University of Florida Levin College of Law
UF Law Scholarship Repository

Working Papers Faculty Scholarship

3-18-2014

Employee Say-on-Pay: Monitoring And Legitimizing Executive Compensation

Robert J. Rhee
University of Florida Levin College of Law, rhee@law.ufl.edu

Follow this and additional works at: http://scholarship.law.ufl.edu/working

Part of the Corporation and Enterprise Law Commons

Recommended Citation
Robert J. Rhee, *Employee Say-on-Pay: Monitoring And Legitimizing Executive Compensation*, Levin College of Law Working Paper, University of Florida (2014), *available at* http://scholarship.law.ufl.edu/working/2

This Article is brought to you for free and open access by the Faculty Scholarship at UF Law Scholarship Repository. It has been accepted for inclusion in Working Papers by an authorized administrator of UF Law Scholarship Repository. For more information, please contact outler@law.ufl.edu.

EMPLOYEE SAY-ON-PAY: MONITORING AND LEGITIMIZING EXECUTIVE COMPENSATION

Robert J. Rhee †

Abstract

This Article proposes the adoption of employee say-on-pay in corporate governance. The board would benefit from an advisory vote of employees on executive compensation. This proposal is based on two considerations: firstly, the benefits of better monitoring and reduced agency cost in corporate governance; secondly, the link between executive compensation and income inequity and wealth disparity in the broader economy.

If adopted, shareholders and employees would monitor executive performance and pay at different levels. Shareholders through the market mechanism can only monitor at the level of public disclosures and share price. Employees can leverage private information. Non-executive managers in particular can better monitor the company and senior executives, based on inside knowledge and a longer term horizon, than diffuse, diversified, and short durational shareholders. Employees collectively possess the corporation's entire information content; the assessment derived there from would be relevant to the board's assessment of executive performance and pay.

On the level of political economy, employee approval would legitimate executive pay in the current social, economic, and political environment in which executive compensation and income disparities have touched public consciousness. Executive compensation is no longer purely a matter of private contracting. Prominent economists have linked excessive pay to economic inequity, a pressing issue of public consciousness today. Employees are a major constituent of the corporate system and our political society. They can act as surrogate public monitors and perform a gatekeeping function of good corporate governance.

---

† John H. and Mary Lou Dasburg Professor of Law, University of Florida Levin College of Law; Professor, Johns Hopkins Carey Business School. I thank the many colleagues who read this paper and provided helpful comments.

Structured properly and achieved fairly as to the executive, employee say-on-pay would politically legitimate executive compensation and income disparity at both the firm and political levels.

TABLE OF CONTENTS

INTRODUCTION 3
I. SHAREHOLDER SAY-ON-PAY 8
A. The Problem of Executive Pay 8
B. Limits of Delaware Corporation Law 14
C. Say-On-Pay and the Dodd-Frank Act 20
D. Voting Results and Limits of Shareholder Monitoring 23
II. EMPLOYEE SAY-ON-PAY 26
A. The Proposal 26
B. Weighed Voting 29
C. Gamed Voting 32
D. Implementation 35
III. BENEFITS OF EMPLOYEE SAY 37
A. Advantage of Private Information 37
B. Reverse Monitoring 39
C. Information Asymmetry in Governance 43
D. Fiduciary Ideals, Board Cover and Leverage 45
E. Public Monitoring and Political Legitimization 48
IV. OBJECTIONS TO EMPLOYEE SAY 49
A. Information Quality 49
B. Rationally Apathetic Employees 51
C. Balance in Corporate Governance 52
D. Employee "Hold Up" 54
E. Political Objections 56
CONCLUSION 57

INTRODUCTION

Executive compensation started to rise significantly in the 1980s, and the 1990s experienced explosive growth that rapidly outpaced the pay of the corporate and broader American workforce.[1] Executive compensation is one of the most controversial topics in corporate governance.[2] The absolute amount of pay has created wide income disparity between top executives and the average worker.[3] The pay problem has created a shared perception that pay is decoupled from performance and a broad sense of social equity. The legitimacy and efficacy of the corporate governance system are in question. Executive pay affects both firm efficiency and social equity in a market society. Compensation influences incentives, which affects production and wealth allocation. A prevailing public sense that wages are not fairly allocated affects morale and social cohesion at both the firm and the societal levels.[4] Prominent economists have identified executive compensation as a "powerful force"[5] for economic inequitable and social "exploitation"[6] of wealth allocation

---

[1] *See* Lawrence Mishel & Natalie Sabadish, *CEO Pay and the Top 1%: How Executive Compensation and Financial-Sector Pay Have Fueled Income Inequality*, ECONOMIC POLICY INSTITUTE, Issue Brief #331, at 6 fig. A (May 2, 2012) (showing historical growth of CEO pay as a multiple of average worker pay since 1965); Carola Frydman & Raven E. Saks, *Executive Compensation: A New View from a Long-Term Perspective, 1936-2005*, 23 REV. OF FIN. STUDIES 2099 (2010) (showing that compensation was flat from 1940s to 1970s, but that pay became more correlated to shareholder wealth since the 1980s).

[2] *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (criticizing executive compensation practices).

[3] *See* Steven N. Kaplan & Josua Rauh, *Wall Street and Main Street: What Contributes to the Rise in the Highest Incomes?*, 23 REV. OF FIN. STUDIES 1004 (2010) (identifying executive compensation as one major source of the increasing income disparity seen in the last several decades)

[4] *See* ROBERT W. KOLB, TOO MUCH IS NOT ENOUGH: INCENTIVES IN EXECUTIVE COMPENSATION 162 (2012) (arguing that "there is a growing awareness of the potential for rising inequity to seriously corrode social cohesion"); William Lazonick, *Why Executive Pay Matters to Innovation and Inequity*, in THE EMBEDDED FIRM: CORPORATE GOVERNANCE, LABOR, AND FINANCE CAPITALISM 415 (eds. Cynthia Williams and Peer Zumbansen, 2011) (arguing that manipulation of executive pay has resulted in economic inequity, reduced innovation, and unstable economic performance).

[5] THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY 334 (2014).

[6] "In a more careful, academic way of putting it I would say that one of the explanations of what is going on is increased exploitation. You see the ratio of wages to productivity going way down, and that certainly is consistent with increased exploitation. And you see that the ratio of CEO pay to worker pay has gone up. So what I would say is that some of the explanations have to do with weakened worker bargaining power,

through the abuse of corporate power.[7] Concentrated wealth affects the working of the larger economy and social welfare.[8] Business scholars have called for a "new paradigm" on executive compensation.[9] Given this business, economic, and political reality, the current controversy over the compensation of chief executive officers (CEOs) will not recede into a private corner of corporate governance with the passage of time unless the problem is fixed.

Executive compensation has entered a new era. Until a few years ago, compensation was not regulated in any meaningful way. It was a matter of private contracting for the employment of the top corporate officer. The Dodd-Frank Act now regulates CEO pay across U.S. public companies.

---

weaker unions, asymmetric state liberalization where capital moves but labor can't move, corporate governance laws that provide relatively little check on abuses of corporate power by CEOs, and an increase of monopoly power because of network externalities." Lynn Parramore, *Joseph Stiglitz on Why the Rich Are Getting Richer -- and Why It Could Get Much Worse*, HUFFINGTON POST (Dec. 19, 2014) (quoting Stiglitz), available at http://www.huffingtonpost.com/lynn-parramore/joseph-stiglitz-on-why-th_b_6354948.html.

[7] *See* PIKETTY, *supra* note 5, at 334 ("[T]he extremely generous rewards meted out to top managers can be a powerful force for divergence of the wealth distribution: if the best paid individuals set their power salaries, (at least to some extent), the result may be greater and greater inequity."); JOSEPH E. STIGLITZ, THE PRICE OF INEQUALITY: HOW TODAY'S DIVIDED SOCIETY ENDANGERS OUR FUTURE 66-67 (2013) (providing an account of income inequity in the U.S. and asserting excessive executive pay as one of the causes); Mishel & Sabadish, *supra* note 1 (arguing that executive compensation and financial-sector pay have caused income inequity).

[8] The credit rating agency, Standard & Poor's, has warned of the serious consequences of income inequity, which has been factored into bottom line projection of economic growth: "At extreme levels, income inequality can harm sustained economic growth over long periods. The U.S. is approaching that threshold. Standard & Poor's sees extreme income inequality as a drag on long-run economic growth. We've reduced our 10-year U.S. growth forecast to a 2.5% rate. We expected 2.8% five years ago." Joe Maguire, *How Increasing Inequity Is Dampening U.S. Economic Growth, and Possible Ways to Change the Tide*, GLOBAL CREDIT PORTAL (S&P Capital IQ, Aug. 5, 2014), available at https://www.globalcreditportal.com/ratingsdirect/renderArticle.do?articleId=1351366&SctArtId=255732&from=CM&nsl_code=LIME&sourceObjectId=8741033&sourceRevId=1&fee_ind=N&exp_date=20240804-19:41:13. According to the World Bank, the 2013 GDP of the United States was $16.768 trillion. http://data.worldbank.org/indicator/NY.GDP.MKTP.CD?order=wbapi_data_value_2013+wbapi_data_value+wbapi_data_value-last&sort=asc. A 0.3% decline in economic growth from 2.8% to 2.5% would imply a reduction in GDP of $50 billion per annum based on the 2013 GDP figure.

[9] *See* Jay W. Lorsch & Rakesh Khurana, *The Pay Problem: Time for a New Paradigm for Executive Compensation*, in THE FUTURE OF BOARDS: MEETING THE GOVERNANCE CHALLENGES OF THE TWENTY-FIRST CENTURY 77 (2012).

The statute mandates third-party review of the compensation package, which is shareholder say-on-pay.[10] Since this reform measure is fairly new, its efficacy remains to be seen in the years to come.[11] Irrespective of whether most voting outcomes approve proposed pay packages (the short but predictable experience thus far), shareholder say-on-pay is a good thing because shareholders now have a legal right to participate in the pay decision. Their opinion is relevant to the board's deliberation, and more relevant information is better than less in informed decisionmaking. Shareholder monitoring may prove to have longterm salutary effects.

Yet even as the ink is drying on the Dodd-Frank Act, the limits of shareholder monitoring are well known. Many diffused, diversified, and short durational shareholders in modern capital markets are rationally disengaged from corporate governance.[12] Furthermore, shareholders are one of many contractual constituents of the firm.[13] One conception of a firm is a "nexus of contracts" among various factors of production.[14] This nexus includes not only top level officers and the board, but also non-executive managers and rank and file employees who contribute to the production function of the firm.[15] However, the framework of U.S. corporate governance as practiced assumes that employees are simply contractual workers hired to produce widgets as directed by corporate managers in a top-down hierarchy. This assumption would dismiss a potentially important benefit that could be gained. As a group, employees

---

10 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1899 (2010).

11 *See* Randall S. Thomas et al., *The First Year of Say-on-Pay Under Dodd-Frank: An Empirical Analysis and Look Forward*, 81 GEO. WASH. L. REV. 967 (2013) (providing preliminary empirical data on voting results); 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 (2012) (same).

12 *See* ROBERT CHARLES CLARK, CORPORATE LAW 390-400 (1986) (discussing the problem of the rationally apathetic shareholder); Edward S. Adams, *Bridging the Gap Between Ownership and Control*, 34 J. CORP. L. 409, 422 (2009) (noting that increasing shareholder involvement is difficult because "the common shareholder today only has a minimal financial interest in numerous different corporations").

13 *See* R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 384 (1937). *See also* Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior*, 3 J. FIN. ECON. 35 (1976) ("There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output.").

14 Jensen & Meckling, *supra* note 13.

15 *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

possess all of the information content of the company.[16] This obvious fact is something that cannot be claimed by shareholders or an efficient capital market where only publicly disclosed information is incorporated into the stock price. Thus, employees possess the capability to assess the performance of the corporation and CEO.

This Article proposes extending the say-on-pay device to employees. The advisory votes of shareholders and employees can provide important and different information to the board. Two distinct benefits inure from a right of employees to participate in pay decisions. From a microeconomic perspective of the firm, employees have great incentive to monitor the company and have private information relevant to the performance of the company and its senior executives. This collective incentive and information should be leveraged. From a political economic perspective, employee say-on-pay would politically legitimate executive compensation. This aspect is important because executive compensation is no longer a purely private matter akin to contracting for the labor of most other employees. One significant factor in growing economic inequity is high executive compensation.[17] The political and economic dimensions of permitting employee voice in executive compensation are significant.[18] Employees would act as surrogate public monitors of executive pay and gatekeepers of good corporate governance in this regard.[19]

This is the first scholarly article proposing employee say-on-pay.[20] The idea here may be viewed as controversial, or perhaps even radical,

---

[16] *See* PHILLIP PHAN, TAKING BACK THE BOARDROOM: THRIVING AS A 21ST-CENTURY DIRECTOR 3 (2007) ("There is increasingly realization that a firm is a place where people meet to exchange specific information for the purpose of engaging in production.").

[17] *See* STIGLITZ, *supra* note 5, at 66-67; PIKETTY, *supra* note 5, at 334.

[18] *See* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 75-105 (1970) (analyzing the economic relationship between participatory voice and loyalty).

[19] *See generally* JOHN C. COFFEE, GATEKEEPERS: THE ROLE OF THE PROFESSIONS AND CORPORATE GOVERNANCE (2006); Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. U. L. REV. 916 (1998).

[20] Upon researching for preemption, I came across two brief references to the possibility of employees say on executive pay in the popular press. *See* Justin Fox, *Who Should Actually Have Say on Pay?*, HBR BLOG NETWORK (May 30, 2013) ("If we wanted to have a real impact on executive pay *levels*, we should probably have *employees* vote.") (emphasis in original), available at http://blogs.hbr.org/2013/05/who-should-actually-have-say-on-pay/; Deborah Hargreaves, *Employees Need a Say on Executive Pay*, THE GUARDIAN (Jan. 9, 2012) ("That is why we believe employees need more of a say on pay."). *Cf.* Gretchen Morgenson, *Employees, Too, Want a Say on the Boss's Pay*, N.Y. TIMES (Apr. 21, 2012) (suggesting that employee-shareholders in ESOPs should have say-on-pay).

since American corporate governance revolves around the triad of board, management, and shareholder. Among these constituents, management, at least, will not view employee say-on-pay warmly. Employees have little formal role in U.S. corporate governance under corporation law.[21] The tension between these principles and the proposal here is more apparent than real. The proposal is consistent with one of the most fundamental tenet of corporate governance, which is informed decisionmaking at the board level. The controversy of the idea would be political in nature.[22] While political consideration is important, it is only one facet of the nature of the problem, and a separate inquiry from whether the idea is economically and legally sound. Furthermore, since say-on-pay is a global corporate governance phenomenon, originating in the United Kingdom and rapidly adopted by many economically advanced countries in Europe before landing on American shores, the idea of employee say-on-pay should be put on the agenda of the global debate on pay, including in countries where employees traditionally have had greater participatory role in the governance of the corporation.[23]

To frame the analysis that follows, a few prefatory comments are warranted. This Article is about institutional design. It is not written to advance a broader agenda of expanding employee role in American corporate governance from nothing to something, or comingling labor and corporation laws.[24] This proposal is instrumental, advancing the use of an established governance device to better monitor senior executives, which

---

[21] *See* Harry W. Arthurs & Claire Mummé, *From Governance to Political Economy: Insights from a Study of Relations Between Corporations and Workers*, in THE EMBEDDED FIRM: CORPORATE GOVERNANCE, LABOR, AND FINANCE CAPITALISM 350 (eds. Cynthia Williams and Peer Zumbansen, 2011) ("The presumption is that workers will not participate in the making of important decisions, including many which directly and dramatically affect their interests."); MARGARET M. BLAIR & MARK J. ROE, EMPLOYEES AND CORPORATE GOVERNANCE 2 (1999) ("Labor directly influences corporate governance structures in the United States less than it does is [sic] in some other countries."). *See generally* GREGORY K. DOW, GOVERNING THE FIRM: WORKERS' CONTROL IN THEORY AND PRACTICE (2003) (analyzing employees' role in corporate governance); BLAIR & ROE (same); MICHAEL LOWER, EMPLOYEE PARTICIPATION IN GOVERNANCE: A LEGAL AND ETHICAL ANALYSIS (2010) (same). In Europe, employees have a greater role in corporate governance. *See* Blair & Roe, at 163-313 (discussing the German and Japanese models).

