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Pay without Performance, The Unfulfilled Promise of Executive Compensation, Part IV: Going Forward

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This paper contains a draft of Part IV and the bibliography of our forthcoming book, Pay without Performance: The Unfulfilled Promise of Executive Compensation (Harvard University Press, September 2004). The book provides a detailed account of how structural flaws in corporate governance have enabled managers to influence their own pay and have produced widespread distortions in pay arrangements. The book also examines how these flaws and distortions can best be addressed.

Part IV of the book discusses how executive compensation – and corporate governance more generally – can be improved. We examine the extent to which pay arrangements can be improved by adopting board process rules, imposing shareholder approval requirements, and making pay more transparent. We conclude that problems with compensation arrangements cannot be fully addressed without ensuring that directors focus on shareholder interests and operate at arm's length from the executives whose compensation they set. To achieve this result, we argue, it is not sufficient to make directors independent of executives as recent reforms has sought to do; it is also necessary to make directors dependent on shareholders by changing the legal arrangements that insulate boards from shareholders.

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Pay without Performance:
The Unfulfilled Promise of Executive Compensation

Lucian Bebchuk and Jesse Fried

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CHAPTER 15: IMPROVING EXECUTIVE COMPENSATION

Executive compensation arrangements, we argued in the preceding parts of this book, have deviated substantially from arm's length outcomes. In our two concluding chapters, we discuss what implications follow for the study, practice, and regulation of executive compensation and corporate governance more generally.

We should stress that our main aim in this book is not to provide a detailed blueprint for reform. Rather, we seek to improve understanding of the problems that have plagued executive compensation. To highlight that such understanding is necessary for addressing these issues, however, we do wish to sketch in this concluding part some of the policy implications of our analysis.

In our view, the problems of executive compensation arise from a basic corporate governance problem. Under current arrangements, directors' incentives to enhance shareholder value are not generally sufficient to outweigh the various factors that induce the board to favor executives. Thus, the problems of executive compensation can be fully addressed only by adopting reforms (which we discuss in the next chapter) that would confront boards with a different set of incentives and constraints. We wish to start, however, by considering in this chapter several remedies that can be applied specifically to executive compensation issues. We discuss below how such reforms can help improve the current situation, and why they cannot fully address the problems we have identified.

Paying for Performance

When well designed, executive compensation can provide executives with cost-effective incentives to generate value for shareholders. Unfortunately, that promise has not yet been fully realized. In examining compensation arrangements, investors should be on guard against those that fail to encourage performance and should encourage those that do so in a cost-effective way.

What should shareholders be on guard against? What should they encourage? As we have seen, much of the gain managers enjoy on their equity- based compensation is not due to their own performance but rather to general market or sector rises. In our view, companies should move to plans that filter out at least some of these windfalls. With such filtering, the same amount of incentives can be provided at a lower cost, or more incentives can be provided at the same cost. A move to give executives restricted stock grants, which provide an even larger windfall than conventional options, is not clearly in the interest of shareholders. In addition, investors should carefully examine arrangements such as generous severance packages that are not contingent on good performance and may therefore undermine some of the good incentives that other elements of the compensation package seek to provide.

Investors should also seek to limit the broad freedom executives have to unwind the incentives created by their compensation plans. As we have noted, there are few if any restrictions, apart from vesting, placed on executives who wish to hedge or eliminate their exposure to equity risk. It may well be desirable to separate the vesting and exercisability of options; doing so would ensure that options that already belong to the executive will remain in his or her hands for some time. In addition, it might be desirable, as one of us has argued in earlier work, to require that executives should disclose *in advance* their intention to sell shares, providing detailed information about the intended trade, including the number of shares to be sold.[1]

Our main aim in this chapter, however, is not to specify the optimal compensation package (which is, of course, likely to vary across firms and over time), but rather to consider improvements in the processes that produce executives' compensation arrangements. Boards are going to continue deciding the details of particular arrangements, as they should. Although shareholders can and should try to influence the general contours of such plans, they are not in a position, and lack the company-specific information needed, to determine the details.

