213. *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 315 (1983) (discussing the theory that outside directors use their positions to cultivate reputations as experts in decision making).

214. *See* Weisbach, *supra* note 178, at 433 (noting that "outside directors are generally respected leaders from the business or academic community whose reputations suffer when they are directors of faltering companies"); *see also* Kenneth A. Borokhovich et al., *Outside Directors and CEO Selection*, 31 J. FIN. & QUANTITATIVE ANALYSIS 337, 337 (1996) (reporting that outside directors are more likely to select a replacement CEO from outside of the firm).

215. Mark R. Huson et al., *Managerial Succession and Firm Performance*, 74 J. FIN. ECON. 237, 258 (2004) (finding that outside CEO appointments lead to increases in expected firm value). *But see* Bebchuk & Fried, *supra* note 1, at 75 (noting that CEOs selected from outside are also prone to attempt to influence the board to put in place lavish executive compensation structures); Bhagat & Black, *supra* note 206, at 264 (noting several ways inside directors might add firm value).

216. *See* Huson et al., *supra* note 17, at 2268 (summarizing studies finding that stock option grants to directors have increased substantially over time); *id.* at 2276–77 (reporting that in a sample of 1,316 firms the stock-based compensation for directors likely increased over time); *see also* Bebchuk & Fried, *supra* note 1, at 77 (noting that director shareholding is related to reductions in executive compensation, a sign of enhanced monitoring by the board).

217. *See, e.g.*, Bhagat & Black, *supra* note 206, at 261 (reporting findings that show a hint that "stock ownership by outside directors correlates with improved performance"); Tod Perry, Incentive Compensation for Outside Directors and CEO Turnover 17 (July 1999) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236033 (finding that "[f]irms with independent directors receiving incentive compensation are more likely to remove a CEO following poor performance than firms that do not have independent boards and do not compensate directors with incentive-based pay"). *But see* Bebchuk & Fried, *supra* note 1, at 74 (suggesting that boards of

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use of stock-based compensation, which creates a stake in the firm for directors, tends to give directors an incentive to be better monitors.[218] Some data suggests that the changes in corporate governance structures might be working. For instance, studies have found that the percentage of CEO turnovers that are terminations has increased over time.[219] Further, boards of directors more frequently appoint an outsider as CEO in these cases, which, as mentioned, can have positive value effects.[220]

However, though some of the features of corporate governance have improved over time, boards of directors are frequently poor monitors of executive conduct.[221] Directors want to maintain their positions of power and influence. The best strategy for doing that is to play to the CEO's favor.[222] For instance, the failures of the board are only amplified in the executive compensation setting. When setting CEO pay, many firms rely on a compensation committee comprised of independent directors.[223] However, as persuasively argued by Professor Bebchuk, Professor Fried, and Professor Walker, the CEO has substantial sway over the process and the ultimate outcome.[224] The CEO can influence who is appointed to the board of directors.[225] Since appointment to the board of directors is relatively lucrative and prestigious, smart members of the board might be happy to ratify a sky-high executive compensation package and keep the

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directors are ineffective monitors because directors have too little tied up in the success of the firm); Weisbach, *supra* note 178, at 451–52 (finding little evidence that stock ownership of board members has a significant effect on the level of monitoring).

218. *See* Huson et al., *supra* note 17, at 2268 (noting that incentive compensation for board members may be related to increased monitoring of firm CEOs).

219. *Id.* at 2278 (noting that forced turnover has increased monotonically across sampled time periods).

220. *Id.* (finding that, over time, boards have been more likely to appoint an outsider as CEO).

221. *See* Simmons, *supra* note 1, at 315–16 (noting CEO pressure and influence on the board); *see also* Bebchuk et al., *supra* note 18, at 766 (summarizing the core problems with director oversight of firm leaders); *id.* at 754 (arguing that boards of directors are ineffective and, as a consequence, executive compensation has reached excessive levels).