[22] *See infra* Section IV.E (discussing the political objection of the executive class).

[23] European countries use employee participation in corporate governance more than the US model. *See* ROE & BLAIR, at 163-238.

[24] Some scholars have sought to explore greater role for employees in formal corporate governance. *See* Brett H. McDonnell, *Strategies for an Employee Role in Corporate Governance*, 46 WAKE FOREST L. REV. 429 (2011); Brett H. McDonnell, *Employee Primacy, or Economics Meets Civic Republicanism at Work*, 13 STAN. J.L. BUS. & FIN. 334 (2008).

is a basic function of corporate governance. The basic premise of the Article is that there *is* a problem of excessive compensation, and the problem arises from failed arm's length bargaining between the board and the CEO.[25] The questions explored here are whether the concept of say-on-pay can be extended to other third-party constituents, and whether the benefits of such a device outweigh potential problems. The logical force of the proposal is apparent if one acknowledges, as one must, that employees possess the corporation's entire information content and this information is relevant to the board's decision on performance and pay.

This Article is written in four sections. Section I provides brief background information on shareholder say-on-pay as mandated by the Dodd-Frank Act. It discusses the empirical data on shareholder voting results, and identifies the recurrent problem of rational shareholder apathy. Section II proposes the concept of employee say-on-pay and discusses the scheme's structure and implementation. The most intricate issue of implementation is how votes should be allocated to meet the twin goals of firm efficiency and social equity. Second III identifies the benefits of employee say-on-pay, including monitoring and modulating executive compensation and decreasing income and wealth disparity in American society. Section IV discusses potential objections to the proposal, including whether the informational input would be reliable and whether employee say-on-pay would tilt the balance in corporate governance away from shareholders to employees.

I. SHAREHOLDER SAY-ON-PAY

A. The Problem of Executive Pay

For much of the twentieth century, CEOs were paid well relative to other corporate workers, but according to some business scholars they were paid on scale suggesting senior "bureaucrats."[26] Commentators,

---

[25] BEBCHUK & FRIED, *supra* note 2, at 23-44. *See* Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 MINN. L. REV. 846, 847-48 (2011) (noting that "the belief that the American executive compensation system works well is a distinctly minority position").

[26] Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Note How Much You Pay, But How*, HARVARD BUS. REV. (May-June 1990). *See* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990) (hypothesizing that market and political forces impose constraints that reduce performance incentives). However, even Jensen and Murphy have recently recognized that executive compensation schemes today are seriously flawed. *See* Kevin J. Murphy &

primarily in business and economics, suggested that contracts should be optimized to reduce agency cost, thereby justifying and leading to greater compensation as incentive for superior company performance.[27] In the 1990s, CEO pay experienced an explosive growth and compensation levels have since remained at high levels relative to worker pay.[28] This growth has level off in the past several years, but what remains after the "big bang" in executive compensation is a new status quo in which top corporate executives are routinely paid wages that are several hundred times the pay of average workers.

Numerous studies have empirically documented the rapid rise of executive compensation. The following are data from one such study (salary figures are adjusted to 2011 dollars).[29]

Year	CEO Compensation (incl. realized options)	Nonsupervisory Worker Compensation	Ratio of CEO-to-Worker Compensation	S&P 500 Index	Dow Jones Index
1965	791,000	38,500	20.5	511	5,278
1973	1,033,000	45,800	22.6	451	3,881
1978	1,413,000	47,600	29.7	282	2,411
1989	2,631,000	44,000	59.8	525	4,081
1995	5,570,000	43,600	127.8	737	6,120
2000	19,482,000	45,900	424.4	1,730	13,006
2007	17,919,000	48,400	370.2	1,487	13,268
2011	12,141,000	50,300	241.4	1,268	11,958
Annual growth rate 1973-2011	*6.7%*	*0.2%*	*6.4%*	*2.8%*	*3.0%*
Annual growth rate 1989-2012	*7.2%*	*0.6%*	*6.5%*	*4.1%*	*5.0%*

According to this study, the ratio of CEO and worker compensation has grown in constant dollar terms at a steady pace since 1973 and 1989. In 1973, the ratio of CEO to worker pay was 22.6x, and with a 5.5% real growth rate the ratio in 2011 was 241.4x. This growth in wage disparity

Michael C. Jensen, *CEO Bonus Plans: And How to Fix Them*, draft paper dated Nov. 19, 2011, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1935654.

[27] *See* Jensen & Murphy, *supra* note 26.

[28] *See* STIGLITZ, *supra* note 5, at 66-67.

[29] Mishel & Sabadish, supra note 1, at 5 tbl. 2. I calculated the annual growth rate data based on the study's information. Other studies and sources have shown slightly different numbers, but all show the same general trend and levels of high ratios of CEO pay. *See, e.g.,* STIGLITZ, *supra* note 5, at 296 n.12, 309 n.88 (providing citations to other sources and data); Lorsch & Khurana, *supra* note 9, at 79 (showing ratio of average CEO pay to average worker pay growing from 44:1 in 1980 to 344:1 in 2007).

reflects the growth of executive compensation that in the period between 1973 and 2011 has outpaced worker pay by a factor of 33. The growth in CEO pay has outpaced the growth in the stock market as measured by the S&P and Dow indices by a factor of two. Executive pay cannot be explained by marginal productivity gains attributable to actions of senior executives.[30]

Executive pay packages were ordinarily matters of internal corporate governance and private contracting, a closed world of boards, executives, and their advisers. As pay packages have exploded in the past several decades and manipulations of compensation have been exposed, compensation has become a controversial public issue. Perhaps the most infamous recent episodes involved the outsized pay package of a former president of the Walt Disney Company for essentially several months of ineffective work,[31] and the "retention bonuses" for Wall Street investment bankers even as they were responsible for causing great economic damage to their firms and the global economy.[32] A recent study shows that many corporations pay their CEOs more than they paid federal income taxes.[33]

---

30 *See* STIGLITZ, *supra* note 5, at 21 ("It strains credulity to think that over the intervening years CEOs as a group have increased their productivity so much, relative to the average worker, that a multiple of more than 200 could be justified. Indeed, the available data on the success of U.S. companies provide no support for such a view."); PIKETTY, *supra* note 5, at 334 ("The most convincing proof of the failure of corporate governance and of the absence of a rational productivity justification for extremely high executive pay is that when we collect data about individual firms (which we can do for publicly owned corporations in all the rich countries), it is very difficult to explain the observed variations in terms of firm performance."); Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 QUARTERLY J. ECON. 901 (2001) (finding that CEO pay in fact responds as much to a lucky dollar as to a general dollar" where luck is defined as factors of firm performance that are outside of the CEO's control).

31 *See* In re Walt Disney Derivative Litigation, 906 A.2d 27, 35 (Del. 2006) ("In December 1996, only fourteen months after he commenced employment, [Michael] Ovitz was terminated without cause, resulting in a severance payout to Ovitz valued at approximately $130 million."). This litigation was widely followed in the media. *See, e.g.*, Jonathan D. Glater, *Big Pay Packages May Fade After Ruling on Ex-President of Disney*, N.Y. TIMES (Aug. 10, 2005).

32 *See* Edmund L. Andrews & Peter Baker, *A.I.G. Planning Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES (Mar. 14, 2009). The banks were so embarrassed to called the payouts "performance bonus" that they were instead called "retention bonus." STIGLITZ, , *supra* note 5, at 79.

33 Scott Klinger & Sarah Anderson, *Fleecing Uncle Sam: A Growing Number of Corporations Spend More on Executive Compensation than Federal Income Taxes*, Institute for Policy Studies and Center for Effective Government (2014), available at http://www.ips-dc.org/fleecing-uncle-sam/. The report finds that 7 of the top 30 American corporations

There is evidence that even basic corporate financial decisions such as payout policy have been improperly affected by the effects of retention of earnings, payment of dividends, and repurchases of stock on the CEO's wealth as tied to the compensation package that includes stock and options.[34]

Such episodes have come to symbolize conspicuous compensation[35] in an era of great economic inequity.[36] Although most issues of corporate governance involving technical and arcane legal rules applied by an insular group of boards, the corporate bar, and mostly Delaware courts, the issue of executive compensation has become a public issue.[37] Public consciousness of corporate governance rises from a conspicuous crisis, as was the case with the governance failures at the turn of the new century resulting in the Sarbanes-Oxley Act and the financial crisis of 2008-2009 resulting in the Dodd-Frank Act.

There are two broad camps of thought on executive compensation. The first is the "optimal contracting" camp, which has argued that contracting for compensation works well and that the levels of compensation seen are the product of market pricing for executive

---

paid their CEOs more than they paid federal income taxes, and that 29 of the 100 highest-paid CEOs received more in pay than their company paid in federal income taxes. *Id.* at 1.

[34] *See* Philipp Geiler & Luc Renneboog, *Executive Remuneration and the Payout Decision* (2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2436343 (discussing the effects of compensation manipulation on payout policy); Lazonick, *supra* note 4, at 424-37 (discussing the use of stock buybacks to manipulate compensation). *See, e.g.,* Ryan v. Gifford, 918 A.2d 341 (Del.Ch. 2007) (involving back dating of stock option grants); Weiss v. Swanson, 948 A.2d 433 (Del.Ch. 2008) (involving "spring-loaded" stock option grants in which options were granted immediate prior to favorable press announcement).

[35] *Cf.* THORSTEIN VEBLEN, THE THEORY OF THE LEISURE CLASS (1899) (observing in the Gilded Age that the wealthy class demonstrates their status through "conspicuous consumption").

[36] *See* PIKETTY, *supra* note 5; Emmanuel Saez & Gabriel Zucman, *Wealth Inequity in the United States Since 1913: Evidence from Capitalized Income Tax Data* (Oct. 2014), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2526356; *Forget the 1%: It is the 0.01% Who are Really Getting Ahead in America*, THE ECONOMIST (Nov. 8, 2014); Robert Frank, *Another Widening Gap: The Haves vs. the Have-Mores*, N.Y. TIMES (Nov. 15, 2014); Steven Rattner, *Inequity, Unbelievably, Gets Worse*, N.Y. TIMES (Nov. 16, 2014).

[37] *See* Hillary A. Sale, *Public Governance*, 81 GEO. WASH. L. REV. 1012, 1013 (2013) (arguing that public scrutiny of corporate governance arises when the ordinary private ordering of corporate governance fails and that "[d]ecisions about governance move from Wall Street to Main Street" as a result).

talent.[38] The second is the "board capture" camp, which has argued that contracting has been undermined by failure of the board to monitor CEO performance and compensation. The most powerful advocates of this criticism have been Lucian Bebchuk and Jesse Fried.[39]

The scope of this Article is not to analyze or rehash these arguments. After a deluge of academic analyses, a general consensus, constituting a collective wisdom, has been reached that there is a problem with executive compensation.[40] The optimal contracting camp occupies a distinctly minority position today.[41]

This Article assumes the consensus view. It is premised on the view that the practice of executive compensation has failed, resulting in economically inefficient and socially inequitable results. Bebchuk and Fried have powerfully argued that the board and the CEO do not bargain at arm's length for compensation, and that CEOs have significant power and influence over the setting of his or her compensation.[42] The observed result over the past several decades has been a failure of contracting, a decoupling of pay and performance, and excessive compensation. Due to managerial power and position, CEOs collect large economic rents.[43] In a

---

38 *See* John E. Core, Wayne R. Guay & Randall S. Thomas, *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1160 (2005) (espousing "optimal contracting theory, which posits that contracts are designed to maximize shareholder value net of contracting costs and transactions costs"); JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 23 (2008) ("The specific executive compensation arrangements that we actually observe, however, simply reflect the result of a bargaining process between shareholders' elected representatives and managers."). Some commentators have even suggested that compensation levels in some cases may be too low. *See* Steven Kaplan, *Are U.S. CEOs Overpaid?*, 22 ACADEMY OF MANAGEMENT PERSPECTIVES 5, 6 (2008) ("It is possible that good CEOs are not overpaid, but underpaid."). *But see* James P. Walsh, *CEO Compensation and the Responsibilities of the Business Scholar to Society*, 22 ACADEMY OF MANAGEMENT PERSPECTIVES 26, 32-33 (2008) (arguing that Kaplan based his analysis on a "selective reading of the available evidence").

39 BEBCHUK & FREID, *supra* note 2, at 23-44, 61-86.

40 *See* Sorapop Kiatpongsan & Michael I. Norton, *How Much (More) Should CEOs Make? A Universal Desire for More Equal Pay*, (forthcoming in *Perspectives in Psychological Science*) (showing that most people, regardless of nationality, share similar beliefs on executive compensation and that their estimates are much lower than the actual amounts executives make). *See also* Gretchen Gavett, *CEOs Get Paid Too Much, According to Pretty Much Everyone*, HARVARD BUSINESS REVIEW (Sept. 23, 2014) (providing a summary of Kiatpongsan and Norton's paper).

41 Thomas & Wells, *supra* note 25, at 848.

42 BEBCHUK & FREID, *supra* note 2, at 23-44, 61-86.

43 *See* Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002);

pre-Dodd-Frank era, Bebechuk and Fried argued that shareholders and the markets have limited influence curbing excessive pay.[44] Their criticism has remained durable even in a post-Dodd-Frank era of shareholder say-on-pay.

However, the premise of this Article goes beyond the Bebchuk and Fried argument. Bebchuk has been a leading advocate of shareholder-centrism.[45] Advocates of shareholder primacy do not connect the role of executive compensation to the broader problem of economic inequity. Their concern is the maximization of shareholder wealth. Presumably much of the din of the "board capture" camp would go silent if the current compensation levels were strongly connected to shareholder wealth. The connection between executive pay and income inequity should be made because this aspect of corporate governance imposes broad externalities beyond senior executives and shareholders.[46] The problem of executive compensation is not just an issue of allocating wealth between senior executives and shareholders. There is a larger question of social equity: that is, the distribution of the gains resulting in excessively large allocations to a small handful of senior executives even though production in a corporation is always a collective endeavor among many factors of production, including employees. Distribution and efficiency are connected.[47]

Excessive compensation poses political and economic questions beyond the immediate microeconomic concerns of agency cost and monitoring and their impact on shareholder value. With that said, shareholder primacy and social equity may not be binary choices. The most efficient outcomes for shareholders may be lower compensation

---

STIGLITZ, *supra* note 5, at 65 ("One of the interpretations of these data is that in effect, during the periods when wages grew so much slower than productivity, corporate managers seized a larger share of the 'rents' associated with corporations."). Economic rent is derived "from the strategic advantage that management possesses in the distribution of the returns to monopoly power." Oliver E. Williamson, *Managerial Discretion and Business Behavior*, 53 AM. ECON. REV. 1032, 1035 (1963).

44 BEBCHUK & FREID, *supra* note 2, at 45-58.

45 *See* Lucian A. Bebchuk, *The Myth of Shareholder Francise*, 93 VA. L. REV. 675 (2007); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

46 *See* STIGLITZ, *supra* note 5, at 66-67; PIKETTY, *supra* note 5, at 334.

47 *See* Amartya Sen, *Does Business Ethics Make Economic Sense?*, 3 BUS. ETHICS QUARTERLY 45 (1993) (arguing that distribution can affect production). On the macroeconomic level, distribution can also affect efficiency. Based on increased inequity of wealth distribution, Standard & Poor's has lowered the growth forecast of the US economy. *Supra* note 8.

levels for senior executives on the whole.[48] This outcome would suit shareholders and employees alike and would tend to make income and wealth distributions more equitable across the corporation and society since shareholders hold wealth across a much broader spectrum of society than the class of senior executives. Income inequity is a major facet of the controversy over executive compensation even though it is not a priority of the shareholder-centric "board capture" school of thought. This Article acknowledges the connection between corporate governance and income inequity.

B. Limits of Delaware Corporation Law

When discussing a failure of an aspect of corporate governance, some may consider the font of reform to lie in state corporation law.[49] This thought is more hopeful than real.[50] There are impediments to any serious reform through state corporation law.