Improving Transparency

We argue in the next chapter for reforms that would increase shareholder power. But even though shareholders have less power than they

[1] Jesse M. Fried, "Reducing the Profitability of Corporate Insider Trading through Pretrading Disclosure," *Southern California Law Review* 71 (1998): 303-392.

should, they do have some, and this is in part why the outrage constraint matters. The greater the understanding of outsiders, the tighter the outrage constraint. Thus, improving the transparency of compensation arrangements is desirable.

In dealing with executive compensation, the transparency of disclosure matters because outsiders' perceptions of compensation arrangements are important. Financial economists often focus on the role of disclosure in getting information incorporated into market pricing. It is widely believed that information can be reflected in stock prices as long as it is known and fully understood by even a limited number of market professionals.

In the case of executive compensation, there is already significant disclosure. As we have discussed, SEC regulations require detailed disclosures of the compensation of a company's CEO and the four most highly compensated executives other than the CEO.[2] Some even believe that this increased disclosure has contributed to the ratcheting up of compensation during the last decade. In our view, however, is it important to recognize the difference between disclosure and transparency, and it is transparency that should receive more attention.

The main aim of requiring disclosure of compensation details is not to enable accurate pricing of the firm's securities. Rather, such disclosure is primarily intended to provide some check on arrangements that are too favorable to executives. This goal is not well served by disseminating information in a way that is understood by a small number of market professionals but opaque to everyone else.

The ability of plan designers to favor managers depends on how compensation arrangements are perceived by a much wider group of outsiders. We have seen that compensation design often seeks to make the amount of pay, or the extent to which pay is decoupled from performance, less salient. For disclosure to affect managerial rents through the outrage constraint, however, such information must reach more than just a select group of market professionals and arbitrageurs.

The outrage constraint, after all, operates through director or management response to disapproval (threatened or actual) from institutional investors or other social reference groups, such as the business

[2] See Reg. S-K, Item 402, (17 CFR 229.402).

press or popular media. As a result, the transparency and salience of disclosure can have a significant effect on CEO compensation. Raw facts buried in a mountain of technical disclosure probably will not do.

Public officials and governance reformers should thus ensure that compensation arrangements be and remain transparent. Several transparency-boosting measures are worth considering.

(i)Accounting treatment of options: It would be desirable to mandate the expensing of options. As we discussed in chapter twelve, FASB, which in the past was pressured not to require the expensing of options, has announced its intention to adopt such a requirement. Even if FASB fails to finalize this requirement, Congress is considering legislation that would force firms to expense the option compensation given to their five highest paid executives. From an accountant's perspective, expensing is desirable because it leads to a more accurate reflection of the firm's financial situation. For our purposes, however, expensing is beneficial because it makes the costs imposed by option-based compensation more salient to investors on an ongoing basis.

Rationalizing the accounting treatment of option plans would also level the playing field among different types of options. It would eliminate a major excuse used to avoid reduced-windfall option plans. The possibility of not expensing conventional options, while reduced-windfall options must be expensed, has long been a convenient excuse for using the former and failing to filter out gains due to general market or sector rises.

(ii) Placing a monetary value on all forms of compensation: It would be desirable to have companies place a dollar value on all forms of compensation and include these amounts in the salient compensation tables. Companies have been able to provide executives with "stealth compensation" by using pensions, deferred compensation, and post-retirement perks and consulting contracts. Although some details of these arrangements have appeared elsewhere in company SEC filings, firms have not been required to place a monetary value on these benefits and to include those values in the compensation tables. These benefits have not even been included in the standard database used by financial economists to study executive compensation. Indeed, such forms of compensation are used in part because the amounts involved can be obscured.

In our view, companies should be required to place a monetary value on each benefit provided to executives -- and to include this value in the compensation tables when executives become entitled to the benefit. In addition, it might be desirable to require companies to place a monetary value on any tax benefit that accrues to the executive at the company's expense – and to report this monetary value. These measures would ensure that shareholders get a more accurate picture of total executive compensation. They also would eliminate distortions that might otherwise arise when companies choose particular forms of compensation because of their camouflage value rather than their efficiency.