222. BEBCHUK & FRIED, *supra* note 1, at 25 (noting that director positions are well-paid and offer several nonfinancial benefits that "give directors a strong interest in keeping their positions").

223. In fact, listing standards often require it. *See, e.g.*, N.Y. STOCK EXCH., LISTED COMPANY MANUAL § 303A.05(a) (2009), *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_3_8&manual=%2Flcm%2Fsections%2Flcm-sections%2F (providing that "[l]isted companies must have a compensation committee composed entirely of independent directors").

224. *See* BEBCHUK & FRIED, *supra* note 1, at 4–5 (arguing that top executives have substantial influence and can use their power to obtain "rents"); Bebchuk et al., *supra* note 18, at 766–67; Bebchuk & Fried, *supra* note 1, at 74 ("Because the CEO's influence over the board gives her significant influence over the nomination process, directors have an incentive to 'go along' with the CEO's pay arrangement, a matter dear to the CEO's heart—at least as long as the compensation package remains within the range of what can plausibly be defended and justified.").

225. *See* Myers, *supra* note 108, at 425–26 (describing the multitude of ways CEOs can influence directors).

CEO happy with them.[226] In fact, since the CEO influences who is appointed to the compensation committee, members of the compensation committee may want to sidestep confrontation with the CEO (not to mention other board members).[227] And the compensation committee has little financial incentive to negotiate vigorously over CEO pay.[228]

Furthermore, members of the board of directors use one post to angle for another position on another board of directors. If directors take a stand against their CEO, they may anger their current "golden goose" and, as the information gets out, alienate other prospective CEOs looking for pliant director candidates.[229] Finally, some have argued that directors have little financial stake in the firm in the first place, which also may make them apathetic about CEO performance.[230] As a consequence, the monitoring features of the relationship—largely pay setting and termination—may not be as effective as perceived.

Finally, even if boards did not have these conflicts, some evidence suggests that the board of directors, a group usually comprised of experts on corporate governance, law, and firm operations, may not have the capacity to determine executive pay levels.[231] For one thing, boards of directors have little to no staff resources.[232] When it comes to setting executive compensation levels, the board of directors relies on the advice of experts retained for that purpose. The board has to hire executive compensation consultants to figure out appropriate levels, and attorneys to draft appropriate contracts. However, the executive compensation "experts" may be of little help.[233] Compensation consultants push for sky-

226. Bebchuk & Fried, *supra* note 1, at 73 (noting that directors want to be reappointed because of pay and prestige and, thus, "have an incentive to favor the CEO"); *see also* Bebchuk et al., *supra* note 18, at 766–67, 770 (noting that the CEO dominates the director appointment process and the economic costs directors face in challenging a CEO).

227. *See* Posner, *supra* note 1, at 1024 (describing CEO "back scratching" or trading favors with compensation consultants and board members).

228. *See* Bebchuk et al., *supra* note 18, at 766–74 (discussing the failures of compensation committees).

229. Bebchuk & Fried, *supra* note 1, at 74 (arguing that a "go along" style may create opportunities for directors to join other boards); *see also* Bebchuk et al., *supra* note 18, at 770–71 (noting the reputational consequence of challenging a CEO).

230. *See* Bebchuk & Fried, *supra* note 1, at 74 (suggesting that boards are ineffective monitors because directors have little tied up in the firm); Myers, *supra* note 108, at 426 ("Typical directors have minimal company holdings, so they suffer little financial penalty if the CEO's compensation arrangement does not lead to optimal results for the corporation.").

231. *See* Bebchuk & Fried, *supra* note 1, at 74 (noting that boards may be ineffective monitors because they do not have "easy access to independent information and advice on compensation practices necessary to effectively challenge the CEO's pay"); Thomas & Martin, *supra* note 1, at 1033 (noting that "[e]ven directors on the compensation committee, with access to expert consultants and all of the facts surrounding these plans, may have difficulty understanding them").