First is the problem of politics and money. Delaware reigns supreme in corporation law, particularly for public corporations where the problem of compensation is most acute.[51] Delaware law is regarded as a kind of a quasi-national corporation law, and its judiciary enjoys its well-earned reputation as preeminent corporate jurists. This expertise is a competitive advantage for the state and generates significant revenue.[52] Since meaningful reform of compensation would most likely result in systemic decrease in executive compensation, any semblance of real reform in Delaware would run the real risk of a "compensation run" to other jurisdictions by those holding the managerial power to make these decisions. Management will want to avoid jurisdictions that will actively scrutinize the grant of compensation. There would be literally millions of

---

[48] *See* BEBCHUK & FREID, *supra* note 2 (criticizing the aggregate dollar values of compensation).

[49] *See, e.g.*, Thomas & Wells, *supra* note 25 (focusing on the fiduciary duty of officers in the contracting process); Lisa M. Fairfax, *Sue on Pay: Say on Pay's Impact on Directors' Fiduciary Duties*, 55 ARIZ. L. REV. 1 (2013) (focusing on negative say-on-pay votes as a basis for fiduciary obligations of boards).

[50] *See* BEBCHUK & FREID, *supra* note 2, at 45-46 (arguing that "judicial review has failed to impose any meaningful constraints on executive pay")

[51] See Lucian A. Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF. L. REV. 1775, 1810 (2002) (noting that over half of all public companies that incorporate in the United States incorporate in Delaware).

[52] *See* Mark J. Roe, *Delaware's Shrinking Half-Life*, 62 STAN. L. REV. 125 (2009) (discussing Delaware's revenue from corporation law); Mark J. Roe, *Delaware's Poltics*, 118 HARV. L. REV. 2491 (2005) (same).

reasons to forsake Delaware. Nothing is more immediately in the self-interest of any worker than compensation. Knowing this, the Delaware legislature and courts will not take action that would seriously compromise the state's franchise.[53]

With this perspective in mind, Delaware courts have applied the traditional doctrines of fiduciary duty, business judgment rule, and corporate waste to review compensation cases. This framework gives a board virtually unfettered discretion to award whatever compensation it decides[54] absent culpable conduct arising from disloyalty, bad faith, bad process, faulty disclosure, waste, or outright fraud.[55] As long as a board makes an informed decision in good faith and shareholders were not deceived, the decision would be effectively bulletproof. Based on this legal framework, derivative suits based on negative shareholder say-on-pay votes have been predictably dismissed in the vast majority of cases.[56]

In the past three decades as executive compensation has exploded and as the courts have been forced to decide bad cases (on the facts) like the *Disney* litigation[57], what have courts done about the problem? No new doctrines have been developed to address the problem.[58] Although there have been some historical instances in which courts have threatened higher scrutiny, they have returned to managerial deference as public dissatisfaction subsided.[59] As commentators have noted, shareholders

---

53 On the occasion when the Delaware courts took action that was deemed significantly against the interests of corporate management, the legislature took immediate action to legislatively overrule the court. Of course, this the famous episode of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), and the subsequent enactment of Section 102(b)(7) exculpation provision. *See* Robert J. Rhee, *Fiduciary Exemption for Public Necessity: Shareholder Profit, Public Good, and the Hobson's Choice during a National Crisis,* 17 GEO. MASON L. REV. 661, 682-83 (2010).

54 *See, e.g.,* Zucker v. Andreessen, 2012 WL 2366448 (Del.Ch. 2012) (upholding severance package of $40 million to a fired executive); In re Walt Disney Derivative Litigation, 906 A.2d 27 (Del. 2006) (upholding compensation of $130 million to a fired executive).

55 State corporation law is most effective as a check on executive compensation when there has been fraud or major defects in disclosure. *See, e.g.,* Weiss v. Swanson, 948 A.2d 433 (Del.Ch. 2008) (holding that the plaintiff sufficient pleaded faulty disclosure and corporate waste in relation to stock option manipulation); Ryan v. Gifford, 918 A.2d 341 (Del.Ch. 2007) (same).

56 *See* Fairfax, *supra* note 49, at 23-25 (describing the current state of derivative litigation).

57 In re Walt Disney Derivative Litigation, 906 A.2d 27 (Del. 2006).

58 *See generally* Thomas & Wells, *supra* note 25, at 865-80 (providing a history of case law on executive compensation).

59 *Id. at* 879.

succeeded in some cases "at some stage of the litigation process."[60] This qualifier is important because what really matters for changing behavior and outcomes is liability, and the threat of liability is not really credible unless there is a real possibility of liability based on the theory of excessive compensation.[61] There has been no case where a board struck down a compensation decision based on excessive amount.[62]

From the framework of longstanding doctrine, courts are right to shy away from meddling in the substantive terms of the employment contract between the corporation and the CEO, if the contract is the product of actual arms-length bargaining. Judges substantially influencing specific contract terms such as the amount of compensation would be frowned upon. Courts can certainly apply their own judgment on the matter,[63] but this contravenes long-existing pillars of corporation law of giving boards deference when they acted in an informed and good faith basis.[64] The board has the authority to decide the business and affairs of the corporation to the board.[65] This authority necessitates the business judgment rule, which is a socially useful rule limiting the liability for officers and directors.[66] Good, bad, or ugly—corporate governance under current standards is stuck with the decisions of boards.[67]

---

60 *Id.* at 879-80.

61 *See* Robert J. Rhee, *The Tort Foundation of Duty of Care and Business Judgment*, 88 NOTRE DAME L. REV. 1139, 1154 (2013) ("The ultimate source of the expressive value of judicial opinions is derived solely from the power to assess liability (i.e., a consultant in a black robe is still just a consultant).").

62 "[Courts] have been hampered, at least in part, by the waste doctrine and its inherent weaknesses, and by lack of any alternative, practicable approach to scrutinizing compensation." Thomas & Wells, *supra* note 25, at 880. When board action fits within traditional theories of misconduct, such as faulty disclosure or waste, courts have acted in the compensation arena. *See supra* note 55 & *infra* note 80.

63 Courts are not incompetent as an intellectual incapability to comprehend and analyze business judgments. *See* Rhee, *supra* note 61, at 1152 ("Despite frequent assertions, scholars have been rightfully skeptical of the argument that courts lack the technical competence to review business decisions.").

64 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (explaining that the business judgment rule "is a presumption that in making a business decision the directors . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company"). *See also* Rhee, *supra* note 61, at 1140 (noting that rules limiting liability of shareholders and directors are two pillars of corporate law).

65 DEL. CODE. ANN. tit. 8, § 141(a); MOD. BUS. CORP. ACT § 8.01(b).

66 *See* Rhee, *supra* note 63.

67 *See* In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, 967 (Del.Ch. 1996) ("[W]hether a judge or jury considering the matter after the fact, believes a decision

Thinking within the current corporate law framework, commentators have suggested that a potential check on self-interested negotiation for compensation could be the fiduciary duty of corporate officers.[68] There are reasons to be less sanguine about the efficacy of this route to reform. As a contracting counterparty to the corporation, officers are entitled to pursue their self-interested economic goals. Fiduciary duty cannot go so far as to suggest that employees and agents should be charities to the firm or that they have a duty to ignore their primary economic interest of vigorously bargaining their wage or stake.[69] Even before the recent recognition of an officer's fiduciary duty in Delaware, the assumption has been that officers were fiduciaries, and so the rise in executive compensation has occurred with this understanding. Public companies are required to have independent board members in their compensation committees.[70] Accordingly, board independence would achieve a largely similar outcome as officer contracting under the halo of fiduciary duty.

Courts are not incapable of developing new doctrines to address new business climates on fairly short notice. Delaware courts rapidly developed new doctrines to confront the new realities of the takeover and leveraged buyout era of the 1980s and 1990s.[71] In executive compensation, however, there have been no similar judicial innovations to design a different review system tailored to the specific problem at hand.[72] This has not been for lack of good test cases that could have served as vehicles for

---

substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational', provides no ground for director liability.").

68 *See* Thomas & Wells, *supra* note 25 (relying on Gantler v. Stephens, 965 A.2d 695, 708-09 (Del. 2009)).

69 Analogously, in partnership law, partners owe fiduciary duty that is said to be "[n]ot honesty alone, but the punctilio of an honor the most sensitive." Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928). But partnership law makes clear that a partner's conduct does not violate fiduciary duty "merely because the partner's conduct furthers the partner's own interest." Revised Uniform Partnership Law § 404(e).

70 Dodd-Frank Act § 952(a). *See* New York Stock Exchange Listing Rule 303A.05(a) ("Listed companies must have a compensation committee composed entirely of independent directors.").

71 *See, e.g.,* Paramount Communications, Inc. v. QVC Network Inc., 637 A.2d 828 (Del. 1993) (applying an intermediate level of judicial scrutiny in the sale of a company); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (determining the fiduciary duty in the context of a cash buyout); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (1985) (determining the scrutiny to be applied in the context of management's defensive measures in a takeover situation).

72 Some commentators have proposed modifications to Delaware's laws of fiduciary duty and judicial review. *See* Thomas & Wells, *supra* note 25; Fairfax, *supra* note 49.

judicial action. For example, the Delaware court openly acknowledged that the circumstance in *Disney* did not display a model of corporate governance;[73] yet bad facts were insufficient to construct a new doctrine specific to governance failure in compensation.

Doctrinal innovations are possible, and the lack of them is a product of choice. As a state supreme court, the Delaware Supreme Court could set forth a bright-line rule on presumption of validity such as compensation that is less than 100:1 ratio between the CEO and the lowest paid employee and that compensation levels beyond that would be scrutinized under a higher standard, for example, entire fairness standard requiring scrutiny of the substance of the business decision.[74] Or consider the possibility of announcing an intermediate scrutiny for severance pay or golden parachutes based on a multifactor reasonableness standard, such as the benefit to the corporation, the corporation's ability to attract executive talent, the length of tenure, the quality of past service, and other relevant facts. Obviously, I am not proposing these rules in this Article. Instead, they are not absurd examples offered simply suggest the potential of a more thoughtful common law process in which the rule of law is malleable to the particular social problem at hand.[75]

The point is that if Delaware wanted to do something about the problem, it could have done so and it has had recurring opportunities. One need not be a Delaware naysayer[76] to believe that Delaware courts,

---

[73] *See* In re Walt Disney Derivative Litigation, 906 A.2d 27, 32 (Del. 2006) (observing that the board's "decision-making process fell short of best practices").

[74] Such bright-line standards are more typically found in the legislative process, but there are prominent examples from U.S. Supreme Court jurisprudence of judicially set quantitative limits. *See, e.g.,* Grutter v. Bollinger, 539 U.S. 306, 343 (2003) ("We expect that 25 years from now, the use of racial preferences will no longer be necessary to further the interest approved today."); State Farm Mut. Ins. Co. v. Campbell, 538 U.S. 408, 425 (2003) ("Our jurisprudence and the principles it has now established demonstrate, however, that, in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process.").

[75] Much of Delaware corporation law, though statute originated, is developed through the common law process. *See* Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1610 (2005) ("Delaware corporate law may be the last vestige of the 19th century common law style in America."); E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1411 (2005) ("Delaware's common law process, which places case law at the forefront of corporate law, is the functional equivalent of judicial legislation.").

[76] *See* William L. Carey, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974). The question of whether corporate law is engaged in a "race to the bottom" or a "race to the top" has spawned a vigorous debate. *Compare id.* at 666

protecting parochial state interests, are simply not inclined to exercise its judicial power to reform executive compensation on a national level in a way that would harm the prestige and economics of the state's corporation law franchise.

Without state legislative mandate, the erection of new doctrinal frameworks to address executive compensation would be a bridge too far for the corporate bench.[77] Courts would have to go outside the comfort zone and habits of familiar doctrines. As the Delaware chancery court stated, "[t]he decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of a board of directors exercising its business judgment." [78] State corporation law is designed to give maximum authority and discretion to informed, non-bad faith decisions on the amount of the pay.[79] Delaware is not a serious solution to the problem of excessive pay.[80] This conclusion is an unremarkable observation of the

---

(advancing the "race to the bottom" argument), *with* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 255-56 (1977), and Ralph Winter, *Private Goals and Competition Among State Legal Systems*, 6 HARV. J.L. & PUB. POL'Y 127, 128-30 (1982) (advancing the "race to the top" argument).

[77] In the past, Delaware courts have created new doctrines, including different standards of review, to address different kinds of problems in corporation law including the takeover arena. *See, e.g.,* Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (providing an intermediate, two-part standard to review a board's defensive action against a hostile acquirer). *See also* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of the Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287 (2001). However, the jurisprudence on compensation has shown little signs that Delaware courts were going take a leading role in the area of compensation by departing from the traditional fiduciary duty, business judgment rule, and waste framework.

[78] In re The Goldman Sachs Group, Inc. Shareholder Litig., 2011 WL 4826104 (Del.Ch. 2011).

[79] *See* Lisa R. Stark, *Delaware Insider: Stockholders Have a "Say on Pay" in Delaware? Lessons from Recent Executive Compensation Decisions*, BUS. L. TODAY (Sept. 2012) ("Stockholders seeking to challenge compensation decisions made by disinterested and informed directors have an uphill battle in Delaware.").

[80] There are the occasional rulings that seem to acknowledge the problem of executive compensation. *See* Thomas & Wells, *supra* note 25, at 879-80. *See, e.g.,* In re Citigroup Inc. Shareholder Derivative Litig., 964 A.2d 106, 139 (Del.Ch. 2009) (ruling that the plaintiff's claim for waste in the grant of Citigroup's former CEO could not be dismissed at the pleading stage). However, these cases work within the traditional framework of corporate waste, which is an exceedingly difficult standard to meet. Irrationality is "the outer limit of the business judgment rule" and "the functional equivalent of the waste test." Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000). Waste occurs "only in the rare, 'unconscionable case"' where a board irrationally squanders corporate

current limits of state corporation law, the contours of which are shaped by corporation law's unique aspects of the politics of revenue-generative lawmaking business, the legitimacy of longstanding doctrinal foundation, and judicial weighing when *stare decisis* confronts new social problems.

C. Say-On-Pay and the Dodd-Frank Act

Regulation of compensation must be prescribed by legislation. This practical understanding gave rise to the say-on-pay phenomenon. Say-on-pay is a fairly new concept.[81] The idea originated in the U.K. where say-on-pay was enacted in 2002.[82] Other countries with advanced economies soon followed. Australia and the Netherlands enacted laws in 2004, Sweden in 2006, and Norway in 2007.[83] The rapid adoption of say-on-pay in other advanced economies indicates a global perception of a problem in executive compensation.

In the U.S., nascent efforts to influence the board's discretion in compensation came in the form of shareholder proxy proposals. The first shareholder say-on-pay proxy proposals were submitted under Rule 14a-8 in 2006.[84] By 2009, say-on-pay proposals were the largest category of shareholder proxy proposals and regularly achieved majority shareholder support.[85] A handful of companies even voluntarily instituted say-on-pay.[86] But these efforts were sporadic, depending on shareholder initiative in proxy proposals.

Say-on-pay first became a federal regulatory requirement in 2008 and 2009, when financial firms receiving TARP funds were required to institute shareholder say-on-pay.[87] During this time, another high profile executive compensation episode captured the public's attention. While the

---

assets. In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del. 2006). As such, the exception has been described as "theoretical." Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1051-52 (Del. Ch. 1996).

[81] For a history, see Thomas et al. (2012), *supra* note 11, at 1217-36.

[82] *Id.* at 1226.

[83] *Id.* at 1227. *See generally* Jan Lieder & Philipp Fischer, *The Say-on-Pay Movement – Evidence from a Comparative Perspective*, 8 EUROPEAN COMPANY & FIN. L. REV. 376 (2011) (discussing say-on-pay in Europe).

[84] Thomas et al. (2012), *supra* note 11, at 1217.

[85] *Id.* at 1217-18.

[86] *Id. at* 1218.

