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The Corporate Officer's Independent Duty as a Tonic for the Anemic Law of Executive Compensation

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Douglas C. Michael*

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INTRODUCTION

History repeats itself in the law as in other arenas. In the law of executive compensation, such a repetition may be imminent. Ever since the advent of the large industrial corporation in the United States, there has been periodic outrage at payments made to its top executives. This repetition suggests that the law has failed to keep pace with the observed problems.

Although the dissonance between the law and public perception of executive compensation has grown again in the 1990s as it has periodically since the 1930s, probably never since then has the public’s perception so clearly been that chief executives lounge in luxury while the average worker searches in vain for employment. The sentiment is universal: “Anyone can tell you what the problem is. Just ask your neighbor or cabdriver—then stand back.”1 As one recent congressional witness put it, “[n]ever have so few done so little to get so much from so many.”2

Modern corporate law has developed an exceedingly deferential response to challenges to executive compensation. Though courts have long claimed the equitable power to trim executive pay packages,3 such power is rarely used. Rather, courts focus on the process used by the corporation’s board of directors in setting the pay level; if it is sufficiently sterilized of improper influence, that will be the end of the matter, never mind the tens of millions paid to one person for one year’s ordinary work.4 By giving minute attention to the processes of the board, courts have missed the larger more fundamental question. “[T]he courts find the question Is this executive being paid too much? more designed to produce a neurosis than an answer.”5 Most calls for reform of the compensation-setting methods adopt this judicial focus by suggesting only that the negotiating position of the board be strengthened.6 Clearly, the existing legal rules are unresponsive to current trends of both shareholder and general popular outrage about the unchecked growth of executive paychecks. No court or commentator has developed a legal rule that focuses on the propriety of the executive’s conduct in accepting such extraordinary amounts of compensation.

But surprisingly, the law has a ready answer to the fundamental question: the corporate officer owes duties of care and loyalty to the corporation, independent of those same but more familiar duties owed by each director.7 This is a longstanding

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1. Geoffrey Colvin, How to Pay the CEO Right, FORTUNE, Apr. 6, 1992, at 61.
4. See generally Robert C. Clark, Corporate Law 193-94 (1986). For a detailed discussion and critique of current legal standards, see infra part III.
6. See infra note 67 and accompanying text.
though mostly overlooked principle of corporation law. Thus, the proper result in some cases may be that a corporate officer should have a duty not to accept unreasonable compensation, even though the board of directors might not itself be liable for approving the compensation. Imposing such a duty would repair a significant failure of modern corporation law by imposing the duty to monitor executive compensation upon those who have the power and information to do so—the corporate executives themselves. This approach will succeed when process-oriented reforms would fail because it overcomes the inherent limitations on the ability of the corporation to negotiate with its chief executive and analyzes the conduct and duties of that chief executive directly. Moreover, imposing such a duty on chief executives will not expose them to overwhelming litigation or liability; rather, it will force the executives, the directors, and the courts to focus on the merits rather than simply the process of executive compensation.

Part I of this Article describes the current and historic uproar over executive compensation in large corporations in the United States. Part II provides the economic background of the process of negotiating executive compensation. Part III analyzes the existing reaction of courts to executive compensation challenges. Part IV collects the sparse history of the corporate officer's separate duties and sketches what those might include if defined by courts today in executive compensation cases. Finally, Part V demonstrates how these duties respond more efficiently to the economic, political, and legal issues involved than current rules.

I. THE CYCLICAL OUTRAGE OVER EXECUTIVE COMPENSATION

The modern corporate executive is a product of industrial expansion and the concentration of corporate control of the late 1800s and the early 1900s. Since at least the 1930s, there has been debate about every decade or so over the amount of money and other benefits received by these executives.
Executive compensation most recently captured the nation's attention last year when, in the midst of declining corporate profits, executives continued to receive "spectacular pay increases." When twelve chief executives of major U.S. corporations accompanied President Bush to Japan early in 1992, complaints about their compensation surfaced in advance of the trip, and the ensuing publicity equalled or surpassed that given to the planned negotiation of trade agreements. The next month, the Securities and Exchange Commission (SEC) staff announced, in letters to ten corporations, that it would not acquiesce in those firms' decisions to exclude shareholder proposals on executive pay from the upcoming proxy statements and annual meetings. Within a matter of weeks Fortune magazine announced that "The issue of [executive] pay has finally landed on the national agenda and won't be leaving soon." The Wall Street Journal shortly thereafter proclaimed 1992 "the year of the pay protest." Politicians from all parties decried high executive pay during the presidential election campaign, and shareholder groups and institutional shareholders have become active, targeting particular overpaid executives. Congressional interest in the subject was apparent in two hearings dedicated to the issue and in legislation designed to allow stockholders to vote on proposals...
regarding executive compensation and to modify the disclosure and accounting procedures in this area.\textsuperscript{20} Later in 1992, the SEC adopted sweeping changes in the proxy system\textsuperscript{21} along with significant modifications in the disclosure required in proxy statements about executive compensation.\textsuperscript{22}

The resulting pressure has spurred several corporations to voluntarily limit executive compensation.\textsuperscript{23} Ironically, the initial response by corporations to the furor over executive pay has apparently served only to fan the flames. Many corporations have restructured executive pay packages to reduce salaries and bonuses but have, at the same time, increased the executives' stock options and similar incentives.\textsuperscript{24} Stock options and other long-term compensation now overwhelm many executives' recent salary cuts.\textsuperscript{25} Some compensation consultants characterize the changes as

\begin{quote}
\textit{Management of the Senate Comm. on Governmental Affairs, 102d Cong., 2d Sess. (1992) [hereinafter \textit{Stealth Compensation}].}
\end{quote}


\textsuperscript{22} \textit{See} Executive Compensation Disclosure, Securities Act Release No. 6962, 57 Fed. Reg. 48,126 (Oct. 21, 1992). The significant new elements in the disclosure system include a single summary table showing both annual and long-term compensation for senior executives, a required report of the corporation's compensation committee on corporate performance factors it considered in setting the CEO's compensation, and a graph showing the cumulative five-year return to shareholders compared with market and industry norms. \textit{See id.} at 48,126-27. Though the SEC undertook a significant cost-benefit analysis in proposing and revising the new rules, \textit{see id.} at 48,143-44, some commentators have questioned the need for this enormous amount of additional information. For a particularly irreverent review, see Marianne M. Jennings, \textit{A Funny Thing Happened on the Way to the Shareholders' Meeting}, \textit{Bus. Law Today}, Sept.-Oct. 1992, at 42.

\textsuperscript{23} "Over the past eight months, United Shareholders has reached and publicized agreements with 14 of the 50 companies in its 1991 target list. Other companies are calling the gadfly outfit to find out how they can keep off its 1992 list . . . ." Salwen \& Lublin, \textit{supra} note 18, at A1. In addition, "[n]ew executive capitulations are reported almost weekly." \textit{Id.} One observer has suggested that pressure from institutional investors and shareholder groups is the best approach to resolving compensation issues. \textit{See} Linda J. Barris, \textit{The Overcompensation Problem: A Collective Approach to Controlling Executive Pay}, 68 \textit{Ind. L.J.} 59, 96-99 (1992).

\textsuperscript{24} Amanda Bennett, \textit{Big Firms Rely More On Options but Fail to End Pay Criticism}, \textit{WALL ST. J.}, Mar. 11, 1992, at A1.

\textsuperscript{25} \textit{See} Bennett, \textit{supra} note 16, at R1-R2. The \textit{Journal's} computation of long-term compensation, which includes gains from exercise of stock options, stock appreciation rights, the value of restricted stock whose restrictions have lapsed, and dividend equivalents shows some interesting results in contrast to some executives' salary reductions. For example, the \textit{Journal} reports that Chrysler's Lee Iacocca, while cutting his 1991 salary and bonus 36% to just under $1 million, received that same year $1.9 million in long-term compensation; Paramount's Marvin Davis took a 25% salary and bonus cut to $2.75 million but received $2.3 million in long-term compensation; Apple Computer's John Sculley took a 39% pay cut to $1.3 million but received long-term compensation, albeit over several years, valued at $14.5 million; and ITT's Rand Araskog, one of the executives who negotiated a restructuring in response to shareholder group pressure, \textit{see} Salwen \& Lublin, \textit{supra} note 18, at A1, took a 27% salary cut to $2.8 million but received over $1 million in long-term compensation. \textit{The Boss's Pay}, \textit{WALL ST. J.}, Apr. 22, 1992, at R9-R11. The SEC's proposed rules on executive compensation have also taken note of this trend, observing that "these changes have accelerated, with long-term incentive compensation overtaking the more tradi-
actions of corporate boards of directors concerned more with appearance—or "shareholder optics"—than substance."28

Many critics maintain that stock options and similar devices are not as daring a move for executives as they might at first appear, because they lack "downside" risk; if the company's stock price declines, the executive's option merely becomes valueless while the shareholders sustain actual investment losses.27 In addition, disclosure problems abound, because the actual value of long-term incentive packages may be difficult to determine, and because most of these incentive methods require little or no charge to earnings under current accounting practices.28 In response, proposals exist for reform of accounting and disclosure treatment of long-term incentive compensation,29 and compensation experts are seeking to devise other methods to better correlate the executive's pay with the company's performance.30

B. A Historical Perspective

With the exception of this current focus on incentive compensation, very little has changed in the executive pay debates over the years. Professor Vagts began his article on the subject ten years ago with a recitation of the business and political background that would apply with equal force to the current controversy.31 And

29. See, e.g., Kay, supra note 27, at 23-27 (discussing bonuses for retaining shares from exercised options, "premium" options priced above the current market price, and bonuses tied to "strategic mileposts" such as achievements in research and development or employee productivity).
30. Professor Vagts' introductory remarks (except for the tellingly dated references to dollar amounts and stock index levels) could have been written today:
Executive Compensation

J.A. Livingston almost 35 years ago correctly predicted "a Congressional investigation of executive remuneration" which "could make unpleasant headlines.

Executive compensation has at least three characteristics that have served over the past few decades to make it an enduring lightning rod for shareholder and public criticism. First, the absolute amounts earned by the top executives of the nation's largest corporations are and consistently have been enormous. Although there certainly is no one correct figure, since the reported averages differ with the year measured, levels of measurement, and sample size, reported amounts are now consistently above $1 million per year, with amounts of $100 million becoming common. Second, the amount of compensation varies in extreme amounts among even the largest corporations; the highest-paid chief executive in these samples may have up to 1,000 times the compensation of the lowest-paid chief executive.

Tremors here and there indicate that a new wave of concern about the generosity of management compensation may be on the way. From the courts one observes a string of cases attacking compensation practices, particularly stock options and other stock plans. The Securities and Exchange Commission has stirred up the waters with endeavors to extract a more meaningful type of disclosure from the managements of publicly held corporations. . . . Even some business writers have arched eyebrows over the recent surge in management compensation that has carried the best paid executives to well over the one million dollar line, which seemed for years—like the stock market's Dow Jones "one thousand"—to serve as a psychological barrier to advances.

Vagts, supra note 10, at 232 (footnotes omitted).

32. Livingston, supra note 10, at 229. He noted in an update that shortly after this prediction Senator Kefauver inquired about high executive salaries in the steel industry, id. at 230, but the recent interest of a different Senate Committee has been even more pervasive. See Stealth Compensation, supra note 19; Runaway Executive Pay, supra note 2.

33. Livingston, supra note 10, at 230. For an example of such headlines, see Abramson & Chipello, supra note 12.

34. Others have used less kind adjectives. Business Week, hardly the voice of the masses, is using words like "mind-numbing," "huge floods of cash," "obscene," and "out of control" to describe current levels of compensation. The figures look like phone numbers. Never, at any time in the history of this country, has there been such a disparity between the pay of the person at the top of the company and the person at the bottom.

Runaway Executive Pay, supra note 2, at 72 (testimony of Nell Minnow, President, Institutional Shareholder Services, Inc.).

35. See The Boss's Pay, supra note 25, at R9 (calculating a 1991 median for 121 chief executives of $1.3 million); Colvin, supra note 1, at 61 (calculating a 1991 average for 282 chief executives of $1.7 million, and for the 30 largest, an average of $3.2 million); United Shareholders Ass'n, supra note 18, at 7 (calculating a 1990 adjusted averages for top and bottom halves of 1000 chief executives of $2 million and $950,000 respectively); Runaway Executive Pay, supra note 2, at 5 (testimony of Prof. Graef S. Crystal) (calculating a current average for 200 chief executives of $4 million). This has been a consistent complaint historically. See, e.g., Nader et al., supra note 10, at 117; Moore, supra note 10, at 10-15.

36. United Shareholders Ass'n, supra note 18, at 10-28, ranks 1990 compensation of chief executives of 918 companies from a low of $100,000 to a high of $99.6 million, or 996 to one. A survey of 232 chief executives' 1990 compensation by Adrienne Linsenmeyer-Hardman & Leland Montgomery, Rolling with the Risk Takers, Fin. World, May 26, 1992, at 30, 43-44, lists the top figure at $117 million and the bottom figure at $250,000, for a differential of 468 to one, though the authors caution
Finally, and perhaps most disconcerting, the compensation of the chief executive has little if any correlation to performance on the job, by any conventional measure.\textsuperscript{37} Not even the new emphasis on “pay for performance” in restructuring executive pay packages seems to link pay and performance.\textsuperscript{38}

Why does all this arouse the public’s outrage? It is not the financial impact; no one has suggested that lavish spending on executive compensation is a severe or even material drain on the earnings of these corporations.\textsuperscript{39} Rather, it is the effect on morals and morale, magnified by the current political and economic climate, that is the problem.\textsuperscript{40}

against comparisons across industries, \textit{id.} at 30. The difference between the highest ($75 million) and lowest ($270,000) reported total compensation in \textit{The Boss’s Pay, supra} note 25, is 277 to one. This too is a characteristic long noted by scholars. \textit{See Mautz & Rock, supra} note 5, at 478 (concluding, even in 1958 that “[t]his extreme range of salaries is a constant occurrence”); Frank D. Emerson \\& Minnette Massey. \textit{Remuneration of Officers and Directors of Listed California, Florida, Ohio and Virginia Corporations, 12} \textit{FLA. L. REV.} 156, 188 (1959) (confirming the conclusions of a 1950 study that variations in compensation are “many and erratic”) (citing \textit{MABEL NEWCOMER. THE BIG BUSINESS EXECUTIVE} (1955)).

37. \textit{See United Shareholders Ass’n, supra} note 18, at 4 (noting that about 30% of the difference in pay is accounted for by company size, and only 4% by chief executive performance, which “leaves about 66% of the differences in CEO pay not explainable by the two things that ought to explain virtually all of the differences”); \textit{Nader et al., supra} note 10, at 115; \textit{Mautz \\& Rock, supra} note 5, at 480 (concluding upon review of various types of pay schemes that “[e]xcept within the broadest ranges, compensation appears not to be related in any discernible manner to . . . the amount of money required to motivate economic man”).

38. \textit{See supra} note 27 and accompanying text.