232. *See* Posner, *supra* note 1, at 1020.

233. *See* Bebchuk & Fried, *supra* note 1, at 78 (arguing that consultants do not help with reaching optimal pay); Simmons, *supra* note 1, at 352–53 (noting some of the failures of

high pay, face conflicts of their own,[234] and frequently get the levels completely wrong.[235] If boards of directors—and sometimes the experts they hire—are not in a position to make educated, unaided decisions about levels of executive compensation, it is not clear why reform advocates would imagine that shareholders are in a position to do so.

2. Shareholders

Shareholders also serve as a check on CEO underperformance. As mentioned, shareholders have at least two powers—the right to vote and the right to sue—that may serve as a check on CEO abuse. Shareholders can hold in check excessive compensation and managerial performance through shareholder voting. In fact, shareholders who control large blocks of shares are particularly able to play a role in checking managerial abuses.[236] Over time, evidence suggests that block holding by institutional shareholders has increased significantly.[237] In one study, researchers found that institutional ownership grew from an average of 35.8% between 1977 and 1982 to 51.75% between 1989 and 1994.[238] Today, institutions control more than sixty percent of the stock of public companies.[239]

However, shareholder ability to ensure adequate performance through voting is severely limited.[240] First, shareholder voting is indirect. It affects directors who, in turn, select the CEO and other high-ranking officers.[241] Second, shareholder voting, as the system is currently designed, means that

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compensation consultants).

234. *See* Bebchuk et al., *supra* note 18, at 772 (noting that compensation consultants are incentivized to push for higher compensation to remain in favor with the managers who selected them).

235. *See* Bebchuk & Fried, *supra* note 1, at 78–79 (arguing that consultants camouflage excessive rents and suboptimal contracts with managers); Myers, *supra* note 108, at 435–36 (noting studies have shown that "the use of consultants is associated with higher measures of excess CEO pay"); Posner, *supra* note 1, at 1024–25 (noting why compensation consultants fail to effectively check CEO compensation); *see also In re* The Walt Disney Co. Derivative Litig., 825 A.2d 275, 280–81 (Del. Ch. 2003) (discussing the failure of a compensation consultant to place value on severance payments to a top executive).

236. *See* Huson et al., *supra* note 17, at 2269 (associating the growth in institutional share ownership with activism at firms); *see also* David J. Denis & Diane K. Denis, *Performance Changes Following Top Management Dismissals*, 50 J. FIN. 1029, 1036 (1995) (noting that large block holder shareholders may create significant pressure for CEO turnover).

237. *See* Huson et al., *supra* note 17, at 2269–70 (describing the rise in institutional ownership).

238. *Id.* at 2277.

239. SEC. INDUS. & FIN. MKTS. ASS'N, FACT BOOK 2011, 65 (Charles Bartlett, Jr. ed., 2011).

240. *See* Heard, *supra* note 8, at 758 (discussing why voting is an ineffective "limited weapon").

241. *But see* Thomas et al., *supra* note 20, at 1260 (noting that one shareholder advisory firm, Institutional Shareholder Services, Inc., suggested that shareholder voting on executive compensation might be more effective than voting to oust directors).

directors are rarely seriously threatened to lose their board seats.[242] As Richard Posner put it, shareholder voting for directors "resembles the system of voting in the Soviet Union and other totalitarian nations."[243] Third, though institutional ownership has grown, because of the sheer size of public companies in terms of capitalization, there are very few large (e.g., just over five percent) holders in public companies.[244] The vast majority of corporations do not have a controlling shareholder to hold managerial abuses in check.[245] This makes it difficult to rely on a large shareholder to fill the monitoring role.[246] Finally, shareholder lawsuits might also be a way to check managerial abuse. However, in the corporate context, the lawsuit is an ineffective way of curbing the growth in CEO compensation or checking managerial abuse.[247] Courts have routinely relied on the "business judgment rule," which effectively gives the board of directors the power to set salaries without little practical oversight. There are exceptions to the business judgment rule, like waste and irrational decision making, but courts have been loath to permit shareholders to go forward with suits that question the board's authority to make compensation decisions.[248]