[87] Emergency Economic Stabilization Act of 2008, 12 U.S.C. § 5221(e); American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 111(e), 123 Stat. 115, 519. About 280 financial firms that received TARP funds were required to hold say-on-pay votes. Thomas et al. (2012), supra note 11, at 1223.

financial markets were collapsing and the American public was suffering through the worst economic downturn since the Great Depression,[88] Wall Street investment bankers and executives received enormous "retention" bonuses.[89] The decoupling of pay and performance on Wall Street was absolute and complete in this case. Since state laws were insufficient to address these kinds of problems, the federal government intervened in this area of corporate governance.[90]

With the enactment of the Dodd-Frank Act, the mandate of say-on-pay was extended broadly to all U.S. public companies.[91] The statute requires that at least every 3 years, the company must allow a shareholder vote to approve executive compensation packages.[92] It also mandates votes on the frequency of the vote (whether taken every 1, 2 or 3 years) and golden parachute payments in a merger or acquisition.[93] In spite of management recommendations for triennial votes, shareholders of most companies have voted to hold say-on-pay votes annually.[94] Shareholder vote applies to the compensation packages of the top five executive officers named in the proxy compensation disclosure.[95] The vote is a straight "for" or "against" the overall compensation package and does not provide for line item voting on various aspects of the compensation package.[96] The vote is advisory and not binding on the board.[97] Say-on-pay does not create or imply any change to the fiduciary duties of the board or create any additional fiduciary duties.[98] The authority to approve compensation packages rests squarely with the board.

---

88 *See generally* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (2011).

89 *See* Andrews & Baker, *supra* note 32.

90 *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) (arguing that federal government intervenes in corporate governance when it perceives failures or inadequacies in state corporation laws). *See also* Mark J. Roe, *A Spatial Representation of Delaware-Washington Interaction in Corporate Lawmaking*, 2012 COLUM. BUS. L. REV. 553 (2012).

91 Thomas et al. (2012), *supra* note 11, at 1218.

92 Dodd-Frank Act § 951 (codified in 15 U.S.C. § 78n-1(a)(1)). The disclosure of executive compensation is provided in 17 C.F.R. § 229.402.

93 Dodd-Frank Act § 951 (codified in 15 U.S.C. § 78n-1(a)(2), (b)).

94 Thomas et al. (2012), supra note 11, at 1249.

95 17 C.F.R. § 240.14a-21(a) .

96 *Id.*

97 Dodd-Frank Act § 951 (codified in 15 U.S.C. § 78n-1(c)).

98 *Id.*

The Dodd-Frank Act also strengthened the board's independence on compensation decisions. Public companies must have independent board members on its compensation committee.[99] Relevant factors in determining independence are the source of compensation of a director, and whether a director is affiliated with the issuer or its affiliates.[100]

The Dodd-Frank Act also recognizes the political and socio-economic dimensions of relative pay and income inequality. It requires disclosure of the median of the annual total compensation of all employees (not including the CEO), the annual total compensation of the CEO, and the ratio of the two figures.[101] Since CEO pay is already required to be disclosed, the important disclosure is the median employee pay. The ratio succinctly communicates pay differential.[102] The disclosure would be required in any annual report, proxy or information statement, or registration statement that requires executive compensation disclosure.[103] The wage ratio disclosure is not a direct benefit to shareholders, who are not so concerned with the relative pay levels. It is a legislative nod to the concerns of employees and the public.

Several salutary benefits of the pay ratio disclosure may be achieved. Shaming may temper the most pecuniary appetites, though there is the distinct possibility that millions of more dollars may ultimately outweigh the cost of these negative feelings. Public disclosure and pressure may also be felt. Although CEOs are public figures, many would prefer to avoid notoriety in the eyes of the public. An eye-catching disparity in pay may depress employee morale and elicit disapproval, which are relevant to the production function. These combined effects may influence pay practices at the outer margins. The pay ratio disclosure is a small step toward greater equity in compensation.

---

99 *See supra* note 70.

100 Dodd-Frank Act § 952. New York Stock Exchange Listed Company Manuel § 303A.02(a)(ii) (providing the test of independence as "all factors specifically relevant to determining whether a director has a relationship to the listed company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member").

101 Dodd-Frank Act § 953(b) (codified in 15 U.S.C. § 78*l*).

102 Thus, for example, if the CEO is paid $15 million and the medium employee income is $50,000, the required disclosure of the ratio would be 300:1.

103 The SEC recently issued proposed rules on implementing Section 953(b). *Pay Ratio Disclosure*, Proposed Rule, Release Nos. 33-9452, File No. S7-07-13, 17 C.F.R. Parts 229 and 249.

D. Voting Results and Limits of Shareholder Monitoring

Since shareholder say-on-pay is fairly new in the U.S., only preliminary data are available on outcomes and their effects. Two informative empirical studies of the first year of Dodd-Frank's mandate have been conducted.[104] The results show that shareholder say-on-pay may be a limited monitoring device.

Shareholders strongly supported management resolutions on pay.[105] Votes in favor averaged 91.2% for all companies.[106] Only 37 companies failed to receive majority support.[107] These negative votes stemmed from shareholder discontent arising from a perceived disconnect between pay and company performance.[108] Overall, shareholder votes were highly correlated with share price returns and the amount of CEO pay.[109] Unremarkably, shareholders favored high share returns and low CEO pay, and disliked low share returns and high pay.[110] Shareholders did not necessarily follow the recommendations of Institutional Shareholder Services (ISS), a proxy advisory firm.[111] While all 37 negative votes followed the negative recommendations of ISS, the firm recommended negative votes for 285 companies, 13% of the companies it reviewed.[112]

---

[104] *See* Thomas et al. (2013), supra note 11; Thomas et al. (2012), supra note 11.

[105] In the 2011 proxy season, about 2,220 U.S. public companies held shareholder votes on executive compensation. Thomas et al. (2012), supra note 11, at 1248.

[106] *Id. at* 1249. Thomas et al. report similar results from other empirical studies. *See* Michael Littenberg, Farzad Damania & Justin Neidig, *A Closer Look at Negative Say-on-Pay Votes During the 2011 Proxy Season*, DIRECTOR NOTES (Conference Bd.), July 2011, at 2 (noting that only 36 companies, or 1.6%, of 2,225 companies in the Russell 3000 that held votes rejected management compensation resolutions). About 71% of companies received more than 90% shareholder vote, 23% received 70-90% vote, and 6% received 50-70% vote. Thomas et al. (2012), supra note 11, at 1250.

[107] *Id. at* 1251.

[108] *Id.*

[109] *Id. at* 1249.

[110] *Id.*

[111] *See* http://www.issgovernance.com/. It provides proxy services to shareholders for a fee, and provides proxy voting recommendations.

[112] Thomas et al. (2012), supra note 11, at 1255. However, ISS still had some influence. In another study, Thomas, Palmiter and Cotter report that when ISS recommended "for" votes, shareholders voted in favor on average 92.6% with no proposals being voted down. When ISS recommended "against" votes, shareholders voted in favor 64.4%, with 31 failed votes out of 173 "against" recommendations. Thomas et al. (2013), supra note 11, at 983.

In light of the mostly positive votes, "the voting gesture mandated by law might have been mostly empty."[113] However, the legal right to a voice on the issue may have changed the dynamics of the dialogue between shareholders and management.[114] In a few cases, management has been responsive to some aspects of shareholder concern.[115] These marginal effects of shareholder voting and generally the limit of shareholder efficacy in monitoring are not surprising. Commentators have previously predicted that say-on-pay will be ineffective because shareholders will not engage in individualized analysis and monitoring of executive compensation.[116] Preliminary data seem to support, in the main, these earlier critiques.

The problem with shareholder say-on-pay is the well-recognized observation of rational shareholder apathy.[117] "Often the aggregate cost to shareholders of informing themselves of potential corporate actions, independently assessing the wisdom of such actions, and casting their votes will greatly exceed the expected or actual benefits garnered from informed voting."[118] Apathy toward monitoring is rational from a cost-benefit perspective. The problem is one of collective action.[119] It is exacerbated when diffused shareholders hold diversified portfolios of many investments,[120] and when the turnover on the typical investment is relatively short even for longterm shareholders.[121] The profile of the

---

113 Thomas et al. (2012), *supra* note 11, at 1265.

114 *Id. See* Thomas et al. (2013), *supra* note 11, at 1002-10 (providing four case studies of the dialogue between shareholders and management resulting from shareholder votes on executive compensation).

115 *See* Thomas et al. (2012), supra note 11, at 1265; Thomas et al. (2013), *supra* note 11, at 1002-10. Some empirical studies have suggested that say-on-pay has not changed the amount of compensation, but instead it changed the mix of cash and incentive pay. *See* Natasha Burns & Kristina Minnick, *Does Say-on-Pay Matter? Evidence from Say-on-Pay Proposals in the United States*, 48 FIN. REV. 233 (2013).

116 *See* 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, 341 (2009) (noting that in the U.K. shareholders approved compensation packages in many thousands of votes with only eight negative votes over a six-year period).

117 *See* CLARK, *supra* note 12, at 390-400 (discussing the problem of the rationally apathetic shareholder).

118 *Id.* at 390-91.

119 *Id.* at 391-92.

120 *See* Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77 (1952).

121 *See* Mark Roe, *Are Stock Markets Really Becoming Really Becoming More Short Term?*, PROJECT SYNDICATE (Feb. 21, 2013) (suggesting that the average hold period for longterm investors like Fidelity and Vanguard was 1.5 years in 2010; citing Martijn Cremers, Ankur Pareek, and Zacharius Saunter, *Stock Duration and Misvaluation*,

shareholder with most incentive to monitor and to engage actively in corporate governance is a longterm, activist, or undiversified shareholder, and while such shareholders exist they are not ubiquitous in a modern, liquid equity market in which diversification is said to be a good thing.[122] Lastly, as the efficient market hypothesis suggests, many shareholders rely on market prices to incorporate all public information, which further diminishes the incentive to monitor investments at the individual holding level.[123]

Evidence in the voting patterns in the U.K. and the U.S. support this conventional view of shareholder apathy.[124] Most shareholders most of the time vote in favor of management's compensation. For a company that has not disappointed shareholders with lower returns or incited their discontent with excessively high executive compensation for poor performance,[125] the default vote would likely be in favor of the compensation package. Even when a proxy advisory firm issues a negative recommendation, shareholders mostly disregard the advice.[126]

A contrary interpretation of the preliminary data could be that shareholders are fully engaged in monitoring compensation, and in the vast majority of cases they voted in favor of compensation packages after informed consideration. But advancing these conclusions would be difficult. Empirical data on voting outcomes do not reveal the thought processes of the many thousands of voting shareholders. One wonders whether shareholders examined the record and made individualized

---

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2190437), available at http://www.project-syndicate.org/commentary/has-short-termism-in-stock-markets-increased-by-mark-roe.

122 *See* Markowitz, *supra* note 120, at 77 (showing that diversification was a normatively good investment strategy).

123 *See* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 327 (11th ed. 2014) ("The evidence of efficient markets has convinced many professional and individual investors to give up pursuit of superior performance. They simply 'buy the index,' which maximizes diversification and cuts costs to the bone."). *See* Basic, Inc. v. Levinson, 485 U.S. 224 (1988); Halliburton Co. v. Erica P. John Fund, Inc., 134 S.Ct. 2398 (2014).

124 *See* KYM MAREE SHEEHAN, THE REGULATION OF EXECUTIVE COMPENSATION: GREED, ACCOUNTABILITY AND SAY ON PAY 145-59 (2012) (discussing the limited of institutional investors as effective monitors of executive pay).

125 *See* Thomas et al. (2012), *supra* note 11, at 1249 (reporting that "low returns and high CEO pay result[ed] in lower say-on-pay support").

126 *See id.* at 1265 ("ISS may be less influential than commonly thought on this type of proposal.").

informed decisions for companies in their diversified portfolios.[127] Also, shareholders are limited to market information, primarily share price returns and publicly disclosed financial results, explaining the relationship between the level of voting support and share price. The problem with shareholder monitoring is well founded.[128]

The conclusion inferred from mostly positive votes is important. A hypothesis of informed decisionmaking would be far reaching. Since compensation levels have not come down due to say-on-pay, the implications would be that there has not been a real problem of executive compensation at all, and that informed shareholders agree with most pay packages. The many critiques are simply much ado about nothing since they do not reflect the concerns of most shareholders. However, this contrary interpretation of data has not been demonstrated to be true, and scholars have not advanced it.

The problem of the rationally apathetic shareholder is significant in shareholder say-on-pay. Even institutional shareholders are not immune because as highly diversified, active traders in a liquid equity market, the cost-benefit analysis is acute. Although proxy advisers could ameliorate the collective action problem,[129] the preliminary empirical evidence suggests that this is not the case.[130] If say-on-pay is limited in its efficacy, it reflects the fact that shareholders are limited in their capability to effectively monitor. Another monitor can be more effective or can complement the efforts of shareholders if the cost of monitoring is low and the incentive to monitor is higher.

II. EMPLOYEE SAY-ON-PAY

A. The Proposal

---

127 *See* Michael Kang, *Shareholder Voting as Veto*, 88 IND. L.J. 1299, 1313 (2013) ("At least for such public companies with dispersed ownership, it is highly unlikely that the multiplicity of shareholders will remain well informed about the company's affairs and then achieve collective agreement on the best course of action for their company.").

128 *See* Adams, *supra* note 12, at 422 (noting that "shareholders have historically been of little importance in monitoring corporate conduct" due to "the collective action problem").

129 *See* Gordon, *supra* note 116, at 351-52.

130 *See* Thomas et al. (2012), *supra* note 11, at 1213 (noting that "the net effect of a negative ISS recommendation on the overall shareholder vote is relatively small at most companies").

This Article proposes the adoption of employee say-on-pay, which would mirror the Dodd-Frank Act's mandate of shareholder say-on-pay. At least once every 3 years, a public U.S. corporation should hold an employee vote to approve the compensation of top executives.[131] Unison of voting between shareholders and employees is not required, as long as employees have periodic opportunities to vote and convey information to the board. However, it would be ideal if shareholder and employee vote in tandem. Most shareholder votes occur annually, and so employee votes should be the same.

Shareholder say-on-pay would be an advisory vote and not binding on the board.[132] The Dodd-Frank Act mandates that the shareholder vote cannot be construed: "(1) as overruling a decision by such issuer or board of directors; (2) to create or imply any change to the fiduciary duties of such issuer or board of directors; (3) to create or imply any additional fiduciary duties for such issuer or board of directors."[133] These requirements should also apply to employee say-on-pay. The board has the ultimate authority to set compensation.

Unlike shareholder say-on-pay, employee vote could be conditioned on a wage ratio trigger. The Dodd-Frank Act requires the disclosure of the wage ratio between the CEO and employees.[134] Employee say-on-pay could be structured to trigger upon exceeding a certain level of wage ratio. There is an efficiency consideration. Say-on-pay is designed to police *excessive* compensation. A certain level of wage ratio could be deemed to be presumptively not excessive when compared to the baseline of the median employee pay, and thus employee say-on-pay could be structured to trigger at a certain level. For example, if the compensation ratio is 20:1—a quaint level in light of the modern trend in compensation—one would question whether a say-on-pay vote by either shareholders or employees is really necessary.

Certain intuitions can guide us. A trigger of 20:1 would most likely be deemed too low, and would take executive compensation back to the 1960s and 1970s.[135] A trigger of 100:1 would probably be too high because

---

131 *Cf.* Dodd-Frank Act § 951.

132 *Id.*

133 *Id.*

134 *Id.* The SEC has announced proposed rules on wage ratio disclosure. *Pay Ratio Disclosure*, 17 C.F.R. Parts 229 and 249 (Release Nos. 33-9452; 34-70443; File No. S7-07-13).