39. In 1990, chief executive salaries of 800 corporations amounted to less than 1% of profits. \textit{See Barris, supra} note 23, at 67. Nader, Green, and Seligman note that “if excessive remuneration were . . . confined to the corporate chief executive, it would seem small once it was divided by the total number of shares in most large industrial corporations.” \textit{Nader et al., supra} note 10, at 117. However, they argue further that, because the chief executive sets the compensation of his immediate subordinates at exorbitant levels as well, the excessive compensation may become “truly expensive.” \textit{Id. See also Vagts, supra} note 10, at 274 (noting that the effect may be significant in smaller corporations, but that “[i]n large corporations, the identifiable harm to any one person is small. A very sizeable overpayment comes to pennies per shareholder”).

40. \textit{See Vagts, supra} note 10, at 274 (noting that, despite immaterial financial impact, “[t]he law pursues these crimes, in part, simply because they are violations of the moral system”). Consider, for example, the following summary of the peculiar alchemy that created the current furor.

Maybe if the economy were thriving and big employers were hiring, no one would care.

Maybe if President Bush hadn’t taken the auto company CEOs to Japan to meet their lower-paid, more successful competitors, or if consumer confidence weren’t in the tank, or if giant companies weren’t still announcing vast layoffs, CEO pay wouldn’t be on the front pages. But all those things have happened, making Americans deeply, bitterly mad and creating an issue no politician can resist.

Colvin, \textit{supra} note 1, at 61. And even in the context of a profitable merger, the impact of executive compensation goes beyond its immediate financial magnitude.

We recognize that the amount of benefits provided . . . to the executives is not overwhelming in proportion to the net worth of the [corporations] and the multi-billion dollar values involved in the merger. Nevertheless, the use of corporate funds for purposes which are not in the best interests of the shareholders cannot be excused simply because the opportunity for such occurs in the course of . . . an overall financial gain for the
The morale of the employees and even the stockholders is likely to be dampened when the chief executive's pay is over 100 times that of the average worker in the corporation. This is especially true if that chief executive has not been doing well by any measure of performance. Indeed, this disparity of compensation along with poor industry performance is the combination that has always tended to produce popular outrage over executive pay. Professor Alfred Conard observed


41. See Runaway Executive Pay, supra note 2, at 5 (testimony of Prof. Graef S. Crystal) (citing 1987-89 median pay of chief executives at 100 times that of average workers). Other estimates by Crystal have gone as high as 160 times; furthermore, “[o]ther compensation specialists confirm Mr. Crystal’s estimates, give or take a few points.” Abramson & Chipello, supra note 12, at A1. In addition, the growth of executive pay far outstripped that of other workers; in the 1980s, executive pay increased four times faster than factory workers’ wages. See Barris, supra note 23, at 60-61 (noting a 212% increase for executive compensation and a 53% increase for factory workers’ wages during the 1980s).

42. See Barris, supra note 23, at 70 (“There is more at stake here than just bad feelings. American competitiveness is also suffering, due in part to employee discontent. . . . Employees won’t follow executives they cannot trust, and they cannot trust executives who see to it that they are overpaid.”); James R. Repetti, Corporate Governance and Stockholder Abdication: Missing Factors in Tax Policy Analysis, 67 Notre Dame L. Rev. 971, 978 (1992) (explaining that inflated executive salaries “lead to low worker morale” and encourage management strategies “that maximize sales and growth . . . at the expense of long-term profitability”). See also Robert A.G. Monks & Nell Minow, Power and Accountability 170 (1991), reprinted in Runaway Executive Pay, supra note 2, at 83 (“Imagine the feelings of the General Motors workers when, after massive layoffs of middle managers and operatives in 1987, the company proposed to pay executives large cash bonuses. . . . The impact on shareholder morale can also be devastating.”). Ms. Minow gives another example in her testimony.

United Airlines Chairman Steve Wolf collected $18.3 million in salary, bonus, and stock-based incentive plans: a tidy sum for heading up a company whose profits fell by 71 percent in 1990. That is 1,200 times what a new flight attendant earned at United Airlines in each of the last 5 years, a period when none of them got a raise. If you were a flight attendant, what would your incentive be to do better for the company, to keep that company competitive?

Runaway Executive Pay, supra note 2, at 10 (testimony of Nell Minow, President, Institutional Shareholder Services, Inc.).

43. The first cases attacking executive compensation appeared in the early years of the Great Depression. Once the new federal securities laws forced disclosure of compensation paid not only before, but after the stock market crash, shareholder and popular outrage surfaced.

While some decline took place in the absolute amounts paid to corporate executives, the purchasing power of the amounts paid was still high and during the depression the executive class as a whole probably suffered less than the rest of the population. In the meantime, working men were being discharged in large numbers, wage levels were falling, and dividends were not being paid.

Washingtorn & Rothschild, supra note 9, at 7. The same could be said of the popular perception today.

[N]ot only have the pay packages of American CEOs and other senior executives risen to unprecedented heights, but they also have become more and more risk-free. In contrast, the pay of American workers, adjusted for inflation and taxes, has gone nowhere during the last two decades or so. And if you want to know something about risk, all you need to do is interview a few of the thousands of American autoworkers who are now standing in length-
several years ago the "disease" of "Abuse of Control" by corporate executives, noting that such abuse "undermine[s] the faith of workers that their productivity contributes proportionately to their own rewards and destroy[s] the perception of commonality in objectives and benefits that gives dignity to work."44

Beyond the impact on the corporation's constituencies, social morals are offended by such corporate largesse. It is simply wrong for chief executives to accept more compensation for their services than they are worth.45 Such rules should have a central place in the law,46 but they are absent from the law of executive compensation. Lawyers and lawmakers need to be concerned when the models—the legal rules—do not compare favorably with the public perception of what the rules ought to be.47

These perceived harms to morals and morale remain despite occasional proof that the problem may not be as bad as it seems. Economists gathering on the fiftieth anniversary of the publication of The Modern Corporation and Private Property,48 while critical of the data included in the book49 and calling its reception "astonishingly uncritical,"50 noted that its ideas and conclusions have endured to an extent not empirically justified. One commentator suggested this is because moral and policy issues retain significance even when they may be economically insignificant, noting that the enduring popularity of the book and its theme is "a testament to our

44. Alfred F. Conard, Theses for a Corporate Reformation, 19 U.C. Davis L. Rev. 259, 266 (1986).
45. "In this [excessive executive compensation], it seems to me, social morals are infringed. The very men who benefit from this system can damage it, perhaps destroy it through greed." LIVINGSTON, supra note 10, at 229.
46. See infra part V.B.2.
47. Professor Eisenberg, in writing about the "myth" that directors "manage" the modern corporation, observed that "[b]ecause it is inherently undesirable for law and practice to be in a state of visible opposition, the drastic skew between the legal and working models... would be of serious concern even if no specific dysfunctional consequences could be perceived." Melvin A. Eisenberg, Legal Models of Management Structure in the Modern Corporation: Officers, Directors, Accountants, 63 Cal. L. Rev. 375, 383 (1975).
48. BERLE & MEANS, supra note 10.
49. See, e.g., Stigler & Friedland, supra note 10, at 248-58, who, using methods and data available to Berle and Means, found no correlation between private or public ownership of firms and executive compensation or profitability.
50. Id. at 258.
uneasy, deep-down feeling that we economists have been missing something important in failing to explore systematically the role of evolving ideological conviction in the changing structure of the economy of the past century." 

Excessive executive compensation creates an appearance of impropriety beyond its economic significance that reaches internationally as well. Even before President Bush and the chief executives accompanying him were criticized during their travels to Japan to discuss trade barriers, the Japanese made it clear that they viewed the high pay of United States corporate executives as a key non-tariff barrier to those corporations' ability to compete in a world market.

These are the peculiar characteristics of executive compensation. Every few years, but especially during periods of economic recession, the topic appears to take on sufficient political appeal to bring it to the national headlines. If indeed it is a problem, why has it not been solved, or different solutions at least attempted? How and why do the levels of pay remain so out of line with popular expectations of the value of that executive's performance? These are the subjects of Parts II and III. Part II describes the economic models and theories of market inefficiency that allow high executive compensation to be paid in the first place. Part III describes the development of legal doctrines that hinder significant challenge to such payments.

II. THE ECONOMICS OF EXECUTIVE COMPENSATION

Economic theory suggests at least three partial causes of high executive pay. These causes are discussed in detail because they bear on the propriety and workability of any solutions to the problem involving a change in legal rules. First, economic theory suggests that agents, such as the executive officers of a corporation, will seek and obtain larger compensation in large corporations because the owners are dispersed and less able to control that compensation. Second, there are significant imperfections in the "market" for chief executives of large corporations, making the traditional discipline of supply and demand particularly ineffective in this instance. Finally, organizational theory of large corporations compounds these effects by increasing the remuneration at the top and divorcing it from any measure of performance.

A. Costs of Non-Owner Managers

Berle and Means were the first to recognize the potential for the interests of

52. See Barris, supra note 23, at 68-69 (noting that existing chief executive incentive pay programs create perverse incentives on the part of the recipients to focus only on short-term gains and to be more risk-averse in their entrepreneurial decisions); Abramson & Chipello, supra note 12, at A1 (reporting that in talks in May, 1991, "[t]he Japanese argued that overpaid American executives were preoccupied with short-term results, worsening U.S. international competitiveness"); Runaway Executive Pay, supra note 2, at 17-18 (testimony of Robert A.G. Monks, President, Institutional Shareholder Partners, Inc., quoting a Treasury Department staff member: "And while we have told the Japanese they have to have more bathrooms and they have to have better highways and better infrastructure, they have told us we have got to have lower executive pay.").
corporate management to diverge substantially from the interests of the shareholders. As soon as the owner-manager of a firm obtains a co-owner, the manager will no longer bear the entire cost of perquisites consumed, and thus will increase consumption of those items. In other words, a manager has an incentive to either perform less well on the job, or to demand more compensation for the same performance if there are other non-manager owners. In the modern corporation, where ownership is so widely dispersed that there is no effective control by the owners, either management has the unrestrained ability to divert corporate resources to personal use, or some mechanism exists to limit that ability.

Economists have postulated several mechanisms that exist to limit a non-owner manager's ability to feast at the firm's expense. First, the process of negotiating an executive's compensation will require the executive to pay next year for this year's "shirking," a process known as "ex-post settling up." This process of settling up has limitations, especially if the negotiations are one-sided in favor of management, as they tend to be. Second, shirking managers might encourage outsiders to consolidate control through a takeover or leveraged buyout. But it is uncertain the degree to which levels of executive compensation influences bidders in the market for corporate control. Finally, some economists simply postulate that assumed pressures toward equilibrium will limit the amount of chief executive


55. See Fama, supra note 53, at 296.

56. Fama recognizes that several assumptions are necessary for this negotiating process to eliminate agency costs, the most telling of which is that "[t]he weight of the wage revision process is sufficient to resolve any potential problems with managerial incentives." Id. at 297.

57. For a discussion of management's domination of the compensation-setting process, see infra part II.B.

58. See Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161, 1168-74 (1981) (noting that other methods of monitoring agency costs are not likely to work well "unless the management team as a whole is subject to supervision and, if necessary, discharge," which is possible only with a hostile tender offer). Jensen & Meckling, supra note 54, presaged the leveraged buy-outs of the late 1980s ten years before by recognizing them as a solution to these costs.

In general if the agency costs engendered by the existence of outside owners are positive it will pay the absentee owner (i.e., shareholders) to sell out to an owner-manager who can avoid these costs. This could be accomplished in principle by having the manager become the sole equity holder by repurchasing all of the outside equity claims with funds obtained through the issuance of limited liability debt claims and the use of his own personal wealth.

Id. at 333-34.

59. Easterbrook & Fischel, supra note 58, at 1173, suggest that outside bidders would be motivated by the potential overall reduction in agency costs throughout the firm. A high executive salary alone does not necessarily mean that agency costs are high. The executive might perform work near the value of his salary, or the agency costs may be limited to the chief executive and may not be material in the overall performance of the company and its stock.
Executive Compensation

shirking that shareholders will tolerate.60

To the extent that these monitoring devices or pressures toward a competitive equilibrium are inhibited due to market imperfections, significant "agency costs" may exist. One such cost, of course, is excessive management compensation.

B. Imperfections in the Market for Chief Executives

The second explanation that economics provides for such high executive compensation is that, independent of agency costs, there is nothing approaching a competitive market for chief executives where supply and demand can exert their traditional moderating pressures. While this in part explains the existence of some agency costs as discussed above,61 it is an independent factor contributing to the high cost of executive compensation.

There is, of course, a superficial "market" for chief executives of public companies. Their compensation is usually set annually by the board of directors or a committee that looks at least casually outside the company to discern other executives' compensation. We can observe the market functioning at least in a mechanical sense: buyers and sellers meet and make bargains. In theory, we might expect the company, as purchaser of the CEO's services, to be sensitive to the amount paid, aware of the prices of competitive services, and ever ready to recruit willing competitors from other companies if the incumbent's pay is too high or performance too poor.

None of these expectations are realistic, however. The directors do not stand ever ready to replace the chief executive; that is reserved for times of crisis, and is certainly not routinely considered on an annual basis.62 And, it is unlikely that there are several "candidates" from whom to choose, because executives are not highly mobile nor motivated exclusively by compensation in choosing a job.63

Independent of this restricted supply is the fact that in this market the same person—the executive—sits on both sides of the bargaining table. The nominal buyer, the corporation, usually makes its purchase through the compensation committee of the board of directors, which traditionally consists of independent (non-management) directors.64 The compensation committee, in turn, relies on compensation information generated by the corporation itself or by an outside

60. See Jensen & Meckling, supra note 54, at 350; Fama, supra note 53, at 297 (noting that some assumptions underlying economic models "amount[] to assuming the desired result"); Harold Demsetz, The Structure of Ownership and the Theory of the Firm, 26 J.L. & ECON. 375, at 390 (1983) ("How could it be otherwise? In a world in which self-interest plays a significant role in economic behavior, it is foolish to believe that owners of valuable resources [stockholders] systematically relinquish control to managers who are not guided to serve their interests.").

61. See supra notes 56-57 and accompanying text.

62. See infra notes 69-70 and accompanying text.

63. See Vagts, supra note 10, at 236-38 (reviewing the economics of the labor market and concluding that "labor transactions . . . are more idiosyncratic than those on the securities markets, and one is left with a conviction that the discipline of the labor market is at best a loose one").

64. See Crystal, supra note 27, at 214.
consultant retained by the corporation.\textsuperscript{65} In reality, however, the internal information, and even the conclusions of the consultant are under control of the chief executive.\textsuperscript{66} Recognizing this fact, most calls for reform of the executive compensation-setting process suggest that independent counsel or consultants be retained by the compensation committee.\textsuperscript{67}

Even if the independent compensation committee were given relevant information, it is not capable of earnest negotiation with the chief executive. Substantial anecdotal evidence from participants in the process indicates that it is the chief executive who controls the choice of all directors, whether "independent" or not.\textsuperscript{68} The culture of a corporate board or committee is not designed to support debate and contention, but rather to build or ratify consensus. This is true of boards generally,\textsuperscript{69} and of compensation committees in particular.\textsuperscript{70} And the types of "independent" directors chosen are often chief executives at other companies, who are especially

\textsuperscript{65} Using this information will tend to impress reviewing courts that the compensation committee has done its job. See Vagis, supra note 10, at 270.

\textsuperscript{66} Crystal, supra note 27, at 215-20; Peter Passell, Those Big Executive Salaries May Mask a Bigger Problem, N.Y. Times, Apr. 20, 1992, at A1, C5 ("[Directors] rarely have the information or incentive to pick the best executives in the first place. In short, . . . concluded [Professor Jeremy Stein of the Sloan School of Management], 'there is no market' for chief executives.").