(ii) Pay and Performance: It might be worthwhile to require companies to disclose to shareholders in a transparent way how much of the gain that managers make on their options is due to general market and industry movements. This could be done by requiring firms to calculate and report the gains made by managers from the exercise of options (or the vesting of restricted shares, in the case of restricted share grants) and to report what fraction if any was due to the company's superior performance over its industry peers. Such disclosure would make much more transparent the extent to which the company's equity-based plans reward the managers' relative performance.

(iv) Unloading of Options and Shares: It might be desirable to require companies to make transparent to shareholders on a regular basis the extent to which their top five executives have unloaded any equity instruments received as part of their compensation. Although a diligent and dedicated researcher can obtain this information by putting together many currently mandated disclosures of trading by executives, requiring the firm to put together and report such information would highlight for all investors the extent to which managers have used their freedom to unwind incentives.

Of course, designers of compensation plans may find or use new ways to make compensation, or its insensitivity to performance, less salient. As new practices (and new means of camouflage) develop, disclosure arrangements should be updated to ensure maximum transparency.

Compensation Committee Procedures

The recently adopted stock exchange requirements seek to provide some formalization of the process that compensation committee must follow. According to the NYSE requirements, each compensation committee must have a written charter.[3] The committee is also required to review and approve corporate goals and objectives relevant to CEO compensation, and to produce a report on executive compensation for the company's annual proxy statement or annual report. Institutional investors have for some time been urging all companies to follow such an approach. [4]

Requiring compensation committees to follow certain steps is an approach we find acceptable but not particularly beneficial. At best, such requirements may force committee members to devote more attention to executive compensation than they have in the past, even though some directors will probably rely on counsel and consultants who use boilerplate language to draft the committee reports. Assuming that directors are solely focused on shareholder interests, forcing them to take certain steps and to articulate what they are doing may be a useful way to make their work more methodical.

Although procedural requirements thus may address problems arising from carelessness and insufficient attention, they do not address those arising from directors' incentives and tendencies to use their discretion in ways that favor executives. With the lawyers and compensation consultants available to give and articulate reasons for the choice of arrangements, the need to follow certain steps and to write a report would not place a meaningful limit on directors' discretion. Thus, the key issue of directors' incentives remains.

Requiring Shareholder Approval

Besides seeking to improve director incentives, which is the subject of the next chapter, concerns about directors' use of their discretion may alternatively lead one to support limiting directors' discretion. The most natural way to do so, without ruling out arrangements that may in fact be desirable for shareholders, is to require shareholder approval of certain board decisions. In particular, two approaches should be considered – requiring shareholder approval of equity-based plans and requiring

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[3] See NYSE Corp. Gov. Rules Section 303A.05.

[4] See, e.g., TIAA-CREF "Policy Statement on Corporate Governance," http://www.tiaa-cref.org/pubs/html/governance_policy (last visited on March 16, 2004).

shareholder approval for specific compensation agreements that include some "suspect" features.

Approval of Equity-based Plans

In the spring of 2003, NYSE and NASDAQ adopted requirements that obligated listed companies to obtain shareholder approval for all equity compensation plans.[5] Although these requirements were hailed by some as an important measure that will address concerns about executive compensation and corporate governance more generally,[6] they are unlikely to do so.

To put these reforms in perspective, we must recall that many companies have already been putting equity compensation plans to a shareholder vote. As we discussed in chapter three, a major impetus for doing so was a desire to avoid the tax penalty imposed on plans lacking shareholder approval. Thus, the new requirements will merely expand an already common practice that has not proven to be an effective constraint on boards.

Shareholder voting on plans gives shareholders dissatisfied with executive compensation (or other matters) an opportunity to register their dissatisfaction. It may also enable them to block the issuance of any more shares and options in the presence of executive pay practices that they find especially outrageous. But voting on equity compensation plans does not provide shareholders in normal circumstances with a substantial influence on the design of compensation arrangements.