135 To be clear, the suggestion that it is "too low" refers to the necessary political compromises that have to take place to enact legislation. By way of comparison, the Japanese ratio of CEO to average employee pay is approximately 16:1. Jason Clenfield, *In*

this level is in the neighborhood of current levels that have caused public and political rebuke.[136] Some compromise in the range between 50:1 to 100:1 seems about right. This range permits high salary, but one suspects that neither employees nor the public would be so outraged by this sort of level. Any rent extraction that may occur would be fairly marginal, and properly deemed insignificant in light of the cost of monitoring.[137]

A concrete example illustrated the point. Suppose the median employee pay at a corporation is $50,000.[138] At a trigger range of 75:1, CEO pay could be $3.75 million without triggering employee say-on-pay. Based on current pay levels of CEOs today, the majority of public companies, most of which are by definition small cap and midcap companies, may not be required to hold employee votes.[139] Since the size of CEO pay is highly correlated to the size of the corporation,[140] the compensation packages for the largest companies would surely be subject to employee say-on-pay.[141]

Parenthetically, the idea of a wage trigger can be applied as to the mandate of shareholder say-on-pay as a tweak of the Dodd-Frank reform. Such votes would be unnecessary if the wage ratio between the CEO and employees does not exceed a certain level. This reform of say-on-pay could have efficiency benefits. One strongly suspects that in light of the correlation between firm size and pay, a significant portion of smaller

---

Japan, Underpaid—and Loving It, BLOOMBERG BUSINESSWEEK (July 1, 2010), available at http://www.businessweek.com/magazine/content/10_28/b4186014341924.htm.

[136] *See supra* note 29 and accompanying table.

[137] *See* Carola Frydman & Dirk Jenter, *CEO Compensation*, at 24 ("Moreover, 'awarding' pay by allowing managers to extract some rents can be optimal if monitoring is costly."), working paper available at http://web.mit.edu/frydman/www/COMP%20SURVEY%2008-02-10.pdf.

[138] *See id.* (providing average nonsupervisory worker compensation). Some companies pay their employees high compensation. *See, e.g.*, Brett Philbin, *Average Goldman Pay: $399,506*, WALL ST. J. (Jan. 13, 2013) (noting the average pay at Goldman Sachs in 2012); Gus Lubin, *Google Has the Highest Average Salaries in the Tech Industry: $141,000*, BUSINESS INSIDER (June 10, 2011) (noting the average pay at Google in 2010).

[139] In 2012, the median total realized compensation of CEOs in the Russell 2000 was $1.8 million. Greg Ruel, *CEO Pay Survey: Stock Option Profits Continue to Pave CEOs' Path to the Bank*, GMI RATINGS at 5 (2013) (based on a sample size of 1349 companies).

[140] *See id* at 4 (showing significant pay differences among CEOs in the S&P Smallcaps, Midcaps, and 500 indices, with 2012 median total realized compensations of $2.4 million, $4.9 million, and $11.9 million, respectively).

[141] *See id.* at 4 (showing that median total realized compensation of $11.9 million in 2012 for CEOs of the Fortune 500 companies); Gretchen Morgenson, *The Unstoppable Climb in C.E.O. Pay*, N.Y. TIMES (June 29, 2013) (noting that the top 100 CEOs were paid a median compensation of $14 million in 2012).

companies,[142] perhaps even a majority, would be exempt from holding say-on-pay votes with a reasonable trigger, and that a great majority of larger companies would still be subject to shareholder vote. One hastens to add that if the idea is appealing in the abstract, the difficulty in practice would be to identify the trigger level. A trigger in the range between 50:1 to 100:1 seems plausible as a political compromise.

B. Weighed Voting

Implementing a voting scheme requires careful weighing of fairness and efficiency considerations. Notwithstanding the rhetoric of shareholder democracy,[143] a corporation is not a platonic political entity.[144] It is an economic organization. In corporate governance, there is no liberty interest in the right to governance. The political principles of universal suffrage and "one person, one vote"[145] do not apply for obvious reasons. Shareholders voting is based on shares held,[146] and shareholder classes of

---

142 The SEC provided an exemption from say-on-pay to smaller companies with less than $75 million in public float until January 20, 2013. *Shareholder Approval of Executive Compensation and Golden Parachute Compensation*, 76 Fed. Reg. 6010, 6010 (Feb. 2, 2011). Smaller reporting companies must now hold say-on-pay votes.

143 Shareholder democracy is frequently used as short-hand for shareholder participation through voting in corporate governance. *See* Hoschett v. TSI Intern. Software, Ltd., 683 A.2d 43, 45-46 (Del.Ch. 1996) (Allen, Ch.) (noting that voting and deliberation aspects of shareholders' annual meeting resembles democratic discourse); Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del.Sup. 1971) (referring to the principle of shareholder voting as "corporate democracy"); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 842-43 (2005) (suggesting that shareholder democracy will enhance shareholder value). *See also* Lisa M. Fairfax, *Making the Corporation Safe for Shareholder Democracy*, 69 OHIO ST. L.J. 53, 55 (2008) (suggesting a link between shareholder democracy and corporate and executive accountability).

144 *See* Hoschett v. TSI Intern. Software, Ltd., 683 A.2d 43, 45-46 (Del.Ch. 1996) (Allen, Ch.) (noting that "the model of democratic forms should not too strictly be applied to the economic institution of a business corporation (where for instance votes are weighted by the size of the voter's investment)"). *See also* Tom C.W. Lin, 47 UC DAVID L. REV. 1351, 1399 (2014) (suggesting that "[c]orporations are not democratic nation-states" and that wholesale attempts to "democratize" them can cause serious harms).

145 *See* Baker v. Carr, 369 U.S. 186 (1962).

146 *See* CLARK, *supra* note 12, at 390 ("We could argue further that voting rights should be proportional to one's share of the residual interest in the firm."). More generally, inequality and inequity are separate concepts in corporation law. *See* Applebaum v. Avaya, Inc., 812 A.2d 880, 886 (Del. 2002) (noting that "equity and equality are not synonymous concepts in the Delaware General Corporation Law"); Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993) ("It is well established in our jurisprudence that stockholders need not always be treated equally for all purposes.").

unequal rights are permissible.[147] Voting rights in corporations serve an economic purpose.[148] Unlike shareholders, employees and creditors typically do not vote on important matters such as director and fundamental transactions.[149] These observations raise a fundamental question of how the voting scheme should be conceived.

Voting in corporations is not based on egalitarian principles. This Article proposes that every employee should have a vote, but that vote allocation should be unequal. Vote allocation should be a function of the potential effectiveness of different classes of employees as monitors of executive performance.

Even the lowest ranking employee of a large public company may have some sense of how the company is doing. But their understanding of CEO performance would not compare to the senior manager of a business unit. Consider a low level worker at a large corporation with a market capitalization of $10 billion. How will the lowest rank and file employee, who may earn $25,000 per year, feel about the CEO earning $10 million, a ratio of 400:1? Would a visceral emotional reaction to the income disparity be relevant? These kinds of anticipated personal reactions at the firm level should not be factors in determining executive compensation.

Employee say-on-pay must principally serve a monitoring role.[150] This function requires informed voting, which communicates relevant information to the board. Weighed voting is required. The allocation of voting rights should be based on employee titles, functions and job descriptions. In rational corporate hierarchies, the quantum and quality of information held is fairly correlated to position in the corporate hierarchy.

Companies should have discretion to allocate votes, subject to a prohibition against gaming. Gaming can be achieved by allocating most voting power to the highest level of executive management since this layer would most favor executive pay proposals. There is a balance between calibrated voting and gamed outcomes. This balance can be achieved either through some qualitative standards, or through bright-line

---

147 *See* DEL. GEN. CORP. L. § 151(a) (permitting different preference rights and classes of stock). Companies like Google, Berkshire Hathaway, Alibaba, and Ford Motor have different classes of common stock with different voting rights.

148 *See* FRANK EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1996) (explaining the importance of voting rights of equity capital).

149 *Cf.* DEL. GEN. CORP. L. § 221 (permitting debt instruments to have voting rights). Absent unusual circumstances, however, it would be odd for debt instruments to have voting rights. Eliasen v. Itel Corp., 82 F.3d 731 (7th Cir. 1986) (Posner, J.).

150 *See* Adams, *supra* note 12, at 442 (noting that full-circle evaluations promote "efficiency and profitability").

quantitative rules.[151] For example, a proportion that allocates 20% of the vote to the non-managerial rank and file workforce might not be an unreasonable mix. This allotment is a significant but nevertheless minority voting power. The visceral reaction of the average employee against a relatively high CEO pay, if that is the fear, would not overwhelm the voting outcome. At the same time, knowing what average employees think about their CEO's pay is still relevant information for the board. Issues like morale, happiness, job satisfaction, commitment to the firm, social cohesion, and sense of common undertaking (if not common lot); and they are relevant factors in the corporation's production function. A small but meaningful allocation serves an information function. Each company should be allowed to calibrate voting such that there can be meaningful participation.

The class of voters with the greatest individual voting power should be the managerial ranks below the highest executive level subject to SEC compensation reporting requirements. This is a significant class of senior executives who are managers of large business units or functions. They possess the best information on the performance of the CEO and the company's prospects, but they are most likely to be biased in favor of the CEO. These competing tensions balance such that they have the greatest *individual* voting power, but not *class* voting power. Class voting power is limited by the pyramidal organizational structure where more senior ranks are smaller in number.

There are compelling reasons to argue that the class of voters with the greatest voice should be the senior and middle managers, the layers below the highest executive ranks.[152] This group is large in most businesses. They connect the shop floor with the executive suite. They have management responsibilities, tasked with executing the strategies given down from above. They have broad organizational awareness, and a good sense of connecting corporate strategy with tactical understanding. They dream of climbing higher the corporate hierarchy, high enough to earn the keys to the executive suites; yet they are not so far removed from the bottom tier to have lost a sense of economic proportion. They report directly to senior executives, and the managerial rank exchanges vital

---

151 *See generally* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992) (analyzing the difference between rules and standards and their best application).

152 "Midlevel management knows how well the company is functioning on a daily basis and which parts of the company's structure needs additional work." Adams, *supra* note 12, at 432.

information. They are in routine contact with outside constituencies such as suppliers and customers. They are important inputs for gauging morale, and influence broader rank and file morale.

Middle and seniors managers collectively know much about the state of the corporation, its trajectory, and the cause and effect of corporate leadership, and in many cases they collectively know more than their individual superiors. They are the leaders in the trenches of the firm, and their collective opinions should not be underestimated even at the rarified board level, though as a practical matter it is difficult for boards to get direct information in this regard.

While the rank and file worker who earns $25,000 may not be an informed voter in some respect, the same may not be said for the $250,000 non-executive vice president responsible for a market segment or a product. Such a person would have significant information on the state of the company, how the senior executives are managing the company, and ultimately the performance of the CEO. Furthermore, the class of vice presidents on the same level would hold a substantial quantum and quality of the firm's total information.

Based on the foregoing reasons, a stylized example of a voting allocation might look something like this: 20% the general workforce, 60% middle and senior managers, and 20% senior officers. In this scheme, fully 80% of the voting power is allocated to the managerial ranks, though the managerial rank is not the same as the rank of senior executives whose compensation are subject to the board's decision. I note that there is no "correct" proportion, but a range of reasonable voting allocations.

C. Gamed Voting

Whenever there is consequential voting, there lurks a potential problem of gaming. There are two kinds of gaming problems here. The first is where the allocation of votes can stack the deck in favor of the CEO. This is structural gaming in which the structure of the scheme determines the outcome. The second is internal gaming in which the vote is affected by the employee's internal motivations apart from incentive to monitor. These gaming effects are related.

Confidentiality in voting is important since retaliation can be a real risk, particularly at the senior ranks.[153] An employee may be rationally fearful if confidentiality cannot be assured. Rank and file employees

---

[153] *See id.* at 431, 437 (stressing the importance of anonymity in full-circle evaluations where subordinates are evaluating supervisors).

would have less to fear. Would a CEO fire some random assembly line worker in a far-flung operation due to a negative vote? Such fear would be more grounded in reality among the senior and managerial ranks, and these ranks are important to elicit information.

Confidentiality can be breached through deductive analysis of voting outcomes if voting allocation is structurally gamed. While it would be impossible for anyone to know how a specific low level employee voted based on voting results, deductive analysis can reveal the votes or voting patterns of employees with significant voting power.

A simple example illustrates the point. Suppose there are four classes of employees below the top executives whose compensations are subject to board approval and public disclosure. The corporate hierarchy has four levels: class A is the senior executives, class B senior non-executive managers, class C middle managers, and class D the general workforce. The class voting allocations are: 20% (A), 28% (B), 30% (C), and 22% (D). Each class has the following number of employees and votes.

Employee Class	Number of Employees	Votes per Individual	Individual Voting Power	Votes per Class	Class Voting Power
A	1	10	20%	10	20%
B	2	7	14%	14	28%
C	5	3	6%	15	30%
D	11	1	2%	11	22%
Total	19	na	na	50	100%

Suppose the compensation package was voted down, receiving 30 "against" votes, which is 60% of the total votes. It is impossible to know how the lower level employees voted, and from the CEO's perspective she may not care as much. The CEO works most closely with the executives and senior managers—the three employees in classes A and B. Since these three hold 24 votes, it is a mathematical certainty that at least one of them voted "against." Also, it is unlikely that only one voted "against." If the class A employee voted "against" (10 votes), then the remaining 20 "against" votes must have come from the collective 26 votes held at classes C and D, which is perhaps an unlikely 77% majority of the lower two classes. If the one negative vote was from a class B employee (7 votes), then the remaining 23 "against" votes must have come from the 26 votes at classes C and D, which is a highly unlikely 88% majority of the lower two classes. These outcomes are plausible, but in varying degrees unlikely. A CEO can be confident that the most like possibility is that two of the three employees in classes A and B—those employees who are the closest

to her—voted “against.” If the CEO had other information as well, for example, past dealings, personal interactions, and emotional intuitions, the identities of the “against” voters could be fairly obvious. By voting “against”, these employees would not have enhanced their career prospects. A CEO who correctly perceives that a majority of her management team does not have confidence in her can solve the problem by replacing the team. Thus, under this voting structure, higher class employees would have incentive to internally game the vote irrespective of her opinions on the company’s prospects and the CEO’s performance.

Such deductive reasoning quickly loses efficacy when the voting permutations increase due to greater number of voters and decreased concentration of voting powers. As the saying goes, there is safety in numbers. Consider a more complex organization with the identical voting allocations by employee rank. The class voting allocations are exactly the same above: 20% (A), 28% (B), 30% (C), and 22% (D). But there are now more employees and thus each employee’s voting power has been diluted significantly.

Employee Class	Number of Employees	Votes per Individual	Individual Voting Power	Votes per Class	Class Voting Power
A	2	10	10%	20	20%
B	4	7	7%	28	28%
C	6	5	5%	30	30%
D	22	1	1%	22	22%
Total	34	na	na	100	100%

Suppose again that there are 60% “against” votes constituting 60 votes. It is not clear what combination of voters produced the 60% outcome. Some combination of six employees at classes A and B must have voted no, but it is unclear who they may be. Again, intuitions and insights from personal dealings may shed some light, but the conclusions may be far less reliable. Much of the deductive reasoning power loses efficacy when votes become confidential due to the ability to hide in numbers.

These simple examples can be generalized to the situations at corporations of various sizes. These examples show that gaming is less problematic at larger corporations than smaller ones due to the increased number of voters. Unless the allocation is clearly gamed at larger corporations, the problem of voting transparency is not so significant. However, giant multinational corporations exist at one end of the size spectrum of public companies. There are many smaller and midcap public

companies where employees and managers may know each other broadly and intimately. In these cases, a concern for confidentiality would be real.

These simple examples also show the relationship between gaming and confidentiality. Gaming can achieved through the structure of the scheme: *i.e.*, giving the employees most likely to vote in favor the most number of votes, which for a CEO would be the highest executive level employees. Gaming can also be internally influenced: *i.e.*, employees voting strategically for self-interested reasons, which affect the highest executive level employees the most. Absent discord at the highest ranks, we would expect that senior executives would be most inclined to support the CEO's pay package, particularly since they would identify with the CEO as they aspire to that level as well. The highest ranking employees have the greatest incentive to monitor company performance and the best inside information, which are reasons why they should have the most votes. Yet too much concentration of voting may result in gaming. The best voting allocation would balance these considerations.

D. Implementation

Despite the framework based on shareholder say-on-pay, several issues are unique to employee voting. The problems are conceptualizing the corporate hierarchy for the purpose of vote allocation, the right to vote for foreign employees, and the mechanics of voting.

Corporations have organizational charts and are defined by a hierarchical system of titles, functions, responsibilities, and powers. Conceptualizing the organization is not a difficult problem. The systems of human resources departments are in place to organize a voting scheme. The asserted difficulty of the task is simply a reflection of the strength of the objection.