\textsuperscript{67} See Crystal, supra note 27, at 243-44; Bruce R. Ellig. Executive Compensation—A Total Pay Perspective 287 (1982); Conard, supra note 44, at 288; Vagis, supra note 10, at 275; Committee on Corporate Laws, Am. Bar Ass'n Section of Corporation, Banking and Business Law, The Overview Committees of the Board of Directors, 35 Bus. Law. 1335, 1348 (1980); Principles of Corporate Governance, supra note 7, § 3A.05 cmt. d. The Council of Institutional Investors, a trade group for pension funds, recently proposed that the corporation's choice of compensation consultant be approved each year by the shareholders. Gilbert Fuchsberg, Investors May Seek Vote on Executive Pay Consultants, Wall St. J., Aug. 27, 1992, at B1; Barris, supra note 23, at 78, remains skeptical about the ability of reforms of the makeup of or information given to the compensation committee to make any difference, concluding that any such reform "must be backed up with further incentives, provided either by the threat of shareholder activism or by judicial action before any significant permanent changes will be realized." Id.

\textsuperscript{68} See Crystal, supra note 27, at 226-27; Moore, supra note 10, at 15; Mautz & Rock, supra note 5, at 488-500; Gordon, supra note 10, at 277 ("[O]nly in a restricted sense can a market for executive ability be said to exist at all. Buyers and sellers are not independent. The chief executive is in a sense his own employer. Within broad limits he frequently sets his own compensation.").


\textsuperscript{70} See Barris, supra note 23, at 76 ("The composition of these [compensation] committees negates any pretense of their impartiality or ability, while the corporate environment in which these teams operate provides a playground for groupthink."); see also Crystal, supra note 27, at 227 ("[I]n . . . boardrooms, it is considered well-nigh traitorous to buck the CEO. If things get bad enough, you can fire the CEO. But until you do, you'd better support him."); Runaway Executive Pay, supra note 2, at 18 (testimony of Robert A.G. Monks, President, Institutional Shareholder Partners, Inc.) ("If you get on a board, in my view you are supposed to be a fiduciary. But if you are a fiduciary on a board and . . . what the chief executive officer is paid is a matter of distress to you, you had best decline to serve."). A recent study of 79 compensation committee chairs indicates that they believe that the chief executive is still "in the driver's seat" with respect to the committee's work. William E. Lissy, Currents in Compensation and Benefits, Compensation & Benefits Rev., May-June 1991, at 5.
likely to support higher compensation for their colleagues. This combination of pressure toward consensus, and the presence on the compensation committee of those predisposed to higher pay for the chief executive makes earnest negotiation of that pay impossible.

Thus, because we observe negotiation over compensation each year and some occasional movement into and out of executive suites, it is tempting to conclude that there appears to be a market for chief executives. However, closer examination shows that this market has a limited number of sellers, and is filled with uninformed buyers incapable of earnest negotiation with those few sellers. These major imperfections prevent the market from efficiently matching articulated demand with available supply.

C. Absence of a Pay-Performance Relation

The aspect of the executive pay controversy that probably generates the most public outrage is the lack of any coordination of pay with performance. It strains the patience of the average American worker, investor, and voter to see large layoffs and poor (or negative) earnings coupled with lavish pay increases in the executive suite.

71. Professor Repetti, discussing federal income tax policy and corporate governance, noted:

Since 63 percent of all outside directors on the boards of America's 1,000 largest companies are chief executives of other firms, the abdication of the board of directors should be expected. Chief executives who serve as directors for companies other than their own are generous in establishing the salaries of management of those companies because the high salaries can then be used to justify large salaries from their own companies.

Repetti, supra note 42, at 977. See also J. Spencer Letts, Corporate Governance: A Different Slant, 35 BUS. LAW. 1505, 1515 (1980). The most frequent choice for a disinterested director is a chief executive at another company. Id. "One wonders, however, if the person among all who is most likely to be generally supportive of the chief executive isn't another chief executive." Id.

Professor Crystal found in empirical studies that "a potent predictor of how much a CEO will earn turns out to be the average pay of the CEOs who sit on the Compensation Committee of that CEO's Board." In addition, there was "a strong association between the extent to which outside directors are paid over the market and the extent to which the CEO is paid over the market." Runaway Executive Pay, supra note 2, at 58 (statement of Professor Graef S. Crystal, citing a study with Professors Charles O'Reilly of the University of California-Berkeley and Brian Main of the University of Edinburgh).

72. Similar conclusions result from theoretical and empirical studies of wages paid to "rank and file" workers. Much of the wage variation remains unexplained by supply-and-demand market forces, firm size, or the presence of collective bargaining. Firms remain willing to pay premiums above the market rate (the rate determined by the worker's productive value) as a method of managing a worker's behavior on the job. In addition, workers tend to use as major reference points, not the price for their services elsewhere, but what their coworkers in the same firm receive, and they have a built-in expectation that this amount will continue to rise over time independent of and in addition to any fluctuation in price levels. See generally JAMES E. ANNABLE, JR., THE PRICE OF INDUSTRIAL LABOR 29, 136-40 (1984). Although these theories are not directly applied by Annable to executive compensation, similarities are apparent in the authorities cited supra notes 68-71, which discuss executive compensation specifically.

73. This market inefficiency may partially explain the wide variation in CEO salaries even in large publicly-held corporations. See supra note 36 and accompanying text. Of course, there are variations in the duties and responsibilities among these CEOs, but no study has examined whether these variations justify up to a thousand-fold variation in compensation.
Extensive empirical evidence exists linking executive compensation and the performance of a company's stock.\textsuperscript{74} Although this might seem at first to be compelling proof of a link between pay and performance, it is illusory for several reasons. Proof that executives with higher pay are found at companies with above average growth as measured by stock price or firm size\textsuperscript{75} does not establish a causal link between the two. Such evidence is equally consistent with a hypothesis that boards of directors and their compensation committees at prosperous and growing firms have no evidence or incentive to justify a cut in the executive's pay, and thus it continues its rise unabated.\textsuperscript{76} To extend the above empirical evidence to suggest a link between pay and performance requires proof of some causal link between executive compensation and executive effort, and between executive effort and firm prosperity. Though the studies do correct firm performance as measured by stock price for general market performance, they cannot correct on a market-wide basis for other individual explanatory factors unique to the company, such as development of a new product, demise of a competitor, or surging consumer demand that may have given the firm good results and growth quite apart from any initiatives from the executive suite.\textsuperscript{77} Anecdotal evidence suggests that traditional stock options do not change an executive's motivation significantly,\textsuperscript{78} yet those options likely increase total compensation.\textsuperscript{79} Although empirical studies also have shown some correlation

\textsuperscript{74} One economist who surveyed 73 companies over 18 years concluded that “firm performance, as measured by the shareholder's realized return, is strongly and positively related to managerial compensation. This result . . . comes as no surprise to economists but may shock editors of many popular business periodicals . . . .” Kevin J. Murphy, \textit{Corporate Performance and Managerial Remuneration}, 7 J. ACCT. & ECON. 11, 40 (1985). Other economists reach similar conclusions when including the executive's gain or loss on stock owned by that executive. See George J. Benson, \textit{The Self-Serving Management Hypothesis: Some Evidence}, 7 J. ACCT. & ECON. 67, 81 (1985) (concluding that even with a small percentage of shares owned by the executives studied, “the amounts they owned yielded annual gains and losses that swamped their remuneration”); Demsetz, \textit{supra} note 60, at 388-89.

\textsuperscript{75} \textit{See}, e.g., Murphy, \textit{supra} note 74.

\textsuperscript{76} The tendency of executive salaries to rise, all other things being equal, has been shown above. The executive has significant incentive to seek increases in salary each year, \textit{see supra} part III.A, and the corporation is for the most part unwilling and unable to refuse the executive's demands, \textit{see supra} part III.B. Indeed, boards of directors and compensation committees often contribute to the trend of pay increases by adopting “premium pricing” as a matter of policy, declaring that their top executives should be paid at “above-average” rates. No company aims for below-average compensation for its executives. Thus, upward pressure is virtually built-in. \textit{Crystal}, \textit{supra} note 27, at 222-23. Nearly identical attributes have been observed in the nonexecutive labor market. \textit{See Annable}, \textit{supra} note 72, at 136-37.

\textsuperscript{77} \textit{See} Barris, \textit{supra} note 23, at 66 (stating that “a compensation plan aimed at motivation may in fact reward an executive for lucky circumstance or crafty tactics instead of individual effort”).

\textsuperscript{78} The absence of “downside” risk, \textit{see supra} text accompanying note 27, is one critical factor. \textit{See also} Kay, \textit{supra} note 27, at 19 (noting that traditional stock options do not link executive and shareholder interests); Bennett, \textit{supra} note 16, at R1-R2 (concluding that, although options have been included in executive pay packages, total compensation is certain to continue increasing); Bennett, \textit{supra} note 24, at A4 (“I can't sit here and say if I didn’t have this [stock-option] program, then my decision-making process would be less good than it is now.” [International Multifoods Corp. Chairman Anthony] Luiso says. Adds Paul Quinn, a group vice president who also swapped cash for International Multifoods stock: “Would I behave any differently if I didn’t have stock options? I don’t think so.”). Compensation experts continue to struggle to relate pay to performance. \textit{See supra} note 30 and accompanying text.

\textsuperscript{79} \textit{See supra} notes 25-26 and accompanying text.
between poor stock price performance and executive turnover, this does not mean that performance figures significantly into compensation determinations. Rather, this evidence reinforces the traditional view of the role of the board of directors: to replace the chief executive if necessary, but to support him or her in all other cases. Despite the statistical correlation between executive pay and stock performance, other empirical research has shown the single most significant predictor of the size of an executive's compensation not to be performance, but rather the size of the employing corporation. Thus, the empirical link between pay and performance is not one suggesting that better pay yields better performance by the company, but rather the other way around: firms prosperous for whatever reason have no motivation to counteract the forces naturally pushing upward on executive compensation, and thus better performance by the firm (for whatever reason) yields better pay for the executive.

Organizational theory also provides several reasons why pay becomes divorced from performance in large corporations. Effective motivation requires a "significant salary differential" between different steps in the organizational hierarchy. The more levels in that hierarchy, the larger the top level compensation must be. And the closer the position to the top level, the larger those differences are. In addition, the sheer size of these corporations generates institutional inertia. The rise through the pay scales of the corporation, for the fortunate few to the rarified level of the chief executive's pay, is simply a result of longevity in many instances.

80. See Michael S. Weisbach, Outside Directors and CEO Turnover, 20 J. Fin. Econ. 431, 458-59 (1988) (finding that poor performance measures are more highly correlated with turnover in firms whose boards are dominated by outside directors); Jerold B. Warner et al., Stock Prices and Top Management Changes, 20 J. Fin. Econ. 461, 487-88 (1988) (finding a significant relationship, but noting that even in the firms with the worst stock price performance, the probability of a chief executive's forced departure in any year was approximately 6%, with lags of up to two years between the poor performance and the executive's departure).

81. See supra note 70.

82. See supra notes 74-78 and accompanying text.

83. See United Shareholders Ass'n, supra note 18, at 4; 1 Washington & Rothschild, supra note 9, at 21.

84. 1 Washington & Rothschild, supra note 9, at 25; Moore, supra note 10, at 14-15 (suggesting that the addition of income tax effects might make a top-bottom differential of up to 100:1 appropriate).

85. Runaway Executive Pay, supra note 2, at 15 (testimony of Ralph V. Whitworth, President, United Shareholders Ass'n, Inc.) (citing a study reporting a 57% difference between chief executive's pay and the next-highest-ranking executive's pay); Ellig, supra note 67, at 2 (noting that although "public pressure on visible compensation for the five or so highest-paid executives serves to retard growth [of compensation] in the upper portion of the [management] structure," "the absolute increases are probably still greater at the upper portion than the lower end"). See also 1 Washington & Rothschild, supra note 9, at 22 & n.72. Recent international comparisons indicate that it is only the top executive's pay that is significantly larger than peers in other countries; middle managers of United States companies receive compensation comparable to their overseas counterparts. See Amanda Bennett, Managers' Incomes Aren't Worlds Apart, Wall St. J., Oct. 12, 1992, at B1.

86. See Runaway Executive Pay, supra note 2, at 15 (testimony of Ralph V. Whitworth, President, United Shareholders Ass'n, Inc.) (citing a survey concluding that "75 percent of CEO's come from right within the company"); Passel, supra note 66, at C5 (citing research on ten companies that
D. Summary

An observer might be tempted to conclude that a functioning market exists for the CEOs of large United States corporations; after all, the executives bargain with nominally independent representatives of the company each year for their jobs. However, those executives have every incentive to seek more compensation constantly, and the nominally independent representatives of the company have built-in predispositions in favor of the executive. Compensation is not linked with firm performance despite evidence that the two coexist more often than not; rather, this suggests only that prosperous firms are by their prosperity able to maintain this trend.

III. The Law of Executive Compensation

Courts review executive compensation arrangements in derivative actions by disgruntled shareholders against the corporation's board of directors. Deciding how much to pay a corporation's executives is the responsibility of the board of directors. The pay of all but the senior executives of the corporation is ordinarily set by other officers, thus the board's judgment is usually involved only in the case of the chief executive officer and a few subordinates. Shareholder challenges are universally limited to the compensation of top executives; no suits have challenged the corporate-wide pay scales. Thus, when plaintiffs challenge executive compensation in court, they are in every case challenging a decision made by the board of directors or delegated to a committee of the board. In most large corporations, this decision is delegated by the board to a compensation committee.

This section summarizes and analyzes executive compensation decisions in the context of existing judicial doctrines governing review of directors' actions. This is difficult at times because existing doctrines and analyses often lack rational analysis. For example, the exact relationship between the directors' duty of care and the business judgment rule has never been successfully explained in any generally acceptable fashion. Nor have the exact relationships between the duty of care, the improved overall performance, noting they had "something in common distinguishing the winners from corporations that tried and failed to change: All 10 brought in outsiders—managers who had not spent a career immersed in the corporate culture that they were pledged to change."); NADER ET AL., supra note 10, at 118 ("[T]he administrators of large industrial corporations . . . at minimal personal risk, serve as the bureaucrats of private industry. These individuals receive their staggeringly large salaries and stock options by rising through executive ranks . . . "); 1 WASHINGTON & ROTHSCHILD. supra note 9, at 28. Similar pressures exist on nonexecutive wages in large firms. See ANNABLE, supra note 72, at 139-41.

87. Occasionally the issue is raised in other settings, such as a defense in an action by the officer to recover salary due, see, e.g., Flight Equip. & Eng'g Corp. v. Shelton, 103 So. 2d 615 (Fla. 1958), or a suit by shareholders to dissolve the corporation, see, e.g., Gianotti v. Hamway, 387 S.E.2d 725 (Va. 1990).

88. See MODEL BUSINESS CORP. ACT, supra note 7, § 8.01(b), which vests all corporate powers in the board of directors. This language or similar language appears in the statutes of every state. See 2 MODEL BUSINESS CORP. ACT ANN. 786-87 (1992).