B. *External Accountability*

Furthermore, external market forces may serve as a sort of *ex post* check on managerial misconduct.[249] Consider, for instance, takeover markets.[250] Firms that have underperforming management will also

242. *See* Posner, *supra* note 1, at 1023 (noting that shareholders wield very little power when it comes to director elections); *see also* Harris, *supra* note 190, at 120–21 (reporting that there are very few challenges to board seats from year to year).

243. Posner, *supra* note 1, at 1023; *see* BEBCHUK & FRIED, *supra* note 1, at 25 (noting that incumbent directors are virtually assured reelection and only in rare cases face any opposition).

244. *See, e.g.*, Bhagat & Black, *supra* note 206, at 246 (reporting the number of larger shareholders (5%) in a sample of public companies and finding that the median number of larger shareholders was one).

245. *See* Bebchuk et al., *supra* note 18, at 761.

246. *See* BEBCHUK & FRIED, *supra* note 1, at 82–83 (noting previous studies that show the influence that a large shareholder can have on firms).

247. *See* Core et al., *supra* note 1, at 1147 (discussing why shareholder suits are a weak constraint on executive compensation).

248. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006) (refusing to grant an exception to the business judgment rule when shareholders complained about a $130 million severance package); *In re* Tyson Foods, Inc., 919 A.2d 563, 591 (Del. Ch. 2007) (noting that "[a] committee of independent directors enjoys the presumption that its actions are *prima facie* protected by the business judgment rule"); *see also* Thomas & Martin, *supra* note 1, at 1031–32 (noting that external markets, such as "labor markets, the market for corporate control, capital markets, and product markets" constrain misconduct).

249. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 414 n.48 (1983) (noting the disciplinary effect of takeover markets).

250. Takeover markets, of course, are not the only market force that could serve as a check on CEO misconduct. The market for labor, capital, and products might also have an inhibiting effect on

perform poorly in the marketplace. As the value of their shares deteriorates, the firm becomes more appealing to takeover artists. The incentives for takeover artists are sharp. In the minds of takeover artists, these firms, at their depressed prices, represent good value. The takeover artist can gain control of the firm on the cheap, replace the underperforming managers, and turn a quick profit as the firm turns around.[251] In fact, the evidence suggests that this is exactly what takeover artists do. For instance, according to studies, the turnover rate for management shortly after a merger is nearly three times the usual turnover rate.[252]

However, while there are exceptions, takeover markets are hardly a broad-based method of responding to managerial misconduct.[253] Specifically, whereas in the 1970s and 1980s when takeover markets were relatively robust, takeover activity slowed considerably in the 1990s once states began to take action and lawyers became craftier at staving off takeover attempts.[254] On the one hand, state legislators in most states have passed anti-acquisition statutes that make takeovers more difficult.[255] These share acquisition rules have made takeovers more complicated by making shareholder votes in connection with an acquisition a requirement

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CEO misbehavior. For a general discussion of each of these, see Bebchuk et al., *supra* note 18, at 774–79. The media also acts as an external constraint on managerial misconduct. The media can report managerial misconduct, cultivate shareholder outrage, and raise the interest of regulators who might pressure managers to improve their behavior. However, the media has no independent conduit for holding managers accountable. Instead, the media is only effective if the board of directors (with all its conflicts) or shareholders (whose powers are limited) are able to do something about what is reported in the press. *See* Heard, *supra* note 8, at 765 (noting that the media has to some extent galvanized reform); *see also* Bebchuk & Fried, *supra* note 1, at 75 (discussing media-driven "outrage" as a constraint on managers); Alexander Dyck et al., *The Corporate Governance Role of the Media: Evidence from Russia*, 63 J. FIN. 1093, 1095 (2008) (reporting findings that news coverage by international newspapers led to course corrections at firms in Russia); Posner, *supra* note 1, at 1029 (discussing the role of the media); *id.* at 1013 n.2 (listing news articles discussing high-profile executive compensation issues).