Although a U.S. public company may have sprawling international operations, voting should be limited to U.S.-based employees. The practical reason is that wage standards across the globe vary radically.[154] In terms of monitoring capabilities and inside information, U.S.-based employees of U.S. firms would probably be better, generally speaking,

---

[154] For example, in 2011 the average Chinese worker earned approximately 42,000 yuan per year, which is approximately $6,900 (at a conversion rate of 1 yuan to $0.16). *Wages in China*, China Labour Bulletin (June 10, 2013) (noting that the average worker made 3,500 yuan monthly in 2011), available at http://www.clb.org.hk/en/content/wages-china. This figure is significantly lower than the average U.S. worker pay. *See supra* note 29 & accompanying chart.

since they are likely to be more knowledgeable about the state of the company. For example, American employees of General Motors may be more knowledgeable about the company than their counterparts in China, and German employees of Volkswagen may have the same advantage over employees in Mexico. For U.S. companies, the information quality provided by U.S.-based employees would generally be better due to knowledge gained from closer physical, informational, and relational proximities.

The most difficult implementation issue is the judgment that would go toward allocating votes. The board should have discretion to exercise business judgment, subject to regulatory guidelines against gaming, to allocate votes within the corporate hierarchy in a way that achieves informed voting. The regulation can be in the form of a report and proposal to the SEC, subject to agency consent, discussing the corporation's organization, categorization of employees, vote allocation assignments per category, and the rationale for the particular assignments. As difficult as allocating votes may be, the exercise of judgment on difficult matters is what boards and executives are paid to do.

Unlike shareholders voting which occurs through an existing proxy process, a company must create a new voting process to achieve employee say-on-pay. This raises the questions of cost. Under the standard theory, agency cost is defined as the sum of the contracting cost between principal and agent, monitoring cost by the principal, the bonding cost by the agent, and the residual loss.[155] This theory suggests that some rent extraction by CEOs may be efficient (economically tolerable) if the monitoring costs of such behavior is greater than the rent extracted.[156]

The cost of establishing voting, while significant, will not be high relative to the issue at stake. Organizational structure already exists, and the most difficult aspect of constructing a voting scheme is the exercise of judgment. Voting would not be a mandatory condition of employment, but like political voting a voluntary act of participation.

Voting can be done electronically. Corporations can easily create a voting portal in which employees can login through a company-issued identification, such as a password or social security number, and vote on the package.[157] Corporations can achieve amazing feats of organization,

---

155 Jensen & Meckling, *supra* note 13, at 308; *see* MICHAEL C. JENSEN, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS, AND ORGANIZATIONAL FORMS (2000).

156 *See supra* note 137.

157 *See* Adams, *supra* note 12, at 432 (stating that full-circle evaluations can be administered through the internet "without much added cost").

data collection, analysis, and use of information technology.[158] An objection that voting would be technologically infeasible or too costly as a direct expenditure would defy credibility based on everyday observations of the routine use of information technology by many parts of society including business corporations.

In conclusion, the implementation of employee say-on-pay is quite feasibility. The real issue is whether employee say-on-pay would produce better corporate governance as to executive compensation, and whether these benefits are outweighed by the objections to the idea. These issues are discussed in the next two sections.

III. BENEFITS OF EMPLOYEE SAY

A. Advantage of Private Information

The principal rationale for employee say-on-pay is that employees hold the corporation's entire information content. The advantage of employees as monitors compared to shareholders is apparent when we consider the question of information through the lens of market efficiency. Economists have classified levels of market efficiency: strong, semi-strong, and weak forms of efficiency.[159] The weak form is the hypothesis that past information such as stock prices has been incorporated into the current stock price, and it is certainly correct.[160] The semi-strong form is the hypothesis that stock price adjust immediately to all publicly available information. There is a question of whether the market is always semi-strong efficient,[161] but one can say without controversy that the market

---

158 *See, e.g.*, Charles Duhigg, *What Does Your Credit-Card Company Know About You?*, N.Y. TIMES (May 12, 2009) (discussing how credit card companies can predict individual consumer behavior through data collection and analysis).

159 *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (proposing that there are three types of market efficiency, which are strong, semi-strong, and weak forms of efficiency). *See generally* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency,* 70 VA. L. REV. 549 (1983)

160 FRANK J. FABOZZI & FRANCO MODIGLIANI, CAPITAL MARKETS: INSTITUTIONS AND INSTRUMENTS 291 (4th ed. 2009).

161 *See id.* ("Evidence on whether the stock market is price efficient in the semi-strong form is mixed."); WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 36 (7th ed. 2012) ("The number of EMH supporters in the financial economic community has dwindled."); Robert J. Shiller, *We'll Share the Honors, and Agree to Disagree,* N.Y. TIMES (Oct. 27, 2013) ("have argued that the theory makes little sense, except in fairly trivial ways. Of course, prices reflect available information. But they are far from

often rapidly incorporates publicly disclosed information such as press releases, disclosures, and annual reports.[162] The strong form is the hypothesis that market price of stock incorporates all public and private information, and this version of market efficiency is certainly not correct.[163] With this broad outline of the efficient market hypothesis in mind, one must conclude that, even if shareholder voting is informed, it can only be based on publicly available information.

On the other hand, employees have not only all of the information available to shareholders (many are themselves shareholders), but they also have private information. "Private information" is not a reference to legally prohibited information,[164] but instead information relevant to the performance of the firm and its executives that are not readily accessible to the public. These kinds of information may include knowledge of specific matters of business operations and strategy, more generalized information on the sense of organizational "well-being," and company morale, which is relevant as an indicator of past and present firm performance and expectation of future performance. Under specific

---

perfect."). The presumption of market efficiency is the basis for the fraud-on-the-market theory of Rule 10b-5 securities fraud actions. *See* Basic, Inc. v. Levinson, 485 U.S. 224 (1988). There are nuances to market efficiency, such the degree and time responsiveness in which public information is absorbed, that are important in securities actions. *See generally* Donald C. Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 WISC. L. REV. 151; Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance,* 28 J. CORP. L. 635 (2003); Baruch Lev & Meiriing de Villiers, *Stock Price Crashes and 10b–5 Damages: A Legal, Economic, and Policy Analysis*, 47 STAN. L. REV 7, 20 (1994). These nuances are not relevant for the discussion here.

[162] *See* Halliburton Co. v. Erica P. John Fund, Inc., 134 S.Ct. 2398, 2410 (2014) ("Even the foremost critics of the efficient-capital-markets hypothesis acknowledge that public information generally affects stock prices.").

[163] "No one these days accepts the strongest version of the efficient capital market hypothesis, under which non-public information automatically affects prices. That version is empirically false: the public announcement of news (good and bad) has big effects on stock prices, which could not happen if prices already incorporated the effect of non-public information." West v. Prudential Securities, Inc., 282 F.3d 935, 938 (7th Cir. 2002) (Easterbrook, J.). *See, e.g.,* Arthur J. Keown & John M. Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, 36 J. FIN. 855 (1981) (showing rapid rise of stock price to reflect merger announcements and acquisition premiums); Leslie A. Jeng, Andrew Metrick & Richard Zeckhauser, *Estimating the Returns to Insider Trading: A Performance-Evaluation Perspective*, 85 REV. ECON. & STATISTICS 453 (2003) (finding abnormal returns of more than 6% per year from insider purchase). Indeed, if the strong form of market efficiency was correct, there would be no need for insider trading laws since insiders would not be able to profit from private information.

[164] *See, e.g.,* United States v. O'Hagan, 521 U.S. 642 (1997) (involving misappropriation of confidential information under the securities laws).

information concerning or leading to inferences of these matters are publicly disclosed, they are private information held only by the collective employees. Under employee say-on-pay, private information would be reflected in the voting results.

If one believes that there is a perfect correlation between information that is readily publicly available, such as public disclosures and press releases, and the private information held by employees (that is, the strong form of market efficiency), there would be no rationale for employee say-on-pay on efficiency grounds. However, no company is perfectly transparent, and private information always exists.

Shareholder and employee say-on-pay would work at different levels of market efficiency. Shareholders are most likely to vote "no" when share prices are declining and as a result can be said to reflect the publicly available information. If employees have a vote, they would be most likely to vote "no" when the information they hold on the executive's role in the corporation's past performance and expectation of the future conflicts with the pay package. This would be private information flowing into the voting mechanism.

B. Reverse Monitoring

Employee say-on-pay serves as reverse monitoring of executive performance and pay. Employees are said to have many roles, including citizens at work, stakeholders, human capital, and investors.[165] Employees can also be monitors of executives. Reverse monitoring is the idea that employees are monitors of their peers including their supervisors, and not just the targets of monitoring by the company.[166] Typically, we think of the evaluation and monitoring in the corporate hierarchy as a sequence of top-down processes emanating from the board to the senior officers, and progressively going down toward the base of the pyramid. But in reality monitoring can be multidirectional.

The application of reverse monitoring is seen in different contexts. It has been suggested that, contrary to conventional wisdom that stock options impart ownership incentives on employees, employee stock options promote a reverse monitoring function, wherein employees are incentivized to monitor peer misconduct or shirking to avoid a decline in

---

165 Arthurs & Mummé, *supra* note 21, at 352-67.

166 Sharon Hannes, *Reverse Monitoring: On the Hidden Role of Employee Stock-Based Compensation*, 105 MICH. L. REV. 1421, 1423-24, 1446 (2007).

the value of their options.[167] Also, whistleblower protections and *qui tam* actions are based on the idea that employees can monitor the corporation and their peers for wrongdoing on behalf of the corporation or the public.[168] It is wise policy to give employees the incentives and the means to monitor organizational governance.[169]

Reverse monitoring is not a radical concept. It is widely used in corporations. Many major public corporations routinely use "full-circle" or 360 evaluations where subordinates evaluate the performance of their supervisors.[170] Such evaluations steadily gained acceptance in the 1980s and 1990s both as a decisionmaking tool and a method for evaluating management.[171] Full-circle evaluations provide crucial information on the performance of senior managers by those they supervise. The only thing radical in the concept of employee say-on-pay is that the top corporate officer would be subject to firm-wide evaluation by all subordinates. But it is not clear why the CEO and senior executives, being an employee as well, should be inherently exempt from such evaluations. Voting would simply formalize opinions already held. It is true that boards evaluate senior executives, but they require information to do so.

The idea that employees can serve as monitors of peers and superiors is based on the plain fact that they possess all of the information content of

---

167 *Id. at* 1423-25. The idea is that individual employees can do more harm to the corporation than they can increase value. Stock options incentivize reverse monitor by employees whose options may be subject to destruction of value by other employees. *Id.*

168 *See, e.g.,* Dodd-Frank Act § 922 (providing whistleblower protection); Sarbanes-Oxley Act § 806 (same); False Claims Act, 31 U.S.C. §§ 3729–3733 (providing for *qui tam* action for fraud against the U.S. government).

169 *See* Hannes, *supra* note 166, at 1424 ("It is hard to imagine anyone in a better position to fulfill this [monitoring] mission [than employees], and because their duties do not include this task, it is wise to give them an incentives to do so . . . ."). *See also* Orly Lobel, *Citizenship, Organizational Citizenship, and the Laws of Overlapping Obligations*, 97 CALIF. L. REV. 433 (2009) (discussing the role of employees in ensuring the legality and compliance obligations of organizations).

170 *See* Adams, *supra* note 12, at 429-35. Companies like Walt Disney, General Motors, American Airlines, Intel, DuPont, IBM, and RCA have used full-circle evaluations. *Id. at* 431, 433. According to one survey, 90% of Fortune 1000 companies surveyed had implemented some form of full-circle or multisource evaluation system. *Id. at* 433 (citing Mark R. Edwards & Ann JU. Ewen, *How to Manage Performance and Pay with 360-Degree Feedback*, COMPENSATION & BENEFITS REV., May/June 1996, at 41). *See* H. John Bernardin & Richard W. Beatty, *Can Subordinate Appraisals Enhance Managerial Productivity?*, 28 SLOAN MANAGEMENT REV. 63 (1987) (arguing for giving employees "voice" in the performance evaluation of their supervisors).

171 Adams, *supra* note 12, at 429.

the firm.[172] Not even the CEO would possess this quantity of information, and certainly the board would not. Shareholders are incapable of observing everything a manager does and is limited to public information. But employees benefit from direct observation and private or difficult to acquire information. Their vote would express this information content. Since this inside information o is valuable,[173] the rationale for reverse monitoring is compelling.

When employees are monitoring peers or supervisors, monitoring is costless and requires only awareness.[174] But one may question the quality of the information. In large corporations, direct observations cannot be made in some circumstances. Most CEOs would be incompetent to evaluate most employees in the company due to the fact that they would not have personal observations arising from direct professional dealings. As a factual corollary, most employees are not in day-to-day contact with the CEO and other senior executives. So does this mean that employees would be equally incompetent? No, the symmetry does not hold.

Interpersonal dealings with the CEO do not define the directness of observation for the purpose of monitoring and evaluation. There is direct assessment in the sense that employees execute the decisions of the CEO and observe the influence of such decisions on the corporate performance and prospects. Information in a corporation is not like water, always flowing downwards; it is like air, ubiquitous in the complex networks of professional relationships and organizational processes. All employees have organizational awareness resulting from being a part of the firm's complex information flow. Information is transmitted and received multi-directionally in a complex organization.[175] The general sense of the collective employees is often accurate.[176] One need not be a historian to

---

172 "[I]nformation is always more complete and reliable within the firm than outside it." PHAN, *supra* note 16, at 15.

173 Existence of inside corporate information is the basis for the prohibition against insider trading. *See id.* at 15 (arguing that insider trading laws prohibit benefiting from inside information, which is superior to public information available to non-insider investors).

174 Hannes, *supra* note 166, at 1424.

175 *See* CHESTER I. BARNARD, THE FUNCTIONS OF THE EXECUTIVE 104-11 (1938) (describing the networks of relationships and communication channels in a complex organization and showing the mathematical permutations of relationships within a firm).

176 *See generally* JAMES SUROWIECKI, THE WIDOM OF CROWDS (2005) (discussing how large groups of people accurately observe, assess, or solve better than a few individuals). *Cf.* Robert J. Rhee, *Terrorism Risk in a Post-9/11 Economy: The Convergence of Capital Markets, Insurance, and Government Action*, 37 ARIZ. ST. L.J. 435, 524 n.437 (discussing the ability of

understand that there have been countless instances in history in which leaders of organizations—be they military, corporations, civic, or governments—have lost the confidence of their subordinates for reasons that have proved to be well founded.

It is doubtful that the board, as a collective group working part-time as board do, would know more about the performance of the CEO than the collective employees including the cadre of middle and senior managers, and the senior executive team. From the perspective of information, the problem for the board becomes greater as the corporation increases in size and complexity, and as the board increasingly relies on information provided by the CEO and the outside advisers hired by the senior executives. Since employees possess highly relevant information, full-circle evaluations can serve a reverse monitoring role in evaluating the compensation packages of senior executives.[177]

Lastly, there is a special form of monitoring and assessment that may have particular usefulness in executive compensation. In some instances, executive compensation may be so patently excessive based on absolute amount[178] or in relation to firm performance[179] or the average worker pay.[180] These cases may be subject to a collective sensibility, something like Justice Potter Stewart's famous quip on pornography "I know it when I see it,"[181] a visceral reaction to something obscene that may serve as a useful standard in extreme cases. Although even gross excessiveness of pay may prove to be too little to overcome shareholder inertia (at least sufficient to obtain a majority negative vote), monitoring by employees may be effective. Employee say-on-pay might be particularly useful in

---

the futures markets to predict accurately on a probabilistic basis political and sporting outcomes).

177 *Cf.* Adams, *supra* note 12, at 435, 437 (arguing that institutional investors use full-circle evaluations from middle managers, among others, to evaluate the compensation packages of senior executives).

178 *See, e.g.,* In re Walt Disney Derivative Litigation, 906 A.2d 27, 35 (Del. 2006) (noting that corporate executive was paid approximately $130 million for 14 months of work).