89. See supra notes 64-65 and accompanying text.

90. The drafters of the Model Business Corporation Act, after considerable effort, declined to offer a statement of the business judgment rule at all, stating only that its elements "and the circumstances for
business judgment rule and the doctrine of "corporate waste" been clarified. Nonetheless, it is not the purpose of this Article to suggest radical reformations of these doctrines, however appropriate. At least in the context of evaluating executive compensation, other existing but largely-ignored rules can bear the weight of rational analysis when the rules governing directors' duties cannot.

A. The Business Judgment Rule and Its Exceptions

As with all decisions by the board of directors and its committees, the protection of the business judgment rule nominally extends to executive compensation decisions as well. The business judgment rule is in essence a presumption that the corporation's directors have fulfilled their statutory duties of care, and it may be rebutted only by a showing of lack of information, good faith, or the honest belief that the action was in the corporation's best interest.

In practice, however, two doctrines operate to preclude judicial deference to decisions of the board of directors under the business judgment rule. First, the decision may involve self-dealing. Because self-dealing is typically considered to be

its application are continuing to be developed by the courts." Model Business Corp. Act, supra note 7, § 8.30 official cmt. The American Law Institute's Principles of Corporate Governance have offered a codification of the business judgment rule in the context of the duty of care, but note that "courts have not expressed it this way." Principles of Corporate Governance, supra note 7, § 4.01(c) cmt. a. The latter's restatement of the business judgment rule has been and will continue to be the subject of much controversy. See Dennis J. Block et al., The Business Judgment Rule: Fiduciary Duties of Corporate Directors 23-26 (3d ed. 1989).

91. See infra notes 130-131 and accompanying text.
92. See infra parts IV-V.
93. See Clark, supra note 4, at 123-24. The Delaware Supreme Court has noted specifically the "directors' broad corporate power to fix the compensation of officers." Aronson v. Lewis, 473 A.2d 805, 817 (Del. 1984).
94. See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (providing a general statement of business judgment rule); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (rebutting the presumptions of the rule). See generally Block et al., supra note 90, at 2-12 (stating the general rule and citing cases).
95. The following two exceptions have been generally recognized. See Vagts, supra note 10, at 268-69; Note, Executive Compensation in Close Corporations: The Need for a Modified Judicial Approach to the Reasonableness Test, 1972 Duke L.J. 1251, 1260.

The Model Act takes the position that it is unnecessary to include officers in conflicting-interest statutes. See Model Business Corp. Act, supra note 7, § 8.31 (1984, withdrawn 1988) & Ch. 8, Subch. F, introductory cmt. 2 ("Conflicts of interest of non-director officers or employees of the corporation are dealt with by the law of agency prescribing loyalty of agent to principal."). See Norwood P.
a violation of the fiduciary duty of loyalty rather than the duty of care, the business judgment rule does not apply. Although the common law rule in such cases was that a self-dealing transaction was automatically voidable, almost all states have replaced this rule with statutes permitting self-dealing transactions if there has been proper ratification by disinterested directors or shareholders, or if the transaction is "fair" to the corporation. Even if properly ratified according to the statute, however, the self-dealing transaction may still be invalidated under common law if it is "unfair" to the corporation. Second, no corporation is generally permitted to give away or "waste" its assets. Thus, a court faced with a well-pleaded allegation of waste of assets through excessive compensation will not accord the directors' decision the deference otherwise proscribed by the business judgment rule. As discussed below, both of these doctrines typically boil down to a test of fairness or reasonableness.

Beveridge, Jr., The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction, 41 DEPAUL L. REV. 655, 670 (1992) (discussing relevant agency law principles). Professor Beveridge concludes that "[b]ecause all agents are fiduciaries, everyone working for the corporation is a fiduciary, although most will have little occasion to exercise any fiduciary power." Id. at 687.

97. The duty of care is not a "distinctively" fiduciary duty:

[M]any persons, by virtue of the law or their own contractual undertakings, owe duties of care to other persons with whom they have nonfiduciary relationships. For example, motorists owe duties of care to pedestrians and to fellow motorists but are not, by virtue of these relationships, under any fiduciary constraint in their pursuit of self-interest!


98. See CLARK, supra note 4, at 124.

99. Id. at 160 (citing Harold Marsh, Jr., Are Directors Trustees? Conflict of Interest and Corporate Morality, 22 BUS. LAW. 35 (1966)). See also Dale A. Oesterle, Limits on a Corporation's Protection of its Directors and Officers from Personal Liability, 1983 WIS. L. REV. 513, 545 n.91 ("Originally, a strict self-dealing disqualification rule controlled: if a director participated in setting his own salary as a director or officer, the resolution was void."). Professor Beveridge vigorously disputes this traditional proposition, and contends that accurate historical analysis proves it "completely erroneous." Beveridge, supra note 96, at 659-62.

100. See BLOCK ET AL., supra note 90, at 691-93 (listing 47 states with such statutes). See also MODEL BUSINESS CORP. ACT, supra note 7, § 8.61 (1988) & § 8.31 (1984, withdrawn 1988).

101. See infra note 112 and accompanying text.

102. See Vagts, supra note 10, at 268 and cases cited infra note 121.

103. See Aronson v. Lewis, 473 A.2d 805, 817 (Del. 1984); 2 WASHINGTON & ROTHSCHILD, supra note 9, at 852; BLOCK ET AL., supra note 90, at 2; Bayless Manning, The Business Judgment Rule in Overview, 45 OHIO ST. L.J. 615, 621 (1984) ("The classic case law position has been that the [business judgment] rule does not protect the directors if they commit an act of corporate 'waste.' No one denies that proposition.").

104. See infra part IV.A.3. Of course, even if these exceptions do not apply, the defendants may not be in for smooth sailing. They must still establish the prerequisite information and good faith to invoke the presumption of the business judgment rule. See Gaillard v. Natomas Co., 256 Cal. Rptr. 702, 716 (Cal. Ct. App. 1989). In addition, there are older cases where the court simply refuses to recognize the business judgment rule. See Gallin v. National City Bank, 273 N.Y.S. 87 (N.Y. Sup. Ct. 1934).
If self-dealing is involved, many states have statutes that protect the contract between the corporation and the interested party from the common law rule of automatic voidability. If self-dealing is involved, many states have statutes that protect the contract between the corporation and the interested party from the common law rule of automatic voidability. This protection is available if one of three tests is met.

First, the corporation may be able to prove ratification by a disinterested board or committee of the board. In most public corporations, such a committee is charged with the executive compensation decisions, foreclosing further attack on this ground. However, the board may have failed to take this precaution, or in the case of most closely-held corporations, all of the directors are interested officers as well.

Failing approval by disinterested directors, approval by disinterested shareholders is the second method to save a compensation decision from automatic voidability. In publicly-held corporations, this option is rarely invoked for that purpose; approval by a properly disinterested board has usually done the job. Nonetheless, shareholder approval of compensation is often sought for other purposes.

In a closely-held corporation, disinterested shareholder approval is likely impossible for the same reason that disinterested board approval is impossible—the shareholders are directors and officers as well.

Finally, the executive compensation decision can be saved from automatic voidability as self-dealing if it is shown to be "fair" to the corporation. As indicated above, this is the only practical alternative in closely-held corporations.

Regardless of statutes removing the automatic voidability of self-dealing transactions, there remains, at least in Delaware, a more fundamental corollary rule from common law. While a transaction may be saved from automatic voidability if it is fair, it will nonetheless be invalidated if it is unfair. Apparently only Delaware

105. See supra note 100 and accompanying text.
106. See Model Business Corp. Act, supra note 7, § 8.62 (1988) & § 8.31(c) (1984, withdrawn 1988). In addition, since challenges to executive compensation by a small shareholder are invariably derivative actions, and thus must meet the requirement of demand made on the corporation or excused as futile, approval by a disinterested board may also be effective after the fact in the context of an independent litigation committee's decision to refuse an objecting shareholder's derivative suit. See Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1984).
108. See Note, supra note 95, at 1256.
109. See Model Business Corp. Act, supra note 7, § 8.63 (1988) & § 8.31(d) (1984, withdrawn 1988); Shareholder approval may also be relevant in the derivative suit context, see supra note 106, in those states where demand on the shareholders is required in addition to a demand on the board of directors; Smith v. Dunlap, 111 So. 2d 1, 5 (Ala. 1959).
112. See Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976); Clark, supra note 4, at 170 (noting that either under the statute or the reasoning in Fliegler, "the transaction stands or falls depending on whether it is fair").
courts have discussed this general requirement, but it is nonetheless significant because of the number of public corporations incorporated in Delaware and because “self-dealing,” as defined in the statutes considered above, extends in Delaware to contracts between the corporation and its officers.

These dual requirements of “fairness” in self-dealing transactions have created an apparently nimble burden of proof. Allocation of the burden is important since the law demands proof of a subjective standard, fairness, which is difficult to prove. When there has been no ratification, the burden will be on the defendant directors to prove, under applicable statutes, the fairness of the transaction. In the second type of case, however, where the self-dealing transaction is challenged as unfair regardless of the statutory rules of voidability, the burden of proof is on the plaintiff. Hence, courts sometimes speak of shareholder ratification as “shifting” the burden of proof from defendants to plaintiffs.

2. Corporate Waste

The business judgment rule does not protect a decision that appears to be a “waste” of corporate assets. Courts often state this proposition, though it is not at all clear why waste should be considered apart from the business judgment rule, rather than as prima facie or even conclusive evidence of failure to meet the prereq-

113. There is some suggestion that other states, California in particular, might follow a similar rule. See Edward Brodsky & M. Patricia Adamski, Law of Corporate Officers and Directors § 3:05 & n.10 (1992).


115. See Beveridge, supra note 96, at 671-73.


117. See supra note 114 and accompanying text.

118. See, e.g., Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979); see also Cohen v. Ayers, 596 F.2d 733, 739-40 (7th Cir. 1979) (applying New York law and holding that shareholder ratification also invokes the presumption of the business judgment rule in favor of defendants). But see Hanrahan v. Kruidenier, 473 N.W.2d 184, 188 (Iowa 1991) (placing the burden of proof on defendants to prove reasonableness of compensation program even though ratified by disinterested committee of the board of directors). See generally Oesterle, supra note 99, at 545 n.91. Oesterle states:

The legal effect of these procedures varies in the common law from jurisdiction to jurisdiction. Do the procedures constitute additional evidence of fairness? Do they shift the burden of persuasion on fairness? Do they shift the standard from unreasonableness to waste? Or do they preclude judicial investigation into fairness absent fraud or other exigent circumstances?

Id.

119. See supra note 103 and accompanying text.
uisites of the rule\textsuperscript{120} or as a failure to fulfill the duty of care itself.

Despite these analytical shortcomings, an attack upon executive compensation as a waste of assets suffers from none of the limitations placed by the law on an attack on the same compensation as self-dealing. No consideration of ratification is necessary, as courts have consistently held that no group can ratify a waste of assets.\textsuperscript{121} The earliest cases involving challenges to executive compensation proceeded on this theory, and the courts, though initially unwilling to invalidate the compensation, expressly affirmed their equitable power to do so.\textsuperscript{122} A further distinction of the action for waste is that a complaining shareholder might not only recover damages,\textsuperscript{123} but may by statute in most states seek dissolution of the corporation as well.\textsuperscript{124}

Most courts evaluating executive compensation alleged to be a waste of corporate assets impose two requirements to approve the compensation: there must be consideration passing to the corporation in exchange for the compensation, and it must bear a "reasonable relationship" to the benefits received by the corporation.\textsuperscript{125}

\textsuperscript{120} See supra text accompanying note 94 (discussing prerequisites of the business judgment rule: full information, good faith, and an honest belief that the action taken was in the corporation's best interests).


\textsuperscript{123} See infra part III.C for a discussion of the defendants liable in actions for waste or conflicting-interest transactions.


One court recently reformulated this test into a three-part test, analyzing: (1) benefit to the corporation; (2) whether the compensation was "unreasonably disproportionate" to the benefit; and (3) whether the services rendered triggered the payments in question. International Ins. Co. v. Johns, 874 F.2d 1447, 1461 (11th Cir. 1989).
The first requirement, that of some consideration, has rarely proved a significant stumbling block for compensation plans. Courts have invalidated only compensation that was clearly in consideration for past services or that required no future service by the employee. Even when corporations amend their stock option plans by gratuitous changes in favor of the executives, courts have found consideration.

The second requirement, known as the “reasonable relationship” or more simply the “reasonableness” test, bears most of the load of judicial analysis.

3. Analysis of Reasonableness

Under either of the above doctrines that preclude application of the business judgment rule to decisions about executive compensation—self-dealing or corporate waste—the analysis usually comes down to finding a reasonable relation between the amount of compensation given to the executive and the benefit received by the corporation in return. This is what makes the transaction “fair” to the corporation under a self-dealing analysis, and it is at the same time what makes the transaction not a waste of assets. However, courts often skip the first logical step, failing to state whether the challenge is based on self-dealing or waste of assets. The resulting analysis is thus usually the same under either legal rule.


129. See, e.g., Note, supra note 95.

130. See Oesterle, supra note 99, at 545 n.91 (“The current standard is easy to state and very difficult to apply.”); Manning, supra note 103, at 621 (“Efforts to develop a functional vocabulary to identify ‘waste’ have been as unsuccessful as corresponding efforts to give operational meaning to the concept of ‘obscenity.’”)

131. Washington and Rothschild noted simply that “[g]enerally, the basis of the decision is not stated with clarity.” 2 WASHINGTON & ROTHCHILD, supra note 9, at 853.

Professor Clark disagrees, arguing that the difference in terminology between self-dealing cases and waste-of-asset cases “marks a real difference in judicial practices,” because courts rarely use a self-dealing analysis. CLARK, supra note 4, at 192. However, this assertion overlooks cases such as those at supra note 116, where in each instance (except the last) the court held the compensation invalid. And there are other cases in which, although the compensation is upheld, the court gives serious consideration to the claim of self-dealing. See, e.g., Hingle v. Plaquemines Oil Sales Corp., 399 So. 2d 646, 651 (La. Ct. App.), cert. denied, 401 So. 2d 987 (La. 1981); Bookman v. R.J. Reynolds Tobacco Co., 48 A.2d 646, 691 (N.J. Ch. 1946). Thus, analysis of executive compensation as self-dealing seems to be more
Courts implicitly recognize the different theories when allocating the burden of proof in these cases, however. When the action is brought challenging as self-dealing an executive compensation package not ratified by the board of directors or the shareholders, the burden is placed on the defendant directors, but shifts to the plaintiffs if there is ratification. When the action is brought challenging the compensation as a waste of assets, however, the burden of proof is on the plaintiff.3

However, this recognition is forgotten in some cases in which courts, in determining the reasonableness of compensation, invoke the business judgment rule in deference to the board's consideration of reasonableness, although the cases arise in the first place only because the business judgment rule is inapplicable. Placement of this transient burden of proof is further evidence of the failure of courts to provide an analytically robust theory of duties of care and loyalty.4

Once courts somehow place the burden of proof and determine the degree of deference, if any, due the board's decision, they will evaluate the actual reasonableness of the compensation. Courts employ differing analyses depending on whether the compensation challenged involves the payment of straightforward salaries and bonuses, or stock options and rights, which are more difficult to value. Cash payments to executives are evaluated against a number of factors, the most frequently mentioned being compensation of similar executives in other companies in the same industry, the success of the company as determined by various financial and accounting measures, and the success of the company as determined by various financial and accounting measures.5

In their earlier analysis of compensation decisions in close corporations, Washington and Rothschild noted that “‘self-dealing’ . . . has been the single most important factor in persuading courts to hold compensation unreasonable,” though that fact alone “will not of itself result in a determination of unreasonableness.” 6

See generally factors listed in 2 Washington & Rothschild, supra note 9, at 856-61; Ellig, supra note 67, at 299; and Lynch v. Patterson, 701 P.2d 1126, 1133 (Wyo. 1985).