To begin with, what shareholders will vote on are general plans with fairly broad features. Shareholders will be asked to approve a certain number of options or restricted shares of given types that the board has at its disposal. There are clearly many key features of executive compensation agreements, however, for which no approval will be necessary. In particular, shareholders will not be asked to approve the number of options any given executive will receive from the total at the board's disposal, what limits on

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[5] NASD Rule 4350; NYSE Listed Company Manual Rule 303A; SEC Release No. 34-48108 (June 3, 2003).

[6] See, e.g., Andrew Countryman, "Investors get say on equity pay; SEC mandates stockholder vote," *Chicago Tribune,* 1 July 2003, p. C3; Amy Strahan Butler, "S.E.C. Passes Rule Changes For Options," *The New York Times,* 1 July 2003, p. C3.

vesting and exercisability, if any, will be imposed in connection with the given options or shares, what bonus and other incentive plans will accompany the equity compensation, what compensation the executive will get in the event of termination and after retirement, and so forth. Equity compensation plans can be worded in a way that gives boards wide discretion to later add such features without shareholder approval. As one prominent law firm advised its clients in a memo, "In light of the new NYSE and NASDAQ shareholder approval rules, stock plans should be drafted broadly so that the company may change the terms of grants without having to amend the plan in a manner that may require shareholder approval under the new rules."[7]

Moreover, even though shareholders will have veto power over the grant of some types of options or restricted shares, they will have little control over how the executive is compensated if they turn down the plan proposed by the board. If, for example, they oppose a plan based on conventional options because such options provide excessive windfalls from market and sector rises, they have little assurance that the board will not instead use very large bonus plans or phantom stock that brings the same payoffs to the executive but worse tax consequences for the company—outcomes they may favor even less than conventional options. For this reason, apart from rare cases of shareholder revolt, we expect that shareholders will approve proposed plans even when they may want the board to design compensation agreements differently. All in all, we do not expect the expansion in shareholders' veto power over equity compensation plans to considerably reduce boards' freedom to set compensation arrangements.

Voting on Specific Features of Compensation Agreements

Although requiring shareholder approval of equity compensation plans is not particularly meaningful, requiring shareholder approval of compensation agreements that include certain features could potentially be more significant. Consider an arrangement that requires shareholder approval for executive compensation plans that include features identified as "suspect" by those designing the arrangements. If we were designing

[7] See Wachtell, Lipton, Rosen & Katz, "Stock Plan Design for the Upcoming Proxy Season," 21 January 2004.

such arrangements, for example, we would require shareholder approval for conventional options that do not filter any windfalls from general market or sector movements, for options that can be exercised shortly after vesting, for any equity compensation plan that does not require executives to provide pre-trading disclosure of intended sales of shares, and for severance benefits that are very large relative to annual compensation. Some shareholder resolutions, and the Council of Institutional Investors (CII), have recommended such arrangements. For example, the CII has recommended that "underwater" options should not be repriced or replaced, and discount options should not be awarded, unless management obtains shareholder approval.[8]

We believe such arrangements could potentially be quite beneficial if they are applied to provisions that actually have a high likelihood of being undesirable. In such cases, this type of arrangement can be regarded as striking a middle course between outright prohibition and unqualified acceptance of such features. If a certain feature appears likely, but not certainly, undesirable, both complete prohibition and unfettered freedom could be costly. Allowing the feature only if the board can persuade shareholders to approve it might strike a sensible balance.

Of course, whether such arrangements benefit shareholders will depend, critically, on which provisions are designated for shareholder approval. Imposing such an arrangement on provisions that are likely to be desirable is counter-productive. Not imposing it on provisions that are quite likely to be undesirable is missing the point. Regulators or exchange officials would not be good for the job, because they would not be able to make choices on a company-specific basis nor to easily adjust the arrangement as new information emerges.

Thus, we consider it desirable to have shareholders themselves determine the arrangements and be able to modify them as they learn more. The problem, however, is that shareholders do not have sufficient power to adopt governance arrangements under the existing rules of corporate law. Currently, shareholders can initiate and vote on precatory resolutions, which are not binding on the board. Permitting shareholders to initiate and approve rules for executive compensation arrangements that are also

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8 See http://www.cii.org/dcwascii/web.nsf/doc/policies_iv.cm (last visited March 16, 2004).

binding on the boards would, we think, be a desirable change in the basic structure of corporate law, and we will return to it in the next chapter.