179 *See, e.g.,* Annie Lowry, *Pay Still High at Bailed-Out Companies, Report Says*, N.Y. TIMES (Jan. 28, 2013) (reporting that executive compensation was high even for financial firms bailed out during the financial crisis).

180 *See, e.g.,* Elliot Blair Smith & Phil Kuntz, *CEO Pay 1,795-to-1 Multiple of Wages Skirts U.S. Law*, BLOOMBERG (Apr. 30, 2013) (reporting that the CEO of J.C. Penney's was paid $53.3 million while the average employee was paid $29,688), available at http://www.bloomberg.com/news/2013-04-30/ceo-pay-1-795-to-1-multiple-of-workers-skirts-law-as-sec-delays.html.

181 Jacobellis v. Ohio, 378 U.S. 184, 196 (1964) (Stewart, J., concurring).

unusual or outlier cases in which there is no reasonable explanation for the size of the pay other than board capture and failure of proper contracting.

C. Information Asymmetry in Governance

A well-known paradox of corporate governance is that the board is the ultimate managerial authority charged with "managing" the senior executives,[182] but the latter possesses far greater information.[183] The typical board meets 4 to 6 times a year for an average of 4 hours per meeting.[184] Information is the source of power and influence in the corporation. Practically, senior executives have significant power in the corporation and influence the board's thinking and actions. The ultimate source of management power is the distinct information asymmetry between the board and the management.[185] If the board had the same or superior information, it could always second-guess or countermand management opinions, recommendations, and decisions.

Much of the corporation's information is held below, synthesized, and then sent upwards in the corporate hierarchy in the reporting process. In most corporate hierarchies the board would not have much contact with employees at lower levels in the routine course of managing the business and affairs of the corporation. This is not a failing of boards per se. Consider a corporation that has 50,000 employees, 1,000 of whom are non-executive managers. Not only do board members have day jobs, but their numbers are woefully insufficient for operational management. Operational management is the job of the senior officers. The liability scheme in corporation law recognizes the reality that the board, albeit ultimate managers, cannot directly engage the largest segment of management.[186]

---

182 DEL. CODE. ANN. tit. 8, § 141(a); MOD. BUS. CORP. ACT § 8.01(b).

183 PHAN, *supra* note 16, at 145. *See* ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE 295 (5th ed. 2011) ("Directors can never know as much about the operation of the company as management, so they are dependent on the CEO for being supplied with accurate, timely, and material information.").

184 PHAN, *supra* note 16, at 37.

185 *Id.* at 146.

186 A failure of the duty to monitor is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996). In Delaware, the standard is "a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system." *Id.* at 971.

We should not mistake infeasibility of operational management with irrelevance of information that could be gotten or undesirability of such oversight if such active management could hypothetically occur. Consider the agency problem of monitoring corporate executives through the lens of the Coase Theorem. In the context of legal entitlements, if transaction costs were zero, parties would rearrange their rights in a way that maximizes efficiency irrespective of the initial assignment of the rights.[187] But once transaction costs are considered, the rearrangement of rights only occurs if the increase in production exceeds the cost of bringing about this reordering.[188] A lesson drawn is that the law should initially assign rights in a way that reflects the hypothetical bargain of the parties.[189] Organizational law can be analyzed from this perspective as well.[190]

One can analyze the agency cost problem of monitoring corporate executives through a Coasean prism. If monitoring costs were zero, the board would vigorously monitor and manage executives. This monitoring would entail acquiring and analyzing information held in the firm. The board would solicit information from employees, in the very same way that senior executives solicit information from subordinates. Since the real world has monitoring cost, such operational management is infeasible. However, if information conveyance can be cost effective, the board would benefit. One such device is employee say-on-pay. The point is fairly obvious: Would employees have something to add in a hypothetical board deliberation on the CEO's performance if the interchange and monitoring costs were low?

---

187 R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2-7, 15 (1960).

188 *Id.* at 15-16. Unless the initial arrangement of rights established by the legal system is efficient, "the costs of reaching the same result by altering and combining rights through the market may be so great that this optimal arrangement of rights, and the greater value of production which it would bring, may never be achieved." *Id*. at 16.

189 Robert J. Rhee, *Toward Procedural Optionality: Private Ordering of Public Adjudication*, 84 N.Y.U. L. REV. 514, 566 (2009). Courts have used the analytic heuristic of an ex ante hypothetical transaction to determine the most efficient rule of law. *See, e.g.*, Stockberger v. United States, 332 F.3d 479, 483 (7th Cir. 2003) (Posner, J.) (noting that "[h]ypothetical-contract analysis is a powerful tool for understanding tort law and determining its scope"); Bamford v. Turnley, (1862) 122 Eng. Rep. 27, 33 (Exch.), rev'g (1860) 122 Eng. Rep. 25 (Q.B.) (analyzing nuisance case from hypothetical decision of individual owner of properties in question).

190 *See* LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 37 (2010) ("When filling gaps in the corporate contracts, courts cannot look to the actual intent of thousands of parties so they make up a hypothetical 'intent' based on what the courts view as reasonable.").

Say-on-pay is a modest device that provides a more diverse mix of information to the board. An important aspect of say-on-pay is the quantum of information: a simple percentage signifying approval or disapproval. Shareholder say-on-pay provides direct, relevant input on the opinion of shareholders. This opinion is based on market and public information. Employee say-on-pay remedies the problem of information asymmetry between board and management by providing direct, relevant input on the opinion of employees.

In the ideal world of zero monitoring costs, the board would gather information from both senior management and employees.[191] Employee say-on-pay provides relevant information that is relatively costless. In this way, it helps to offset the informational power of management over the board, which can promote board capture and work against good corporate governance.

D. Fiduciary Ideals, Board Cover and Leverage

Employee say-on-pay promotes fiduciary ideals. The "board capture" criticism asserts that corporate governance has broken down in the realm of executive compensation. The board is a fiduciary of the corporation. While the legal rules of corporate governance make it exceedingly difficult to impose remedies for the board's breach of fiduciary duty, legal rules are distinct from fiduciary ideals.[192] In a world of ontological truth, there can be no doubt that there are many instances in which fiduciary duties are not in fact kept. In any adjudication, the probable and the provable are not always the same.[193] Adjudications in corporation law are not so special that they rise above the indisputable limitations of the adjudicatory process.[194] In fact, corporation law is analogous to criminal law in the

---

191 In some companies, the board has complete access to employees according to their corporate governance guidelines. For example, the board of Intel has complete access while the board of General Motors is restricted in its access by management. PHAN, *supra* note 16, at 172-73.

192 Commentators have suggested that corporate law incorporates standards of conduct as opposed to legal rules of liability. *See* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporation Law Work?*, 44 UCLA L. REV. 1009 (1997); Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437 (1993).

193 *See* L. JONATHAN COHEN, THE PROBABLE AND THE PROVABLE (1977).

194 For example, the old chestnut, *Kamin v. American Express Co.*, 383 N.Y.S.2d 807 (1976), can be understood from the divide between the probable and the provable. "It can be explained by improper but unprovable motives such as a vain attempt to support short-term stock prices for the purpose of executive compensation, or obfuscating the

sense that legitimate and overriding policy considerations, as seen in the burdens of proof and presumptions respectively, produce numerous adjudicatory errors from the perspective of ontological truth.[195]

In the realm of executive compensation, the fiduciary ideal is simple: the board should award compensation free of structural bias in favor of management, informed with all public and private information available, and based on performance. In this respect, employee say-on-pay promotes fiduciary ideals. It communicates relevant information in a manageable form at low cost. It is simply an added measure of informed decisionmaking, which is the hallmark of the fiduciary duty of care.[196]

In corporate governance, there is a symbiotic relationship between the board and the management. Boards depend on management. A negative aspect of this co-dependency is structural bias. The problem is not difficult to fathom. CEOs have significant influence on board compensation and nominations. Insider board members, such as senior executives, are subject to the CEO's authority in their roles as officers. The board is a social institution populated by an elite group of individuals who routinely interact with each other in their business, social, and political worlds.[197] Although a genial and collegial working relationship between the board and the management is a good thing, it would also lead to structural bias.[198]

A number of devices tend to offset structural bias and empower the board's independence. Board members are subject to fiduciary duty.[199]

---

nature of a failed investment which would have been made clearer with the recognition of a loss. Thus, *Kamin* can be seen as an unprovable duty of loyalty case that had to be brought as a duty of care case." Rhee, *supra* note 61, at 1149 n.56.

[195] By "error," I do not mean honest mistakes based on hindsight, but instead violations of fiduciary duty that go undetected or unproven due to the height of the legal hurdles.

[196] *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[197] *See generally* Rakesh Khurana & Katharina Pick, *The Social Nature of Boards*, 70 BROOK. L. REV. 1259 (2005) (discussing the social environment of a board and the resulting behavior of board members).

[198] *See* BEBCHUK & FRIED, *supra* note 2, at 61-79 (discussing structural bias in compensation); Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith , and Structural Bias*, 32 J. CORP. L. 833 (2007) (discussing structural bias in compensation and the *Disney* compensation litigation). *See also* Kenneth B. Davis, Jr., *Structural bias, Special Litigation Committees, and the Vagaries of Director Independence*, 90 IOWA L. REV. 1305, 1307-09 (2005) (discussing "structural bias").

[199] *See, e.g.*, Smith v. Van Gorkom 488 A.2d 858 (Del. 1985); Cede & Co. v. Technicolor, Inc., 634 A. 2d 345 (Del. 1993).

They routinely retain outside advisers on various matters such as lawyers and financial advisers. There are legal requirements on the appointment of independent directors,[200] the composition of important committees of the board,[201] and board deliberation procedures.[202]

Say-on-pay can counteract structural bias as well. The board gets information independent of management control. A board would find it uncomfortable to ignore a negative vote of shareholders or employees. The sense of public accountability would be great. Ignoring the concern of employees, particularly arising from the management ranks, would be detrimental to business operations. To do so, the board could be viewed as insensitive to employees, which poses a business problem. If excessive executive compensation is a possibility due to structural bias, employee say-on-pay could offset some of this bias.

Employee vote can provide cover for the board's compensation decision. A board may want to award high compensation in a facially difficult situation for proper reasons. Or, it may not want to award high compensation but the social, political, and bargaining situation is complex. A normative basis for engaging in compensation negotiation would be helpful.[203]

Consider a facially difficult situation. The board of a distressed company proposes to award a CEO with high compensation. Depending on the circumstance, a board could rightly award high compensation to a CEO of a troubled company. Management talent would be needed to right the ship, and such talent would have opportunity costs. Good executives may have other better opportunities and may be wary of entering into a bad situation unless the incentives compensate for those foregone opportunities. These situations can be politically difficult internally and

---

[200] *See, e.g.*, New York Stock Exchange Listing Rule 303A.01 ("Listed companies must have a majority of independent directors.").

[201] *See, e.g.*, *id.* Listing Rule 303A.04(a) ("Listed companies must have a nominating/corporate governance committee composed entirely of independent directors."); *id.* Listing Rule 303A.05(a) ("Listed companies must have a compensation committee composed entirely of independent directors.").

[202] *See, e.g.*, *id.* Listing Rule 303A.03 ("To empower non-management directors to serve as a more effective check on management, the non-management directors of each listed company must meet at regularly scheduled executive sessions without management.").

[203] *See* G. RICHARD SHELL, BARGAINING FOR ADVANTAGE: NEGOTIATION STRATEGIES FOR REASONABLE PEOPLE 89-114 (2d ed. 2006) (suggesting that various kinds of leverage exist to bargain successfully).

externally. But suppose employees, properly recognizing the situation, votes positively. Upon a favorable vote, who can complain?

Consider the case where a board seeks to reign in compensation for rational reasons, but has complex considerations in scaling back executive pay.[204] Working against the board's inclination on executive pay may be the social bonds between board members and the CEO, a prior history of high wages, CEO influence on particular board members such as insider members, and a reticence to disturb collegiality. Many of these factors create the structural bias in favor of deference to CEOs. In this situation, a negative employee vote can give the board leverage in an arms-length negotiation, and also provide cover for the decision to reduce compensation.

E. Public Monitoring and Political Legitimization

At current levels, executive compensation is seen by academics, politicians, and the public as illegitimate. Controlling the levers of corporate power, CEOs have distributed greater portions of the corporation's production to themselves while employees shared less. The public has come to view executive compensation as rent extraction gained through the power of position, unconstrained by personal qualms.[205] Executive compensation has become a public issue. In addition to the Dodd-Frank Act, there is the possibility of other public reforms. Reform of compensation can be done through tax law.[206] It can be done through flat restrictions or caps on compensation.[207] In the extreme case, the government can have a direct role in determining how much an executive can pocket in compensation through special taxes or wage control.[208]

Employees would serve as public monitors and gatekeepers. Public approval is needed to legitimate, socially and politically, high executive compensation. Without this legitimacy, boards will continue to feel a

---

[204] *See* PHAN, *supra* note 16, at 47-62 (presenting a case study of a company and board that was highly influenced by the CEO).

[205] *See* STIGLITZ, *supra* note 7, at 42 (noting that CEOs have amassed riches through "an enhanced ability to take more from the corporation that they are supposed to be serving, and weaker qualms about, and enhanced public toleration of, doing so").

[206] *See* Ethan Yale & Gregg D. Polsky, *Reforming the Taxation of Deferred Compensation,* 85 N.C. L. REV. 571 (2007).

[207] *See* Ingolf Dittman, Ernst Maug & Dan Zhang, *Restricting CEO Pay*, 17 J. CORP. FIN. 1200 (2011).

[208] *See* Landon Thomas, Jr., *Britain to Levy a One-Time Tax on Banker Bonuses*, N.Y. TIMES (Dec. 9, 2009).

pervasive public pressure even as they continue to award high compensation packages. It is difficult to predict how the problem will ultimately play out. Will there be further regulatory scrutiny as the divide between the very wealthy and the rest increases?

Even as CEOs are enjoying high compensation, there is longterm uncertainty. Social cohesion in a corporation was stronger in the past than it is now.[209] Current compensation strikes discord in broad constituencies. A compensation package should be broadly supported by the many constituents of the corporation, including in the broadest sense the public. "This is because executive compensation continues to be a hot button issue among the unions, community activists, shareholder interests groups, and institutional shareholders; it represents a powerful signaling device." [210] Employee say-on-pay can legitimate high executive compensation. Suppose the CEO's pay package was approved by shareholders and employees, and informed by the advice a board exercises its independent judgment and awards high compensation. What would and should the public's response be?

IV. OBJECTIONS TO EMPLOYEE SAY

A. Information Quality

A potential objection to employee say-on-pay would be that employee voting would not yield quality information. Instead, the vote would be tainted by a number of irrelevant considerations: for example, personal feelings toward the CEO, socio-political agendas of individual workers or their unions, ignorant or uninformed voting, and class envy. A key difference between shareholders and employees is that shareholders vote with only criterion in mind—stock value. Employees may apply multiple criteria. The objection goes to the reliability of the information gotten from the voting results.

This objection is flawed. A firm is composed of a collection of its employees, each holding a unique packet of information. In this respect, a firm can be seen as an information market.[211] If so, the voting outcome

---

209 *See* STIGLITZ, *supra* note 5, at 67.

210 PHAN, *supra* note 16, at 154.

211 *See id.* at 3 ("There is increasingly realization that a firm is a place where people meet to exchange specific information for the purpose of engaging in production."); BARNARD, *supra* note 175, at 73, 82 (defining an organization as a system of consciously coordinated activities persons within must communicate information with each other).

would in many cases accurately reflect the collective opinions held.[212] Many opinions may be misguided or ill-informed, but systemic errors are difficult to achieve since random errors tend to cancel each other. An evaluation on the whole would reflect the overall information held within the corporation.

Although employees may bring different perspectives, their criteria would not be random. They would fairly reflect rank in the hierarchy. The higher in the hierarchy an employee is, the more the criteria would seek to evaluate the CEO's job performance and the less they would be sensitive to wage differential. Greater seniority promotes greater affinity and identification with high paying jobs. There may be natural affinity (structural bias) toward supporting executive pay.