See 2 Washington & Rothschild, supra note 9, at 856 & n.24 (citing cases); Ellig, supra note 67, at 299; Winkelman v. General Motors Corp., 44 F. Supp. 960, 970 (S.D.N.Y. 1942); Wilderman v. Wilderman, 315 A.2d 610, 615 (Del. Ch. 1974); Hingle v. Plaquemines Oil Sales Corp., 399
cial measures, the ability and performance of the executive, and the absolute size of the payments. One commentator has suggested that the focus on the corporation and the executive, at least in close corporation cases, is misguided, and that courts should instead focus on the remaining returns available to the complaining minority shareholder.

Compensation under stock option, restricted stock, and similar incentive plans is given a less-searching analysis by courts, presumably because of the difficulty in valuing the consideration given by the corporation, a problem obviously not present in cash compensation cases. Consideration for the grant of the stock option or right is usually found in the executive's promise to remain in office in order to exercise the option or right. When existing options are modified favorably to the executive, however, courts simply assume consideration otherwise not apparent.

Turning to the evaluation of the adequacy of the consideration, some courts have recognized that the link between the executive's performance and any increase in

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140. See 2 Washington & Rothschild, supra note 9, at 857 & n.28 (observing "[i]ncreases in sales, profits, assets, capital, surplus, and the like" are considered in the cases, though noting that "[t]he significance of such factors has not always been made evident"); Winkelman, 44 F. Supp. at 970 (growth of and return on assets); Wilderme, 315 A.2d at 615 (general success of company); Hingle, 399 So. 2d at 649 (return on assets); Crowley v. Communications for Hosp., Inc., 573 N.E.2d 996, 1000 (Mass. App. Ct. 1991) (gross revenues or net income before taxes); Miller, 256 N.W.2d at 768 (basis for measuring success not stated); Bookman v. R.J. Reynolds Tobacco Co., 48 A.2d 646, 691-92 (N.J. Ch. 1946) (return on assets and equity, stock price, and dividends); Gallin, 281 N.Y.S. at 803-04 (surplus, earnings, and deposits).


142. See 2 Washington & Rothschild, supra note 9, at 861 (suggesting size of payments is a factor, but "few opinions, if any, expressly rely on size in the abstract as a determinative factor, and its influence, if any, is an unexpressed one"); Rogers v. Hill, 289 U.S. 582, 591 (1932) (stating that "the payments . . . have become so large as to warrant investigation in equity in the interest of the company"); Winkelman, 44 F. Supp. at 970 (concluding that plaintiffs failed to show that compensation was unreasonably excessive); Kerbs v. California E. Airways, Inc., 90 A.2d 652, 658 (Del. 1952) (finding payments under profit-sharing plan "[in view of the present earnings of the company . . . do not seem shockingly large").

143. See Note, supra note 95, at 1270-73. See also Ellig, supra note 67, at 299 (listing "[n]o or low dividends" as a factor indicating unreasonable levels of compensation in privately-held companies).

144. See supra note 28 and accompanying text.

145. See supra notes 126-28 and accompanying text.

stock price is doubtful. However, courts more frequently brazenly finesse the question, noting the difficulty of valuing such options and rights and relying on the assumed expert judgment of the directors, even though it is the adequacy of that very judgment that is at issue.

**B. The Close–Public Corporation Distinction**

Although the legal rules discussed above apply regardless of the size of the corporation, commentators have universally recognized that closely-held or “close” corporations fare differently than publicly-held or “public” corporations. Nonjudicial restraints, such as the disclosures required by the federal securities laws, operate implicitly to limit executive compensation in public corporations. Close corporations rarely employ outside directors or officers, with the result in most cases that decisions on executive compensation always involve self-dealing. The result is that courts in public corporation cases are more frequently able to impose process-oriented rules, such as disinterested director approval, and most often uphold executive compensation decisions, while in close corporation decisions, none of these rules are available to preclude direct application of the “reasonableness” test. This distinction and the disparate results continue today; courts do occasionally strike

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147. See Berkowitz v. Humphrey, 163 F. Supp. 78, 91 (N.D. Ohio 1958) (holding that “the postulate that an increase in the market value of the stock is attributable solely to the extraordinary services rendered by [the executives] in response to the incentive of additional compensation ... is demonstrably false”). See also Rosenthal v. Burry Biscuit Corp., 60 A.2d 106, 110 (Del. Ch. 1948) (stating that an executive with the possibility of stock ownership on top of a substantial salary and bonus cannot result in a substantially intensified effort by the executive).


149. See 2 Washington & Rothschild, supra note 9, at 849 ("The law, implicitly recognizing the practical distinction [between close and public corporations], has followed divergent paths ... ").

150. Note, supra note 95, at 1253-57. In proposing revisions to its disclosure rules regarding executive compensation, the SEC noted that it is attempting "to enhance the workings of market forces with respect to executive pay." Executive Compensation Disclosure, supra note 14, at 29,583.

151. Professor Clark suggests that courts have not adopted a categorical rule invalidating executive compensation unless approved by disinterested directors because such a rule would not be suitable for close corporations. Clark, supra note 4, at 219-21.

152. Professor Vagts summarized the distinction evident in the reported cases:

Only a handful of cases actually show the courts grappling with the question—how much is too much—in the context of a large public corporation. ... The courts in [close corporation] cases ... tend to roll up their sleeves and grapple with the task of finding a fair market value for the services rendered.

Vagts, supra note 10, at 252-53, 256. See also Moran v. Edson, 493 F.2d 400, 405-06 (3d Cir. 1974); O'Malley v. Casey, 589 P.2d 1388, 1389 (Colo. Ct. App. 1979) (recognizing that conflict-of-interest statutes will rarely be an issue in close corporations, and "reasonableness" is the only appropriate test).
down compensation in cases involving close corporations, but no modern case has found a court upsetting a public corporation executive compensation arrangement.

The close-public distinction in courts' analyses highlights the importance of recognizing the corporate officer's independent duties in public corporation cases. In close corporation cases, courts are frequently, if not universally, drawn to consider the defendants' duties, typically as director or controlling shareholder, so separate analysis of those duties as an officer would be redundant. In public corporation cases, however, the only role played by the recipient of the compensation is that of officer. There is therefore a more compelling need to consider the separate duties that attach to the recipient as an officer only. The failure to do so has led to the current public outrage over executive compensation.

C. Applications Under Other Laws

 Courts routinely examine the propriety of executive compensation in cases arising otherwise than by shareholder suits invoking the duties of the directors, shareholders or officers. Putting aside the fact that recoveries under these laws will not necessarily be made by the corporation or its shareholders, the policies underlying each of these laws are likely sufficiently distinct to preclude their application in the state corporation law context. Nonetheless, they do serve as examples, worthy of examination of the courts' willingness to grapple with directors' and executives' judgments of reasonableness, in contrast to the deference without analysis given by the business judgment rule under state corporation law.

 Compensation paid by a corporation to its executives may be an expense deductible by the corporation in calculating its income subject to federal tax. Not surprisingly, a body of case law has arisen under this rule that is "the largest, most varied, and interesting store of information about markets for executives and their compensation that is available." And since the statutory standard is one of "reasonableness," similar to that used in the cases decided under state corpora-

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154. Vagts, supra note 10, at 254-55. The lone possible exception since Professor Vagts' article is Gaillard v. Natomas Co., 256 Cal. Rptr. 702 (Cal. Ct. App. 1989), which did not impose liability on the corporation and directors, but reversed the lower court's summary judgment in their favor.


156. For a full discussion of this duty, see infra parts IV-V.


158. Vagts, supra note 10, at 258.

159. I.R.C. § 162(a) (1988) provides for deduction, in calculating taxable income, of "all the ordi-
tion law, courts in tax cases successfully analyze questions finessed in the corporation law context. Recent cases continue this trend of substantive analysis based on a flexible list of factors. However, because the legitimate focus of the government and the courts in these cases is only upon tax laws and policies, the applicability of these "reasonableness" decisions to state corporation law is dubious at best.

The amount of executive compensation is also an issue in cases involving reor-

nary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—(1) a reasonable allowance for salaries or other compensation for personal services actually rendered."

160. See supra note 129 and accompanying text.

161. See Vagts, supra note 10, at 260-61.

162. The list of factors considered typically begins with those in Mayson Mfg. Co. v. Commissioner, 178 F.2d 115, 119 (6th Cir. 1949): employee's qualifications; nature, extent, and scope of work; size and complexities of the business; salaries compared with gross and net income; prevailing general economic conditions; salaries compared with distributions to stockholders; prevailing rates of compensation for comparable positions in comparable concerns; salary policy of the corporation's employees; and, for smaller corporations, the compensation paid to the individual in past years. See, e.g., 1 BORIS I. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 22-21 to 22-22 (1981); Rutter v. Commissioner, 853 F.2d 1267, 1271-75 & 1271 n.7 (5th Cir. 1988) (citing similar lists of factors applied in other circuits); Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315 (5th Cir. 1987); Kennedy v. Commissioner, 671 F.2d 167 (6th Cir. 1982).

One researcher analyzed 75 reported Tax Court cases involving compensation for the statistical significance of the Mayson factors, concluding that those factors explain 87% of the variance in the decisions made by the court. Those variables with the highest explanatory values were average compensation paid in prior years, sales, employee qualifications, and scope of the employee's duties. Joseph L. Boyd, An Empirical Investigation of Reasonable Compensation Determination in Closely-Held Corporations (1977) (unpublished Ph.D. dissertation, University of South Carolina).

163. Professor Bittker argues that the "reasonableness" portion of § 162(a)(1) may be redundant, as it is simply another way of stating that the allowance is only for compensation for services, "forbid[d]ing the deduction of payments inflated to disguise a nondeductible transfer." Bittker, supra note 162, at 22-19. See also Trinity Quarries, Inc. v. United States, 679 F.2d 205, 210-11 (11th Cir. 1982) (focusing primarily on whether large compensation is a disguised dividend); Builders Ctr., Inc. v. United States, 571 F. Supp. 83, 87 (M.D. La. 1983) (noting that the government is "ever vigilant to ensure that no return on investment is disguised as personal compensation. The ultimate objective, of course, is to see to it that corporate dividends are paid only with after-tax dollars, as the Congress has prescribed."). Such a characterization of the payments is not relevant in a corporation law context analyzing the directors' and officers' duties, apart from considering whether minority shareholders in a close corporation have been "frozen out" from a reasonable investment return. See Note, supra note 95.

164. As discussed above, the focus of the tax law is to expose nondeductible transfers masquerading as deductible salaries, and only incidentally on the reasonableness of the payments. Although Professor Bittker posits that it is impossible to separately analyze "whether an amount is paid for services and whether it is reasonable in amount," Bittker, supra note 162, at 22-20, he lists six of the most significant Mayson factors, at least three of which—employer's earnings, ownership, and employer's dividend policy—are focused on matters more related to the nature of the payment than its reasonableness. Id. at 22-23 to 22-26. Washington & Rothschild observed that "[t]he taxing authorities have not stressed 'excessiveness' of compensation as such or sought to substitute their views for those of the corporate taxpayer with regard to what constitutes good corporate practice or sound social policy. Rather, the point of view of the tax authorities has been revenue-conscious." 2 WASHINGTON & ROTHSCHILD, supra note 9, at 760.
ganization under the Bankruptcy Code.\textsuperscript{166} Courts routinely examine compensation paid to officers of operating debtor corporations in reorganization,\textsuperscript{168} as well as claims by officers for compensation due prior to the bankruptcy filing.\textsuperscript{167} Payments made by the bankruptcy trustee after commencement of the case are measured by necessity and governed by the trustee's duty; prefiling employment contracts do not govern this decision.\textsuperscript{168} Absent specific claims by the trustee of breach of duty, the duties of care and loyalty are rarely at issue in cases involving claims of employees for services rendered prior to bankruptcy.\textsuperscript{169} Under nonbankruptcy law, creditors may recover unreasonable compensation paid by insolvent corporations to their executives.\textsuperscript{170} These cases, however, involve considerations of fraud, whether inferred or actual,\textsuperscript{171} and thus do not necessarily otherwise relate to an officer's or director's positive duties of care and loyalty.

The amount of executive compensation may also be relevant in determination of claims for Social Security benefits.\textsuperscript{172} However, the objective under that law is to assure that compensation is not understated.\textsuperscript{173} This policy is clearly dissimilar to the policies underlying state corporation laws.

Federal and state laws limiting managerial compensation exist that govern enterprises such as investment companies,\textsuperscript{174} common carriers,\textsuperscript{175} and insurance

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\item[166.] Compensation for services rendered to an ongoing business after filing of the bankruptcy petition may be ordered by the court under 11 U.S.C. § 330(a)(1), providing for payments to "officers" of the bankruptcy estate, or may be available under 11 U.S.C. § 503(b)(1)(A), providing for payment of "the actual and necessary costs of preserving the estate, including wages, salaries or commissions for services rendered after the commencement of the case." Analysis under § 330(a)(1) is usually limited to compensation of outside professionals such as appraisers, accountants, and attorneys. See 2 COLLI\textsc{er} ON BANKRUPTCY ¶ 330.04 n.a (15th ed. 1992). The distinction is that payments under § 330(a) require prior court approval, but payments under § 503(b)(1)(A) may not. See id.\textsuperscript{150}
\item[167.] Unless claims by a debtor corporation's employees fall within the exceptions of 11 U.S.C. § 507(a)(1) (administrative expenses incurred after commencement of the bankruptcy case) or § 507(a)(3) (certain wages earned within 90 days of commencement), those claims are treated equally with all of the debtor's other general unsecured claims. 3 COLLI\textsc{er} ON BANKRUPTCY ¶ 503.04 n.23 (15th ed. 1992). See, e.g., \textit{In re Heritage Village Church & Missionary Fellowship, Inc.}, 92 B.R. 1000, 1021-22 (Bankr. D.S.C. 1988) (analyzing a claim under an alleged employment contract).
\item[168.] See 3 COLLI\textsc{er} ON BANKRUPTCY ¶ 503.04 at 503-28 to 503-28.1 (15th ed. 1992). Generally, a bankruptcy trustee will be able to avoid employment contracts under 11 U.S.C. § 365(a), at least as to wages and salaries. A more complicated question is presented by long-term and deferred compensation arrangements. See, e.g., Patterson v. Shumate, 112 S. Ct. 2242 (1992).
\item[169.] See \textit{Heritage Village}, 92 B.R. at 1014-18 (awarding trustee $1 million for counterclaims based on breach of officers' and directors' fiduciary duties under South Carolina law).
\item[171.] See \textit{id.} (involving two different sections of New York law permitting recovery either with or without actual intent to defraud).
\item[173.] For example, the issue in \textit{Notini} was whether a recently retired executive was underpaid by the corporation in an effort to maximize the available Social Security benefits. See \textit{id.} at 554.
\item[174.] See § 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) (1988), \textit{discussed in} Vagts, supra note 10, at 266-68 & n.157 (citing cases) and 2 TAMAR FRANKEL. THE REGULATION OF MONEY MANAGERS 279-85 (1978) (discussing suits under § 36(b)).
\end{enumerate}
}
companies. However, the focus of these statutes and the agencies and courts implementing them is clearly on groups other than shareholders in a traditional industrial corporation: ratepayers, insurance carriers and policyholders, and mutual fund shareholders. Any coincidence in analysis in these cases has not been persuasive to any court considering the similar question raised under general corporation law as applied to otherwise unregulated companies.