251. *See* George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 889 (1989) (explaining the high premiums associated with takeovers as a function, in part, of "slack in target management").

252. *See, e.g.*, Jensen & Murphy, *supra* note 170, at 253 (discussing briefly turnover rates at merged and unmerged firms).

253. *See* Bebchuk & Fried, *supra* note 1, at 74 (noting the inadequacy of the market for corporate control); Posner, *supra* note 1, at 1029 (noting that competitive activity in the market is not likely to weed out agency costs since the problem plagues all firms).

254. *See* Robert Comment & G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 J. FIN. ECON. 3, 4 (1995) (reporting decline in takeover activity); *see also* Bebchuk & Fried, *supra* note 1, at 74 (noting the inadequacy of the market for corporate control as a check on CEO behavior); Huson et al., *supra* note 17, at 2266 (noting the decline in disciplinary takeover activity).

255. *See* Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621, 631–32 (2003) (noting that the majority of states have statutory protections against hostile acquisitions, including share acquisition statutes).

of state law. On the other hand, lawyers have been adept at crafting antitakeover corporate governance provisions that insulate directors and their appointed managers from the possibility of a takeover and accompanying ouster.[256] These include provisions such as elaborate poison pills and staggered board elections.[257] By simply staggering when board elections occur, the incumbent board can delay a takeover attempt by a year or two, during which time the takeover artist is likely to lose interest. These antitakeover provisions probably insulate CEOs from the prospect of a takeover and repercussions for their actions.[258]

Furthermore, even when the legal barriers to a takeover can be surmounted, takeover markets frequently fail as broad monitoring devices. Takeover artists frequently only seek out firms that are going to create very significant returns.[259] For instance, even one of the great proponents of the disciplining effect of takeover markets, Frank Easterbrook, has conceded that a takeover artist would only be interested if the returns are at least twenty percent.[260] This is a tall order and surely eliminates many firms with subpar managers as potential takeover targets. Put differently, though corporate leaders may be laggards, in the average case this will not make them a good target for a takeover in an economic sense.

CONCLUSION

The go-to reform for executive misbehavior has become executive compensation schemes of the pay-for-performance variety. These schemes are straightforward. The threat of pay reduction (or prospect of increased compensation) might incent CEOs to perform well. However, these schemes are at most a second-best solution to the problem of CEO accountability. The current reforms for managerial misbehavior elide the central concern of most shareholders—ridding firms of underperforming CEOs. Thus, private sphere experts who are concerned about executive

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256. Grundfest, *supra* note 88, at 858 ("The takeover wars are over. Management won. Although hostile tender offers remain technically possible . . . it will be difficult for hostile bidders to prevail in takeover battles, even if shareholders support the insurgents' efforts.").

257. *See* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1144 n.5, 1153–55 (Del. 1989) (discussing the firm's defensive tactics); Moran v. Household Int'l, Inc., 490 A.2d 1059, 1083 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985) (approving poison pill's use); Subramanian, *supra* note 254, at 625 (noting that the board may adopt a poison pill as a defensive tactic "in a matter of hours if necessary").

258. *See* Bebchuk & Fried, *supra* note 1, at 78 (noting that antitakeover provisions are associated with "excess compensation" for managers).

259. *See* Bebchuk et al., *supra* note 18, at 777 (noting that takeover interest is only piqued by the prospect of significant returns and "substantial performance shortfalls").

260. Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 567 (1984) ("There are few acquisitions today at premiums in the 1-20% range. This means that when combinations could produce benefits of 20% or less to investors, they are unlikely to occur.").

performance ought to look in a new direction. One way to hold an executive accountable is to give shareholders a vote on whether the executive should be retained—not how much he or she should be paid.