At the lower levels, employees may pose a problem arising from multiple criteria and perspectives. They are the lowest paid workers, and thus would be naturally skeptical of high wages. On average, they may be less educated and less informed about the state of the company than their managers. They may be influenced by organized labor. They are the furthest removed from direct dealings with the CEO. Their evaluations of performance may be uninformed or suspect. The risk of the application of more diverse criteria is greater in the lower ranks.

If the lower ranks are problematic, why permit voting at that level? Despite the risks, the lowest rank and file employees serve three useful functions in the overall scheme. First, there is a benefit to egalitarian inclusion of all employees.[213] The broader political legitimization function of employee say-on-pay would require such voting. From a managerial perspective, the exclusion of the majority of employees would be demoralizing and undermine organizational cohesion. Second, natural skepticism of high compensation, a systematic bias perhaps, would tend to offset the structural bias held by senior executives. Third, when a CEO's pay is so large as to absolute amount or wage differential, the expression of collective outrage would serve an important public and governance function. These benefits outweigh the particular problems at the lower rank and file level.

As discussed earlier, the balance of these considerations suggests a weighed voting scheme. Neither rank and file employees nor senior executives have the controlling block of votes. That block should be held by the middle and senior nonexecutive managerial ranks. The assigned

---

212 *See* SUROWIECKI, *supra* note 176.

213 *See* HIRSCHMAN, *supra* note 18, at 76-105 (describing the benefit of loyalty engendered by members having participatory voice in an organization).

weights acknowledge the potential risks to information quality. One must assume that on the whole employees evaluate each other in good faith, and that good faith is not dependent on the directionality of the evaluation, that is, whether it is top-down or bottom-up. Nor is good faith inherently exclusive to senior executives and boards.

B. Rationally Apathetic Employees

Like political citizens or corporate shareholders, employees may be rationally apathetic. Like political voting, employees may think that the personal cost-benefit of voting is not worth it, or that their single vote (vote allocation) may not make a difference. Some employees may not care at all about the issue at stake, or think that they have sufficient information to make an informed vote. Some may consider the right a chore without any tangible payoff.

There are significant differences between political or shareholder voting and employee voting. In political voting, there is not an insignificant cost, which is time off from work or leisure and trekking to the voting booth. Employee voting is virtually cost free. Voting can be done online. The most significant cost to the employee is the time used to weigh the amount of pay with the executive's performance. This consideration, while real, is not time consuming in the mold of performing financial analysis, assessing investment opportunities, and such. The decision would not require spreadsheets of analyses. It would be in the mold of an instantaneous judgment call: Given the company's performance and trajectory and the CEO's responsibility for them, has the CEO earned the proposed compensation? Employees will already have a good sense of the company's performance, trajectory, and the executive's performance. Due to weighed voting, those who have the best information have greater voting power, and thus empowering the incentive to vote.

A problem with the rationally apathetic shareholder is that the shareholder may not have very good information on the issues put to them. The benefits of diversification increases the work required to be informed. If so, this calls into question the informational quality of the vote and the motivation to vote. Consider the most basic shareholder governance function—voting on directors. Suppose the shareholder holds a modestly diversified portfolio of 30 stocks[214] and each company has a

---

[214] *See* Meir Statman, *How Many Stocks Make a Diversified Portfolio*, 22 J. FIN. & QUANT. ANALYSIS 353, 355 (1987) (showing that a portfolio of 30 stocks would result in an expected variance of under 20.87%, whereas a portfolio of 1000 stocks would result in an

10-member board with no cross memberships. A shareholder may not have good opinions about each of these 300 directors. Rational apathy and situational ignorance may be related.

Employees are situated differently. They know a great deal about the company, its competitors, its position in the competitive landscape, and its trajectory. In many companies, the information flow within the firm is complex and efficient. Like blood in the body, information flows to the necessary parts of the firm. Unlike shareholders and the many directors and officers in their portfolios, employees will be greater information and familiarity with the senior executives of the company. Since they have more information and are better informed, and since their voting is almost costless, the degree of apathy seen in shareholders will tend to be less in employees.

Lastly, employees are more motivated to vote than shareholders. They have undiversified firm-specific investment in their career.[215] In cases where employees are vested in their careers and "exit" is far from frictionless,[216] they will have incentive to vote and participate. This incentive arises from different motivations and sentiments. Voting would be almost cost free, and so the degree of shirking would be less. We can also assume that as a collective whole, and unless morale has deteriorated, employees care about their company and its prospects. The principle of meritocracy undergirds the sense of fairness in a competitive market society. Thus, employees would be motivated to speak on the issue of fairness in wage and sharing of economic production.

C. Balance in Corporate Governance

In U.S. corporate governance, employees have had little formal role. Most boards of public companies do not have employee representatives,[217]

---

expected variance of 19.21%). *See also* Robert J. Rhee, *The Madoff Scandal, Market Regulatory Failure, and the Business Education of Lawyers*, 35 J. CORP. L. 363, 372 (2009) (suggesting that significant diversification can be achieved with a mix of 30-35 stocks).

[215] *See* Margaret M. Blair & Lynn A. Stout, *Specific Investments: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719, 738-39 (2006) (noting that employees make undiversified firm-specific investments); ROE & BLAIR, at 58-87.

[216] *See* HIRSCHMAN, *supra* note 18, at 21-29 (describing a constituent's choice of "exit" or "voice" whenever an organization is perceived to be declining or unsatisfactory to the member).

[217] The U.S. corporate governance system is different from countries like Germany that carves out a formal role for employees in its system of codetermination. *See generally* JOHN T. ADDISON, THE ECONOMICS OF CODETERMINATION: LESSONS FROM THE GERMAN

and senior executives typically view their relationship from a hierarchical perspective where they transmit information and directives down the chain of command. Corporate law does not prohibit a corporation from establishing greater employee participation, but this is not the practice among public companies. A potential objection may be that employee say-on-pay would significantly alter the balance of power in corporate governance away from the traditional triad of board, management, and shareholder. This concern is unfounded.

If the objection is that employee say-on-pay may influence the board, this no objection at all. Legally, say-on-pay does not diminish or change the board's legal authority to manage the business and affairs of the corporation.[218] It is an advisory vote. At most, say-on-pay exerts soft constraints on the board's virtually unfettered business judgment.

Ideally, say-on-pay should influence the board. When shareholders leave the couch of apathy, their opinion on executive compensation is relevant to the mix of information. Likewise, employee opinion is also relevant. Unlike the board, employees observe the CEO daily. They implement the CEO's strategies and decisions, and they are in good positions to assess the efficacy of corporate decisions, and the CEO's performance and leadership. These points are obvious and uncontroversial. If so, why would directors in good faith not want to know the opinion of employees in the process of being informed in their decisionmaking?

One can imagine many situations in the past where information from employees could have been helpful to the board. Could there have been enough honest employees at Enron to give the board pause as to whether Jeff Skilling was a good CEO? Would employees at WorldCom, charged with integrating the many bad acquisitions the company made, have properly expressed their views on Bernie Ebbers' pay package? Business history is replete with many examples when boards could have been better served with information held by the collective employees. The benefit of such information is particularly acute when there is a substantial problem within the firm.

EXPERIENCE (2009) (discussing the German model of codetermination in which corporate governance is legally shared with employees); ROE & BLAIR, at 163-238; David Charny, *The German Corporate Governance System*, 1998 COLUM. BUS. L. REV. 145 (1998) (same); IRENE LYNCH FANNON, WORKING WITHIN TWO KINDS OF CAPITALISM: CORPORATE GOVERNANCE AND EMPLOYEE STAKEHOLDING: US AND EU PERSPECTIVES (2003) (comparing the European model of corporate governance, which has a greater role in employee participation than the US model).

[218] Dodd-Frank Act § 951.

Communicating relevant information to the board is a core function of corporate governance. Say-on-pay does not contain complex or overwhelming amount of information. Employee say-on-pay does not tilt the balance in corporate governance, formally or informally. It is consistent with the ideal that boards are the ultimate managers but that their decisions should be informed. In the final analysis, the provision of relevant information to the board, so long as its assimilation is not so taxing as to be counterproductive, is always a good thing.

D. Employee "Hold Up"

Another objection could be that employee say-on-pay would create an employee "hold up" problem. If compensation would depend in part on employee approval, the tacit collusion may be that a CEO would be incentivized to keep employees happy though this may undermine firm profitability and shareholder value. She could raise salaries of employees because this would narrow the wage disparity ratio. Or, she might not go ahead with needed layoffs because it would be unpopular. Employee say-on-pay could be used as a coercive "hold up" device.

There is some merit to the "hold up" objection. If employee approval is a factor in pay decisions, CEOs may become more sensitive to the happiness and needs of employees. Are marginal increases in the wages of corporate employees achieved through implicit quid pro quo such a bad thing? With respect to the distribution of the corporation's gains among management, shareholders, and employees—the principal internal constituents having claims on the production gains—if employees get a little more than they currently get, it should not be a cause for alarm. Minimum wage laws do precisely this as between shareholders and employees, absent perfect pass-through to customers in the form increased prices. It is true that the distributional effect is created by a newly formed device of corporate governance. But so what? Currently, executives get a lion's share of the gain from production as among employees.[219] This raises an issue of equity and fairness in the corporate enterprise. Laws often have such effect, including corporation law.[220]

---

[219] *See supra* note 29 and accompanying table (indicating that CEO pay has greatly outpaced the income of workers).

[220] Many rules in corporation law and corporate financing affect distribution. *See, e.g.,* Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm'n Corp., 1991 WL 277613 (Del. Ch. 1991) (ruling that fiduciary duty shifts to creditors when the corporation is in the zone of insolvency); Metropolitan Life Insurance Co. v. RJR Nabisco, Inc., 716 F.Supp.

There are many corporations in history[221] and currently[222] that pay employees very well. A distributional effect from the current baseline is not objectionable per se.

The "hold up" would become a bigger problem if CEOs are in effect substantially captured by employees such that there are significant questions of efficiency. Large business decisions and strategies—such as mergers, layoffs, strategic outsourcing, labor contracts, etc.—should be made in the interest of the corporate enterprise[223] and not to the parochial interests of management or labor. A merger not consummated to protect employee interests may be just as bad a merger consummated to increase the CEO's empire and pay. But the risk of these concerns is minimal.

Firstly, rank and file employees should not be given the controlling block of votes. The managerial ranks should be given the controlling block. By virtue of a pyramidal corporate hierarchy, these employees constitute a minority in numbers. They are already higher paid than most employees in the firm. They are managers, think like managers, and would vote like managers.

In important transactions, the considerations and influencing factors may be much greater than the isolated interplay between management and employees. CEOs report to the board. They are subject to market pressures such as stock price, activist shareholders, and Wall Street. They are influenced by the market for corporate control.[224] Like other employees, they are influenced by concerns for their professional

---

1504 (S.D.N.Y. 1989) (ruling that bondholders have no recourse for lost value when the corporation engages in a leverage buyout); Katz v. Oak Industries Inc., 508 A.2d 873 (Del.Ch. 1986) (ruling that bondholders have no recourse when the corporation engages in a coercive exchange offer).

221 *See, e.g.,* Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919) (noting that Henry Ford wanted "to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes"); *Henry Ford's $5-a-Day Revolution*, available at http://corporate.ford.com/news-center/press-releases-detail/677-5-dollar-a-day (noting that Henry Ford paid employees very well).

222 Investment banks typically pay their employees very high wages, which have been typically in the range of 40% to 50% of net revenue. *See supra* note 138.

223 This is defined as the long-run value of the firm including the value of all securities. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 BUS. ETHICS Q. 235 (2002).

224 *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

reputations and the next job, which is the market process of ex post "settling up."[225]

Assume, for example, the CEO is forced to do the one thing that will alienate employees the most—layoffs. As a result, disaffected employees vote against the CEO's pay package, which is large because the board felt it needed to incentivize a talented CEO and pay for her opportunity cost. Two years have passed, and the drastic move turned out to the right one. The company was saved and is moving toward financial health again. Would a board deciding on compensation be able to put the negative employee vote in the context of the situation and make an informed, independent judgment on the merit of the pay? Yes, a professional board, acting on an informed basis, would be able to contextualize the negative vote by employees. One also suspects that in reporting process, the senior management, the only internal group that has routine board access, would duly explain why employees are unhappy with management and why this unhappiness is not correlated with the best interest of the corporation.

In the final analysis, employee "hold up" at the margins is a good thing or fairly harmless on the whole. Wage increases across the economy might be a good thing since more equitable distribution of wealth may be more efficient.[226] When there is a fundamental conflict between the preferences of employees and corporate actions, employee "hold up" is simply one of many factors that influence the CEO and that a board must consider in determining executive compensation.

E. Political Objections

If this Article reaches beyond academic discourse and into the public sphere, as is the hope of any scholar seeking worldly influence, there will be another objection. The most visceral objection may come from a conviction that employees have no place in opining on the pay packages of senior executives. Some CEOs may be threatened by the notion that employees would be evaluating them and approving their pay packages. There may be strongly held convictions on social and political order

---

225 *See* Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 295-306 (1980) (suggesting that labor market should create proper incentives through "ex post settling up"). *But see* Rhee, *supra* note 61, at 1176 (arguing that "the current problem of excessive executive compensation calls into question whether this 'settling up' process is efficient, or even works when the amount of compensation diminishes an executive's long-term incentives").

226 *See supra* note 8.

among some economic and business communities. These strong objections would coalesce into a concentrated political interest group, which would vigorously advocate against employee say-on-pay.[227] This is the political reality. Senior executives as a political interest group have not embraced the concept of shareholder say-on-pay. Employee say-on-pay would run into strong political headwinds. This objection is relevant as a pragmatic matter. However, I do not believe that the politics of reform would be the death knell of an otherwise good idea.

The idea of employee say-on-pay is pragmatic and politically feasible. As with any major reform, such as the Sarbanes-Oxley Act or the Dodd-Frank Act, a public perception of the necessity of reform drives the legislative process. The idea of employee say-on-pay will be prominent in the academic and policy debate because it is legally and economically sound in theory. One cannot predict the brew of political, economic and social circumstances that would overwhelm strong political opposition. It could be that social inequity reaches an intolerable point or another corporate or financial crisis occurs, galvanizing further reform.

Also, the debate on executive pay is a global one. The idea of employee say may have appeal in other parts of the economically advanced world. Shareholder say-on-pay was first implement in the U.K. and then rapidly adopted in continental Europe and other common law countries, including now the U.S. In other developed economies in Europe, the role of employees and labor in corporate governance is more prominent than in the U.S. It is conceivable that employee say-on-pay may be adopted first in other parts of the world, and then later imported into America as was the case with shareholder say-on-pay. The fact that say-on-pay as a corporate governance phenomenon has been so widely adopted across advanced economies suggest that there are limits to the political power of corporate executives. That limitation also suggests that employee say-on-pay is also politically feasible.

CONCLUSION

---

[227] Berle and Means saw early the political dimensions of business, and characterized business leaders as tinged with sovereign-like qualities. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4 (reprint ed. 1991) ("The power attendant to such concentration has brought forth princes of industry, whose position in the community has yet to be defined."); Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1366 (1932) (suggesting that corporate executives operate "more as princes and ministers than as promoters or merchants").

Few would dispute that in most companies the CEO should be the highest paid employee, that they should be well compensated compared to others for good performance, and that they should be entitled to personal wealth after a lengthy successful tenure. However, the pay of a single senior employee in a corporation raises the issue of corporate efficiency and income inequity, and the broader spillover of these issues in the public and political discourse. The case for employee say-on-pay is compelling. Employees can monitor senior executive performance better than shareholders because they possess inside information, and they have direct incentive to monitor. Employee say-on-pay is feasible and cost effective. Employee input leverages all of the information held in the corporation, and it can assist the board in making an informed decision on executive pay. Employee approval can also politically legitimize executive compensation in an era in which executive pay and income inequity have touched public consciousness.

The benefits of employee say-on-pay outweigh the objections. Concerns about information quality can be controlled through weighed voting. Employee say-on-pay does not fundamentally shift the balance of power in corporate governance. Legal power still resides with the board, but the board must now consider additional relevant factors in making an informed decision. The interests of shareholders and employees are not categorically inimical to each other. The use of employee input can be used to advance the interest of shareholders in insuring that executive pay is coupled to performance and does not reach grossly excessive levels.