IV. THE CORPORATE OFFICER'S INDEPENDENT DUTIES

The preceding parts of this Article have explained the problem of excessive executive compensation, the economic incentives that create it, and the existing legal rules that are largely powerless to combat it, especially in large publicly-held corporations. To apply the corporate officer's independent duties to the question of executive compensation, and determine whether those duties and the resulting rules would yield better results, this part first reviews their curious history and current status. A corporate officer's duty of care and duty of loyalty have long been implicit in corporation law, but have been made explicit or separately considered by courts in executive compensation decisions only recently.

A. Origins

The earliest statements of the corporate officer's duties, in occasional cases and in treatises, combine the duties of directors and officers. Not only is the analysis of officers' duties ignored or at best appended in the margin to a fuller analysis of directors' duties, but nonfiduciary and fiduciary elements are mixed indiscrimi-

175. See 2 WASHINGTON & ROTHSCCHILD, supra note 9, at 788-94.
177. Professor Vagts, discussing management fee cases involving investment companies, concluded that the failure of significant limitations leads one to ask "whether the market can be a meaningful control on compensation in any context if not so in the . . . mutual fund . . . where the investors confront the question of compensation in a more direct, uncomplicated way than do shareholders of an operating business." Vagts, supra note 10, at 268. See also Subcommittee on Executive Compensation, American Bar Association Section of Corporation, Banking and Business Law, Executive Compensation: A 1987 Road Map for the Corporate Advisor, 43 Bus. Law. 185, 406-15 (1987) (discussing distinct policies underlying limits on executive compensation in the banking, insurance, and public utility industries).
178. See, e.g., 2 SEYMOUR D. THOMPSON & JOSEPH W. THOMPSON, COMMENTARIES ON THE LAW OF CORPORATIONS 794-95 (3d ed. 1927) (stating that the director's fiduciary duties consist of ordinary care and good faith and noting only that "[t]his rule is of equal application to the directors and other officers of the corporation"); 1 CHARLES F. BEACH, JR., COMMENTARIES ON THE LAW OF PRIVATE CORPORATIONS 392-412 (1891) (chapter entitled "Fiduciary Position of Directors and Officers, and Herein of Promoters" has no specific separate discussion of officers' duties except a notation on Pittsburg Mining Co. v. Spooner, 42 N.W. 259, 260 (Wis. 1889), a case referring generically to "officers" of the corporation but only involving officer/directors).
179. "Where the issue of officers' liability has been discussed, it is almost invariably in the shadow of directors' conduct." Sparks & Hamermesh, supra note 8, at 215. See also supra note 178 and accom-
nately.\textsuperscript{180} And when discussing executive compensation in particular, early writers began focusing on the payer of the compensation to the exclusion of the recipient.\textsuperscript{181}

Modern analysts have built upon this shaky foundation, rarely separating the officer's duty from the director's, or the duty of care from the fiduciary duty of loyalty.\textsuperscript{182} The result is an analytic "black box" into which facts are fed and from which decisions emerge. Nothing is known about the process, though everyone assumes its legitimacy. Given this confused history, it is perhaps no surprise that the officer's independent duties have been largely ignored. To clarify the analysis, the elements of the duties of care and loyalty are considered separately below. Imposing some analytical rigor on existing caselaw concerning the duties of care and loyalty is a difficult task,\textsuperscript{183} but the purpose is to show that, whatever the current state of the law, separate analysis of the officer's duties fits within and is compatible with it.

\section*{B. The Duty of Care}

The corporate officer's separate duty of care was first clearly stated only in

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\item \textsuperscript{180} See supra note 178. Duties of care are not, strictly speaking, fiduciary duties. See DeMott, supra note 97.
\item \textsuperscript{181} See, e.g., Henry W. Ballantine. Ballantine on Corporations 409 (1927) ("Both the stockholders and directors, in fixing compensation of officers, must act in good faith, and reasonably."). This is the substance of modern analysis as well, as the same sentence appears in 5A Fletcher Cyclopedia of the Law of Private Corporations 80 (1987). Discussion of the officers specifically focuses on their authority to bind the corporation with respect to their salaries and not the exercise of any fiduciary duty. See 3 Thompson & Thompson, supra note 178, at 453-54.
\item \textsuperscript{182} Clark, for example, in discussing the duty of care, initially states the duty as one owed by officers and directors, see Clark, supra note 4, at 123, but the ensuing discussion focuses without explanation solely on directors, see id. at 123-40. Henn and Alexander follow a similar pattern. See Harry G. Henn & John R. Alexander. Laws of Corporations and Other Business Enterprises 612 (1983) (general statement); id. at 614-15 (specific discussion of directors); id. at 621 (general statement); id. at 621-23 (discussion of directors). The authors' discussion of fiduciary duties in close corporations essentially omits the officer entirely. See supra note 155. Professor Hazen notes specifically that \footnote{\textsuperscript{183} See supra notes 90-92 and accompanying text.} "[t]he second prong of managers' fiduciary duty is their duty of care." Thomas L. Hazen, The Corporate Persona, Contract (and Market) Failure, and Moral Values, 69 N.C. L. Rev. 273, 279 (1991). One possible reason for this treatment is the confluence of facts in most cases. "Although a number of decisions discuss the duty of care, most have arisen in the context of alleged breaches of the duty of loyalty. There have been only a handful of cases invoking the duty of care in the absence of a conflict of interest." Id. at 279 n.35. Block has dropped separate consideration of officers altogether. Compare Dennis J. Block et al., The Business Judgment Rule: Fiduciary Duties of Corporate Directors (3d ed. 1989), with Dennis J. Block et al., The Business Judgment Rule: Fiduciary Duties of Corporate Directors and Officers (2d ed. 1988).

The notable exception is the focus on the officer's separate fiduciary duty in the specific contexts of self-dealing and usurpation of corporate opportunities. See infra note 201 and accompanying text.
\end{enumerate}
\end{footnotesize}
Executive Compensation

1984, with the adoption of section 8.42 of the Model Business Corporation Act.\textsuperscript{184} This section, new in the 1984 revision of the Model Act,\textsuperscript{185} parallels the older and more familiar language stating an identical duty of care owed by directors.\textsuperscript{186} The drafters of the Model Act apparently felt the derivation of this separate duty from the director's duty was obvious, as no separate justification is given.\textsuperscript{187} This or comparable language now appears in twenty-one states' corporation laws.\textsuperscript{188}

Thus, it appears to be no stretch of now-settled authority that a corporate officer owes a separate duty of care to the corporation. In cases of executive compensation, as with all of the executive's other decisions, the compensation may be received only if in good faith, with the care of an "ordinarily prudent person," and in the officer's reasonable belief, it is in the best interests of the corporation.\textsuperscript{189} Although no court has directly ruled on such a theory, the governing principles can be drawn directly from the identical duty owed to the corporation by its directors, as the drafters of the Model Act themselves suggest.\textsuperscript{190}

The threshold question, as with cases involving directors, is the applicability of the business judgment rule. Under current analysis, the rule's protection may be unavailable either because the self-dealing removes the presumption itself, and permits courts to directly consider the director's or officer's exercise of due care,\textsuperscript{191} or because the question is not one of the breach of the duty of care at all, but is only a question of breach of the fiduciary duty of loyalty, to which the business judgment rule ordinarily does not apply.\textsuperscript{192} Thus, although it is unknown why the business judgment rule's protection is unavailable, it is possible that courts are confusing duty of care analysis with duty of loyalty analysis, and if forced to consider the duty of care alone, might conclude that the rule's protection is at least initially available.\textsuperscript{193}

\begin{itemize}
\item \textsuperscript{184} \textit{Model Business Corp. Act}, \textit{supra} note 7, § 8.42(a) states:
\begin{quote}
An officer with discretionary authority shall discharge his duties under that authority:
(1) in good faith;
(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
(3) in a manner he reasonably believes to be in the best interests of the corporation.
\end{quote}
\textit{Id.}
\item \textsuperscript{185} \textit{See 2 Model Business Corp. Act Ann.} 1067 (1992).
\item \textsuperscript{186} \textit{See Model Business Corp. Act, supra} note 7, § 8.30(a).
\item \textsuperscript{187} \textit{See id.} § 8.42 official cmt.
\item \textsuperscript{188} \textit{See 2 Model Business Corp. Act Ann.} 1068 (1992) (listing statutory provisions).
\item \textsuperscript{189} \textit{See Model Business Corp. Act, supra} note 7, § 8.42(a).
\item \textsuperscript{190} \textit{See id.} § 8.42 official cmt. (noting that the standards discussed with respect to the directors' duties are "generally applicable to nondirector officers as well as to directors").
\item \textsuperscript{191} \textit{See Clark, supra} note 4, at 124.
\item \textsuperscript{192} \textit{The Principles of Corporate Governance} do invoke the business judgment rule as do occasional cases. \textit{See Principles of Corporate Governance, supra} note 7, § 5.03(a)(2)-(3) and cases cited \textit{supra} note 134. However, the business judgment rule applies in these instances only to shield the decision by the directors or other person authorizing the payment of compensation; nothing is said about the decision of the recipient officer.
\item \textsuperscript{193} This is the logical conclusion if self-dealing is relegated to discussion under the duty of loyalty. It may well be that the presence of self-dealing is only relevant evidence in a duty of care
\end{itemize}
Assuming a court were to proceed on a strict duty of care analysis, and the business judgment rule's presumption were to apply, the plaintiff would be required to prove one of the rule's prerequisites was not met by the defendant: full information, good faith, and a belief that the challenged compensation is in the best interests of the corporation. If one of these prerequisites is not met, the court would directly consider the officer's conduct in relation to the duty of care. To date, however, the only one of these prerequisites carefully considered is the adequacy of information before the decision-maker. In executive compensation cases, there would be little doubt that the officer is fully informed about all matters concerning his or her own compensation. Indeed, the relative paucity of information given the board compared with that available to the officer is a major market imper-

analysis if the presumption of the business judgment rule presumption is overcome. This is largely hypothetical analysis, however, because cases decided rarely if ever present a duty of care question separate from evidence of self-dealing. See supra note 182. For example, in Platt v. Richardson, [1989-1990 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,786 (M.D. Pa. June 6, 1989), the court stated succinctly that "[t]he business judgment rule applies only to directors of a corporation and not to officers." Id. at 94,231. However, the court had already determined that there were sufficient questions of self-dealing, implicating the duty of loyalty, which would make the business judgment rule unavailable in any event. Id. As to the broad statement of inapplicability of the business judgment rule to officers, Platt's statement has been relegated "to a distinct minority position." Sparks & Hamermesh, supra note 8, at 235.

194. The burden of proof in such cases is apparently upon the plaintiff to show that one or more of the prerequisites to the business judgment rule are absent. See Principles of Corporate Governance, supra note 7, § 4.01(d).

195. See Gaillard v. Natomas Co., 256 Cal. Rptr. 702, 716 (Cal. Ct. App. 1989); see also Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985) (discussing whether directors were fully informed in the context of a sale of the corporation).

196. See Van Gorkom, 488 A.2d at 878-88 (concluding that business judgment rule does not apply and proceeding to examine directly the directors' compliance with the duty of care).

197. In both Van Gorkom and Gaillard, the question was only whether the directors were fully informed. The other prerequisites, good faith and an honest belief in the best interests of the corporation, are only occasionally considered. See, e.g., Sugarman v. Sugarman, 797 F.2d 3, 10 (1st Cir. 1986) (finding bad faith on the part of defendant director permits court not to defer to board's decision on his compensation). The apparent identity of elements of the business judgment rule and of the underlying duty of care itself has been the source of much confusion.

In [invoking the business judgment rule], courts have sometimes used language similar to the standards set forth in section 8.30(a) [duty of care]. The elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts. In view of that continuing judicial development, section 8.30 does not try to codify the business judgment rule or to delineate the differences, if any, between that rule and the standards of director conduct set forth in this section. That is a task left to the courts and possibly to later revisions of this Model Act.

MODEL BUSINESS CORP. ACT § 8.30 official cmt. (1988). That task, at least as undertaken by the Principles of Corporate Governance, removed the "honest belief" prerequisite, the one most confusingly similar to the duty of care itself, and requires only that the decision-maker be fully informed, without an interest, and be acting in good faith. Principles of Corporate Governance: Analysis and Recommendations § 4.01(c) & cmts. d & e (Proposed Final Draft 1992). The prerequisite of good faith, in turn, is satisfied at least where there is no illegality, though no other specific components of good faith are discussed. See id. § 4.01(a) cmt. d (citing Miller v. AT&T, 507 F.2d 759 (3d Cir. 1974)).
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fection. However, courts focusing explicitly on the officer's duty of care might add new elements to the duty of full information. Clearly, the executive is informed about all components of the compensation package, the pay of colleagues, the company's performance, and so on. But did the executive consider the impact of the compensation, under all the circumstances, on the corporation's public image, workers, or shareholders? These are questions courts could explicitly bring into the calculus—questions that all observers but the courts are currently asking. Such analysis might lead to the conclusion that the officer was not fully informed, thus removing the protection of the business judgment rule. In addition, the rule's protection could be defeated if the plaintiff can plead a sufficient case of waste of assets, or if the court for some reason does not apply the business judgment rule at all.

C. The Duty of Loyalty

Modern substantive analysis by courts and commentators of the corporate officer's fiduciary duty of loyalty focuses almost exclusively on self-dealing, insider trading, corporate opportunities, and the like. Absent fraud or some other extenuating circumstances, the ordinary negotiation by a corporate officer with the corporation regarding compensation will not involve any of these issues. Executive compensation, rather, is currently analyzed only from the standpoint of the directors' duty.

A separate duty of loyalty is imposed on officers of a corporation in the Amer-

198. See supra part III.B.

199. A sufficient pleading of waste of assets removes the presumption of the business judgment rule with respect to the director's duty of care. See supra notes 102-03 and accompanying text. Because the same rules are to apply in considering the officer's duty of care, see Model Business Corp. Act, supra note 7, § 8.42 official cmt., presumably this exception would apply in analyzing the officer's duty of care as well.


201. See Clark, supra note 4, at 141-50; Henn & Alexander, supra note 182, at 628-51; Principles of Corporate Governance, supra note 7, §§ 5.04-07. Other cases concerning the officer's fiduciary duty typically concern only questions of agency, authority, and respondeat superior. See Sparks & Hamermesh, supra note 8, at 220 (noting that the corporate officer's duty of loyalty "is a duty owed under general principles of agency law"). See also Henn & Alexander, supra note 182, at 624-25; 2 Model Business Corp. Act Ann. 1068.1-.2 (1992) (collecting cases). Professor Christy, discussing generally the limitations of the duty of loyalty, noted that "[c]ourts are willing to recognize only problems concerning directors' and officers' personal dealings with the corporation, usurpations of corporate opportunities, and appropriations of confidential corporate information. . . . In other contexts, however, courts have abdicated decisional responsibility." J. Gordon Christy, Corporate Mismanagement as Malpractice: A Critical Reanalysis of Corporate Managers' Duties of Care and Loyalty, 21 Hous. L. Rev. 105, 174 (1984).


203. See supra part III.A. Of course, in most states the duty of loyalty would not be implicated if the recipient of compensation is not a director. Even in those states where a contract between the corporation and a non-director officer is brought within the self-dealing statute, see supra note 96, the resulting fairness requirement is imposed on the corporation—the board of directors—and not on the executive recipient.
ican Law Institute's *Principles of Corporate Governance*. Section 5.01 states a general duty of fair dealing imposed upon "senior executives." Prior to its appearance in the *Principles*, such a duty existed, if at all, only implicitly in statutes providing for avoidance of the common law rule of automatic voidability. No such separate statement of an officer's fiduciary duty was necessary according to the drafters of the Model Act, who believed that agency law adequately covered the subject. In keeping with current statutes, however, the *Principles* recognize the more relaxed standard of review given to executive compensation decisions by the board of directors and permit the board's decision to discharge the officer's liability as well.

Outside of the *Principles*, only two hints of a separate fiduciary duty owed by a corporate officer in accepting compensation otherwise appear in court decisions. First, courts occasionally opine in dicta of such a duty. Second, and more telling, are cases specifically discussing the liability of individuals once a breach of the otherwise amorphous duty of care is found. Typically, each defendant is both an officer and a director of the corporation. Occasionally, however, non-officer directors are held liable for authorizing amounts paid to others, indicating that the duty involved is owed primarily by the directors. Courts also hint of a duty owed sepa-

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204. The duty is styled as "the duty of fair dealing" to refer only to those situations in which the director or officer has a pecuniary interest as a subset of the traditional "duty of loyalty" referring to conflicting interests generally. See *Principles of Corporate Governance*, supra note 7, part V introductory note a.

205. "Directors, senior executives and controlling shareholders, when interested in a matter affecting the corporation, are under a duty of fair dealing . . . ." *Principles of Corporate Governance*, supra note 7, § 5.01. "Senior executives" are the officers of the corporation as that term is ordinarily understood. See id. §§ 1.27, 1.33.

206. See supra notes 96-100 and accompanying text.

207. See supra note 96. See also Brodsky & Adamski, supra note 113, § 3:08 ("Although not all of the statutes cover transactions with nondirector officers, the same general common law rule imposing the burden of proving fairness on the interested party should apply to transactions with officers as well as to transactions with directors.").

208. See *Principles of Corporate Governance*, supra note 7, § 5.03 & cmt. a. See also Clark, supra note 4, at 192-93 (discussing the "relatively loose scrutiny of executive compensation under corporate law principles"). Both comments, however, focus clearly on the directors' liability, even though the *Principles of Corporate Governance* purport to discharge the officer's duty of fair dealing in this fashion as well. See *Principles of Corporate Governance* supra note 7, at § 5.03(a).

209. See, e.g., Koplar v. Warner Bros. Pictures, Inc., 19 F. Supp. 173, 188 (D. Del. 1937) ("As a matter of morals such payments may be questioned. Directors have the power to award just compensation. That power should be used, not abused. Fair human requirements [on the part of the recipients] should set some limits to salaries."); Pogostin v. Rice, 480 A.2d 619, 625 (Del. 1984) (citing plaintiffs' allegation that "permitting and accepting the payments were breaches of fiduciary duty" (emphasis added), but not separately discussing the latter issue); Flight Equip. & Engineering Corp. v. Shelton, 103 So. 2d 615, 623 (Fla. 1958) (stating that "[t]he officers of a corporation occupy a quasi-fiduciary relation to the stockholders and the corporation"); Chelsea Indus., Inc. v. Gaffney, 449 N.E.2d 320, 326 (Mass. 1983); Adelman v. Conotti Corp., 213 S.E.2d 774, 780 (Va. 1975) (quoting from the Chancellor's opinion letter that "[e]ven though transactions between [the defendant officers] and the Board might meet the arms length requirement this does not do away with the stockholders' right to have the actions measured against duties owing to them").

rately by the non-director officers.211

Thus, it appears that the officer’s fiduciary duty of loyalty remains amorphous. Though it is well-defined in personal self-dealing, insider trading, and corporate opportunity cases, this duty is often stated but never directly applied in executive compensation cases. No court has separately considered this duty, and even where clearly stated, as in the Principles of Corporate Governance, it is dischargeable by the conduct of others—namely, the board of directors. However, this duty could be a powerful and analytically useful tool if properly invoked.

D. A Return to Reasonableness

Under either the duty of care or duty of loyalty analysis, courts would likely turn, as they do in cases involving directors, to a general discussion of reasonableness of the executive’s compensation. Under the duty of care analysis, reasonableness would be the measure of the officer’s due care or whether corporate assets are being wasted.212 Under the duty of loyalty analysis, reasonableness would likely be used as a limit on the court’s inquiry as is currently done when considering directors’ liability.213

But the reasonableness would be judged as evaluated by the officer as recipient,

211. In Teren v. Howard, 322 F.2d 949, 955 (9th Cir. 1943), the court held that non-officer directors were not liable for excessive salaries. A subsequent decision by the appellate division, however, was reversed on this point by the court of appeals. See Godley v. Crandall & Godley Co., 139 N.Y.S. 236, 246 (App. Div. 1912), rev’d, 105 N.E. 818, 821 (N.Y. 1914). The memorandum affirmance in Carr is without opinion and apparently does not recognize the court of appeals’ reversal in Godley. A later court of appeals decision accepts the holding of Carr with no mention of Godley. See In re Horowitz’ Will, 78 N.E.2d 598, 600 (N.Y. 1948).

In Crowley v. Communications for Hosp., Inc., 573 N.E.2d 996 (Mass. App. Ct. 1991), one non-officer director settled with the plaintiffs, leaving only officer-directors when the case was decided. Id. at 998 n.4. See also HENN & ALEXANDER, supra note 182, at 690 & n.2 (citing cases).

Non-officer directors’ liabilities may be limited or eliminated by the state statutes limiting directors’ liabilities enacted following Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). These statutes typically limit a director’s liability for breach of the duty of care, but not the duty of loyalty. Unfortunately, however, this distinction is not clear in many of the statutes, see James J. Hanks, Jr., Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification, 43 BUS. LAW. 1207, 1212-15 (1988), nor is it clear in the courts’ decisions, see, e.g., Hanrahan v. Kruidenier, 473 N.W.2d 184, 188 (Iowa 1991) (holding that “[t]he claim [of director liability for authorizing excessive executive compensation] is premised solely on, neither a breach of care nor a breach of fiduciary duty, but rather a hybrid of the two”). The impact of these liability-limiting statutes which specifically apply to officers is discussed infra part V.B.3.

212. See supra part III.B.3.

213. See supra note 208 and accompanying text.
not as evaluated by the directors as grantors. It is this twist on the traditional analysis that makes the separate duty of the officer uniquely valuable in evaluating executive compensation in public corporations. Courts would thus be empowered to meet the cases challenging executive compensation with relevant economic and policy analysis. Would imposition of this fiduciary duty on the part of the executive officer work to reduce either the levels of compensation in public corporations or at least the periodic public outrage? Part V examines the shortcomings of the current legal rules and the potential advantages of analysis of the officer’s independent duty.

V. THE OFFICER’S INDEPENDENT DUTIES AS A SOLUTION

To determine the value of analysis of the officers’ duties rather than directors’ duties, this part examines the comparative faults of current legal analysis and evaluates the comparative advantages of application of the officer’s separate duties.

A. The Shortcomings of Current Analysis

It is obvious from the headlines that the current legal system has failed to respond to the public outrage over executive compensation.\textsuperscript{214} The current rules fail because they place no responsibility upon the executive for setting that compensation. Even when new doctrines or cases suggest actual liability might run to the executive,\textsuperscript{210} that liability exists only when the directors have failed in their duty. It is a curious rule of law that evaluates one person’s liability according to another’s conduct absent traditional principles of secondary liability.\textsuperscript{216} If indeed there exists a separate duty on the part of the recipient officer, why should that duty be discharged by the directors? The current rules offer no answer to this puzzle. The result is that directors, properly creating an independent committee, can rely on the information provided by a one-sided market as judged by directors sympathetic to the recipient officer. If they follow this process, the law absolves all persons involved from any liability.

One possible solution is to augment the role of the board of directors by requiring them to take a more active role in the review of the executive’s performance and compensation. Many commentators have suggested increasing the amount and reliability of information available to the directors.\textsuperscript{217} More fundamental changes in the directors’ decision processes with regard to executive compensation have also been suggested.\textsuperscript{218} However, these reforms are intended to be voluntary.\textsuperscript{210}

\textsuperscript{214} See supra part IA.
\textsuperscript{215} See supra note 211.
\textsuperscript{216} In Teren v. Howard, 322 F.2d 949, 955 (9th Cir. 1963), discussed supra note 211, the court suggested a primary-secondary liability relationship, but the recipients of compensation in that case were all directors of the corporation as well. See id.
\textsuperscript{217} See supra note 67 and accompanying text.
\textsuperscript{219} See id. at 63 (suggesting that any wait for a change in laws or regulations risks further declines in national competitiveness, and that any such changes, being politically motivated, may do more
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and it is unlikely that reviewing courts invoking the business judgment rule would be able or willing to impose any such change.

B. The Comparative Advantages of the Officer’s Duty as a Guide for Judicial Analysis

In contrast to the existing system, the recognition by courts of a separate duty of the officer recipient would place the ability to control compensation and the effective legal responsibility for doing so in the same person. Suggestions that the board of directors become more active in reviewing the executive’s pay and performance rely on changes in entrenched behavior, and would require changes in the law as well to be effective. By contrast, courts may take “off the shelf” a long-standing, though rarely recognized duty, the officer’s independent duty, and immediately put it to work. As discussed below, this would efficiently dampen the economic motivations of officers to overcompensate themselves and reinforces long-accepted notions of a positive fiduciary duty, yet will not likely lead to extraordinary liability on the part of these officers.

1. Placing the Duty to Control with the Ability to Control

Executive compensation in public corporations has grown out of control because the duty to control it has been placed by the law largely in the hands of those who have no ability to do so: the board of directors. Imposing the primary duty on the officer instead avoids this problem.

The economic analysis presented above posits three reasons why excessive executive compensation exists. A legal rule that relies on the corporate officer’s duties effectively counteracts each of these economic motivations. First, nonowner managers have economic incentives to consume excess perquisites, or “shirk.” Recognizing the officer’s duty to consider in good faith the best interests of the corporation gives the officer a significant incentive to avoid shirking, an incentive absent from current law with its focus on the directors’ conduct. Second, executives have at their disposal an imperfect market in which they bargain with under-informed and sympathetic purchasers. Under existing analysis, that market is not manipulated by the directors whose conduct is at issue, and thus courts are constrained to accept its results. But no such reliance may be had by the executive who selects compensation experts or by last year’s salary alone compounds the excesses of this year’s salary; the market is no defense. Finally, economic analysis recognizes the separation of pay from performance as a cause of excessive executive compensation. Focusing on the officer’s duties, particularly the fiduciary duty, imposes on the officer the obligation to return to the trust what should not have been harm than good).

220. “[T]he norms of behavior in most boardrooms are dysfunctional. They discourage directors from speaking out, especially if they are going to be critical of management, and they inhibit independent directors from asserting leadership among their peers.” Lipton & Lorsch, supra note 218, at 66.

221. See supra note 219 and accompanying text.

222. See supra part II.
received, regardless of the genuine intent of the payers.

Consider the hypothetical case of a chief executive of a large public company with a compensation package of several hundred thousand dollars of base pay, a bonus measured by the corporation's net income, and some traditional stock options. The base pay would likely be determined based on a survey of certain other chief executives in carefully-selected companies.\(^{223}\) The bonus is paid because the company's net income rose over last year's, though it lagged significantly behind competitors and a profit was made only by significant liquidations and layoffs. The stock options are a bargain because the company's poor performance has depressed the stock price, so the chief executive will derive a future benefit from past poor performance.

Under current law, the compensation package will survive a challenge by a disgruntled shareholder, provided it is arrived at by a compensation committee composed of independent directors who commissioned a survey and undertook some deliberations. Once these requirements are met, the business judgment rule presumption protects the merits of the committee's decision from further inquiry.

Consider in contrast the officer's separate duties of due care and loyalty. No business judgment rule presumption would exist to protect the officer's analysis from judicial review.\(^{224}\) Challengers will thus be able to examine the officer's conduct directly. Are the compensation packages of peers selected by or for the compensation committee representative? Is there or has there been any effective competition for the chief executive's position—has that person ever been involuntarily replaced? Did the executive consider the impact on employee morale and productivity of lavish compensation in the midst of layoffs? Can the executive conclude rationally and in good faith that it is in the best interests of the corporation to reward relatively poor performance so richly? Was the risk and work effort really 100 times greater than that of the factory worker, or was it partially the result of longevity in the executive suite? In accepting stock options, can it be concluded in good faith that the future price of the corporation's stock accurately measures the value of the services rendered? These are the questions the executive will be asked. And instead of relying on perfunctory examination of her contract by the board of directors, the defendant executive will be put to the task of proof and persuasion that there was no "shirking" or "consumption of excessive perquisites" involved, that the negotiation process was fair and there was no overreaching, and that the amount of compensation is reasonable in light of all relevant factors surrounding the position, the company, and even the overall economy.

The court would thus, for the first time, be required to include these relevant factors in its analysis. Opinions would evaluate the robustness of the market for

\(^{223}\) Crystal suggests that these "surveys" are in many cases unabashedly result-oriented. See Crystal, supra note 27, at 44-45.

\(^{224}\) If the challenge is based solely on the officer's duty of care, the business judgment rule presumption might arise unless courts add new elements to the duty to be fully informed, which is one of the rule's prerequisites. See supra notes 191-200 and accompanying text. If the challenge is based on the officer's fiduciary duty of loyalty, however, the business judgment rule should not apply. See supra text accompanying note 97.
executive compensation upon which the directors otherwise rely. While the directors can throw up their hands and honestly state that, although the market is imperfect and overpriced, they have no option but to offer the market price, the officer as recipient, the person who sets the price in the imperfect market, would have no such defense. Courts would instead consider other existing explanatory factors, such as the organizational hierarchy and the need for pay increases at each level, the extent to which the compensation arrangement assures that the corporation's superior performance is actually a result of the executive's efforts, and perhaps even the executive's actual work effort as well. Courts would also be able to explicitly incorporate in their analyses factors contributing to the current popular criticism of executive compensation, such as the effects on employee and stockholder morale. In the investigation of those issues and the resulting explicit judicial analysis of them, the relevant questions will at last be asked and answered.

2. Rediscovering Positive Duties

In addition to the greater efficiency of placing duty and responsibility in the same person, reliance on the officer's independent duty is advantageous because it makes explicit this long-implicit but often-ignored rule. Officers have a duty, and it should be recognized. They should decline unreasonable compensation because it is the right thing to do.

In many situations, corporate law has recognized the ability of a well-functioning market to balance economic motivations for the maximum benefit to all participants instead of imposing positive rules directly. When markets are operating efficiently, they respond to all concerns more flexibly and efficiently than external rules. Executive compensation is now viewed as an area to be governed by market forces; the role of the law to date has been to ensure that this market functions as efficiently as possible. Current reform efforts merely continue this pattern, assuring accurate measurement and disclosure of compensation costs, improving disclosure to shareholders, and increasing the amount and reliability of the compensation information given to the board of directors. But when it is clear, as with executive compensation in public corporations, that the market has significant failings, the law should return to imposition of positive duties. Indeed, the original imposition on

225. See supra notes 64-71 and accompanying text.
226. See, e.g., Fama & Jensen, supra note 54; Fama, supra note 53; Jensen & Meckling, supra note 54; authorities cited supra note 60.
228. See id. See also the recent proposals of the SEC to bolster disclosure in this area, discussed supra note 22 and accompanying text.
229. See supra note 67 and accompanying text (discussing retention of an independent consultant to the board of directors' compensation committee).
230. Professor Hazen argues for the retention of fiduciary principles in corporation law, noting that economic analyses fail to take into account "'economic man's' rational self-interest when embodied in corporate managers' bargaining with their shareholders;" nor do they "take into account fairness considerations." Hazen, supra note 182, at 298.

Professor Brudney, noting the market failures in this area, observes:
corporate directors and managers of duties of care and loyalty was in response to
the need to provide protection for investors and creditors outside the market's
operation.231

It is universally recognized that the rule at which courts chip away with excep-
tions is clear and unwavering: the corporate executive holds power in trust for the
benefit of others.232 At the same time, it is equally recognized that a limit on judi-
cial review of the executive's exercise of that power is necessary to allow the
executive to function at all. This is the genesis of the business judgment rule233 and
other less pervasive limits on otherwise strict trustee-like duties.234

It is of course impossible to state categorically when relaxation of the strict
rules is appropriate. This is the inherent tension in the grant of power to corporate
managers and the responsibility which that grant necessarily imposes.

The question is not academic. Its solution . . . would give greater flexi-
bility to corporate managements in certain respects. . . . But where no
showing of benefit can be made, and where one group within the corpo-
ration is to be sacrificed for the benefit of another, it would, equally,

[M]etaphorical allusions to contract or to the principal-agent relationship are inapposite if
the task is to enable the investor to limit management's capacity to reward itself. . . . In
the case of management of large public corporations, the fiduciary restrictions are . . .
neither prophylactic, nor indeed very vigorous, so the need for stockholder consent . . . to
avoid their prohibition is not so great. Nevertheless, the nexus-of-contracts view [reliance
on the market to create necessary contractual limits] invokes such informed consent to
justify even broader managerial discretion to reward itself. But the difficulty is that such
consent is neither appropriately informed nor volitional.


Professor Vagts makes similar observations directed specifically at executive compensation.

While predominant public opinion will accept great inequalities if justified by the market
and market-related concepts of what is earned and deserved, it is difficult to legitimize any
amounts larger than that. [T]he considerations of corporate legitimacy, integrity, and
morale involved are important. They indicate that, even if in the overall economic scheme
of things, the amounts of money involved are not of vast importance, the problem is worth
expending effort on in order to keep it under control. These problems fall between the
meshes of the relevant markets and must be consciously addressed by the responsible
institutions.

Vagts, supra note 10, at 274.

231. One writer notes that it was generally recognized as early as the 1920s that we could no
longer rely on the market to be the "pervasive, impersonal policeman it had once been, or had once
seemed to be." JAMES W. HURST. THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE

232. See BERLE & MEANS, supra note 10, at 247-49; DAVID C. BAYNE, THE PHILOSOPHY OF
CORPORATE CONTROL: A TREATISE ON THE LAW OF FIDUCIARY DUTY 23-34 (1986); Beveridge, supra
note 96, at 671; Hazen, supra note 182, at 278-79.

233. "In a sense, the business judgment rule is just a corollary of the usual statutory provision that
it is the directors who shall manage the corporation." CLARK, supra note 4, at 123. See also Vagts, supra
note 10, at 274 (commenting that "intervention into corporate activity ordinarily is at some cost to the
efficiency of the business operation").

circumscribe the use of certain apparently absolute powers.238

And the general problem of allocating responsibility and authority exists unmitigated in the specific area of executive compensation. It is difficult to reconcile rules imposing duties of care and loyalty with rules giving managers the discretion to run the firm.

This antithesis burdens the law with a paradoxical challenge: To establish standard and acceptable processes for adequately compensating the [manager] for his vast abilities, and to outlaw both the individual’s personal appropriation of official, corporate assets, and the officeholder’s personal retention of unjust compensation either during or after the tenure of office.238

Thus, the purpose of a return to imposition of duties of care and loyalty is not to universally renounce reliance on market-based or contract approaches, but rather to recognize their limits. When the market is imperfect or the contracting process one-sided, as it clearly is with executive compensation, positive rules must be used to supply the motivation to act in accordance with social norms since the market has failed to do so.237

Courts have accepted this notion without serious question. It appears infrequently in cases only because of current law’s focus on the duties of the directors in setting executive compensation. When courts turn as an aside to the recipient, the officer’s duty is astonishingly clear to them.238 From the earliest cases declaring, but declining to exercise the power to limit executive compensation, courts have indicated the duty lies initially with the recipient. “The duty of the . . . executives participating in the bonus seems plain—they should be the first to consider unselfishly whether under all the circumstances their bonus allotments are fair and reasonable.”238

Thus, it is clear that corporation law recognizes the primacy of rules of law, relying on marketplace substitutes when efficient. Executive compensation is an area that should be reclaimed from market-based deferential rules. A return to the positive legal rule is hardly novel, but rather revives a doctrine universally recognized

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237. Professor Hazen, comparing freedom-of-contract and fiduciary duty analyses, concludes:

The fiduciary paradigm is a necessary limitation on the right to contract within the corporate setting. This limitation . . . is warranted because of the recognition of the relative unequal power positions of the various corporate constituencies. The fiduciary principle also is applicable because a corporation is not only an economic institution but is also a powerful political and social institution. . . . Finally, corporate managers . . . are in fact managing other people’s money.

Hazen, supra note 182, at 318.
238. See supra note 211 (discussing cases addressing officers’ liability for excessive compensation).
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even in its dormancy.240

3. The Scope of Executive Officer Liability

It would surely be an initial concern of public corporations and executives that such a rule would create extensive and indeterminate liability on the part of the recipient. One need only recall the virtually instantaneous response of the bar, commentators, and state legislators to the imposition of similar liability upon directors in Smith v. Van Gorkom.241 However, such concerns will likely be overstated. As discussed below, any liability imposed pursuant to this analysis will run only to the individuals at the peak of the corporation's authority structure, and will be circumscribed by clear legal principles.

The source of the current controversy is the overpayment of the chief executives and a handful of subordinate officers in the largest thousand or so corporations doing business in the United States.242 Thus, although the problem is significant independent of its monetary impact,243 it can be redressed by imposing duties and corresponding liability on a universe of a few thousand potential defendants.

Only executives shouldering these duties of care and loyalty would be subject to liability. The duty of care is imposed only upon "[a]n officer with discretionary authority;"244 thus, the duty is only as broad as the discretion vested in that officer. Furthermore, the term "officer" refers only to those persons designated by the directors in those capacities.245 And the duty of loyalty owed apart from the ordinary duty of agent to principal is similarly imposed only upon the top executives.246

240. Recognizing and returning to the standard of a positive fiduciary duty would be an improvement over current law's deference to the process followed by the board of directors, but it is of course no guarantee. In cases involving close corporations, courts have routinely focused on fiduciary duties. See supra notes 149-56 and accompanying text. The vigor of those duties has been found by some to be waning. See Mitchell, supra note 155.

241. 488 A.2d 858 (Del. 1985). One commentator noted: "The corporate bar generally views the decision as atrocious. Commentators predict dire consequences as directors come to realize how exposed they have become." Bayless Manning, Reflections and Practical Tips on Life in the Boardroom after Van Gorkom, 41 Bus. Law. 1, 1 (1985). See also Hanks, supra note 210, at 1208-09 (discussing the response of liability insurance carriers and ultimately of state legislatures, and analyzing resulting legislation).

242. See supra notes 35-36.

243. See supra notes 39-52 and accompanying text.

244. Model Business Corp. Act, supra note 7, § 8.42(a).

245. See id. § 8.40(a).

246. See Sparks & Hamermesh, supra note 8, at 216 (noting that "[f]or purposes of determining whether fiduciary duties attach, the scope of the term 'officer' seems to be a function of responsibilities"). See also Principles of Corporate Governance, supra note 7, part V cmt. a. This document titles these persons "senior executives," referring only to the top three or four individuals in the hierarchical authority of the corporation and its "principal business unit[s]." Id. §§ 1.27, 1.33.

For example, in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969), the court considered whether certain officers of Texas Gulf Sulphur were obligated to inform the board of directors of material business developments before accepting stock options. The trial court's holding, not appealed on this point, was that two TGS employees, "not being then members of top management (although [one] was a vice president) had no duty to disclose their knowledge . . . before accepting their options," id. at 857, and that they "could reasonably assume that their superiors, . . .
In addition to these limitations on the scope of the duties of care and loyalty, challenges to executive compensation will likely be limited to those at the top because those are the individuals with disproportionately larger pay. The executives ranking below the top of the corporation's authority structure are not likely to be recipients of compensation that would be considered so excessive to be challenged by potential plaintiffs.

Liability will not be indeterminate if measured by the officer's duties of care and loyalty. Courts possess the analytical tools to make reasonableness evaluations. They do so in evaluating executive compensation under other laws, and countless other applications of reasonableness exist in the law. Courts will make principled decisions because they have the ability to do so, and await only proof by advocates of the proper standard by which to measure the conduct at issue. In addition, the threat of litigation may serve to correct imperfections in the market for executive compensation. If lower salaries are agreed to, and plaintiffs are ultimately unsuccessful, a needed measure of certainty would be restored. Executives with the guidance of counsel can apply the legal doctrines to avoid litigation as well as to survive it.

Nor will the liability of officers be debilitating. Most observers agree that most executives of large public corporations possess managerial and entrepreneurial skills commensurate with their positions. Even staunch reformers concede that top execu- who were directors of the corporation, would report the [information to the board] if that was advisable."

Id. at 856. Although the duty involved in this case was one imposed under Securities Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (1992), the duty and its discharge by reliance on superiors is similar to the fiduciary duty involved in conflicting-interest transactions.

247. See supra note 85 and accompanying text.

248. See supra part III.C. See also Barris, supra note 23, at 87 (“Since courts have been able to grapple with this problem in other contexts, [tax, close corporation and partnership cases], there seems to be no real justification to balk at applying the same analysis to public companies. In either large or small operations, clear abuses should be recognizable.”).

249. Professor Christy argues that courts should apply generally recognized tort and contract principles to allegations of managerial misconduct, as they do in countless other substantive areas of the law. The analytical tools that courts lack, he suggests, can be supplied by advocates educating the court on current recognized business standards, as the advocates do with professional standards in many other areas of the law. See Christy, supra note 201, at 174-76. To do less, he chides, “is as if in medical malpractice cases courts dismissed all claims except those in which the surgeon amputated the wrong limb.” Id. at 168-69. Barris, writing in 1992, concurs with Christy's 1984 assessment.

Not only is the court capable of determining “how much is too much,” but there is no rational reason why a court cannot examine a compensation package [to evaluate incentive payment plans]. . . . The court should go beyond a mere inquiry into whether the corporation has followed the proper procedure and get to the ultimate question of the appropriateness of huge compensation packages. Plenty of tools are available to assist in the undertaking, including independent analysts and masses of comparative compensation data.

Barris, supra note 23, at 87-88.

Statistical analysis of Tax Court cases involving executive compensation revealed consistent use by courts of several commonly-accepted factors in determining the reasonableness of compensation. The researcher advocated more dedicated use of statistical models, exhorting that “[c]ourt implications from this study are that rational means exist to aid factual determinations . . . .” Boyd, supra note 162, at 99.
tives are entitled to a hefty premium over the average wage for their services. To the extent application of duties of care and loyalty results in trimming of executive compensation, defendants would have little to complain about, for they are merely being held to their legal duties. This is a standard comparable to that of other professionals and long-stated in the law as a positive duty owed by them as quasi-trustees.

Would such liability reduce the quality of management of public corporations or otherwise impinge on top executives unfairly or unreasonably? No experts have shown a link between current so-called "incentive" pay plans and superior executive performance; it is thus equally unproven that reduction of otherwise unreasonable compensation in a fair and reasoned fashion would reduce efforts or performance. And, even the most extreme reductions of executive pay, perhaps from seven figures to six, are unlikely to be considered confiscatory or unfair.

Finally, in at least five states, those same post-Van Gorkom statutes limiting directors' liability operate in the officers' favor as well. Thus, to the extent an officer's liability for receiving unreasonable compensation is held by courts to sound as a violation of the officer's duty of care rather than duty of loyalty, liability will be limited. Even if this list of states is expanded, such limitation of individual liability will not eviscerate the officer's duty of care. It binds only shareholder plaintiffs, who could, of course, still seek to enjoin future excessive compensation.

Thus, although liability of any officer for excessive compensation will likely be limited, it will nonetheless be significant to that particular officer and, more importantly, to the corporation's workers and shareholders. The message sent by holding officers to their preexisting duties of care and loyalty is that the chief executives will be required to consider their own compensation with the same diligence as their other business decisions. This change will have an impact on the corporation's

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250. See, e.g., Runaway Executive Pay, supra note 2, at 5 (suggesting a top salary of 20-30 times average wages) (testimony of Professor Crystal).

251. See id.

252. See id.; BAYNE, supra note 232; BERLE & MEANS, supra note 10.

253. See supra notes 37-74 and accompanying text.

254. One symptom of the problem which has stirred public outrage can be found in statements like that of International Multifoods' Anthony Luiso, who, in agreeing to reduce his salary approximately ten percent to just under $700,000 in exchange for stock options, noted that it "would be painful . . . but also something that I could afford to give up and still put food on the table." Bennett, supra note 24, at A4.

255. See Hanks, supra note 210, at 1241; BLOCK ET AL., supra note 90, at 42-43 (listing 5 states: Louisiana, Maryland, Nevada, New Jersey, and Virginia). See generally MODEL BUSINESS CORP. ACT, supra note 7, § 2.02(b)(4) & official cmt. 3(i).

256. These statutes and executive compensation cases have drawn rather unclear lines in this area. See supra note 210.

257. In addressing similar concerns with respect to directors' conduct, Hanks notes:

They are unlikely to view these provisions as a green light for inattention, self-dealing, or other mischief. . . . They know they can still be sued by third parties or for equitable relief, and most directors, like most human beings, do not enjoy litigation even when their own assets are not at risk.

Hanks, supra note 210, at 1244.
constituencies beyond its monetary impact on officers individually or collectively.258

CONCLUSION

The refrain of outrage at compensation paid to the top executives in public corporations is at the heights of its now predictable reprise. The public perception of unfairness is undeniable. The law can and should repair this unfairness. By putting to work well-established but dormant principles, the law can place the duty to consider the best interests of the corporation firmly on the shoulders of those who can do it most efficiently: the recipients of executive compensation. By doing so, we can restore the confidence of all participants and policymakers in the process as well as the outcome, and perhaps make this reprise the last.

258. See supra text accompanying notes 242-43.