The Limits of Voting on Executive Pay Arrangements

We strongly support shareholder voting. As we discuss in the next chapter, we consider it desirable to increase the role of shareholder voting in elections for directors and in setting the basic ground rules of corporate governance. The design of executive pay arrangements, however, is not an area where shareholder intervention via voting can completely substitute for the decision-making of a board that effectively guards shareholder interests.

Shareholder voting can establish some outer limits to what boards can do without specific shareholder approval. There are interventions that shareholders can make based on their general knowledge about the basic structures of compensation arrangements. But good directors are still needed to make the many and complex choices within these outer limits and to negotiate with the executives. These are tasks that require getting into case-specific detail and having some back and forth. Shareholder voting cannot substitute for all this.

Executive Compensation and Corporate Governance

Thus, our conclusion about shareholder voting on compensation matters, as with the other measures considered in this chapter, brings us back to the basic corporate governance problem. How do we improve the incentives of directors and make them more likely to focus on shareholder interests? Although the measures we have considered would improve executive pay arrangements, they would not address the problems fully. A more complete solution would require an improvement in corporate governance in general.

The measures we have discussed would all leave directors with significant discretion, as well they must. The measures do not by themselves provide directors with a new set of incentives. Further improvements in the design of executive compensation would require improvement in director incentives. Such improvement, in turn, would of course have a beneficial effect not only on executive pay arrangements but also on other decisions made or reviewed by the board. Thus the analysis of executive compensation problems calls for a reform of basic corporate governance, which is the subject of the next chapter.

We would like to note yet another important connection between executive compensation and corporate governance. This relationship involves the extent to which executive pay can be relied on to address problems of corporate governance.

Many financial economists and students of corporate governance have in the past relied heavily on executive compensation as a remedy for potential agency problems. On their view, incentive schemes can address such problems and align the interests of managers and shareholders. We have seen however, that this belief is not well grounded. Because the act of determining pay arrangements is itself subject to an agency problem, we should not assume that such arrangements have been set, or currently are set, in the way that could best address agency problems.

Recognition and Reality

We wish to end this chapter by emphasizing how important it is to recognize the critical role of managerial influence in determining executive compensation. Widespread recognition of current problems with executive compensation, a recognition that we seek to advance with this book, can have an effect on reality.

Acknowledgment of these current problems by practitioners of corporate governance, and, in particular, by institutional investors, may alleviate the situation to some extent. The nature of managers' influence over their compensation is such that widespread recognition of its existence and mechanisms may do much to limit the problem. We have argued that the magnitude of the problem depends on the extent to which outsiders are aware of it. Simply increasing awareness of the problems then, would tend to counteract camouflage and help reduce the problems we have identified.

To improve executive compensation practices, investors and reformers need more than power alone; they need information and awareness also. Awareness is critical because both groups need to know what to look for and what to focus on. Thus, all participants must recognize the key role that managerial influence has played and continues to play in executive compensation, the myriad of factors that contribute to managerial influence, and the range of ways in which this influence manifests itself.

We believe that it is also important for our fellow academic researchers to appreciate fully the magnitude of the agency problems involved in executive compensation. Financial economists have been great supporters of equity-based compensation schemes, appreciating their promise of providing desirable incentives to management. This enthusiasm has added legitimacy to the large increases in executive compensation during the past decade.

Financial economists should recognize that incentives schemes also have, as it were, a "dark side." The schemes' actual design may sometimes be a product of agency problems within the firm, rather than an instrument for combating them. Because of these agency problems, executive compensation has yet to fulfill its promise and has even created some perverse and distorted incentives. We see clear signs that financial economists are now spending more time examining some of the adverse effects that compensation arrangements have had on management behavior. We hope they will focus more closely on the role of managerial influence and devote as much attention to studying it as they have to the model of arm's length contracting.

CHAPTER 16: IMPROVING CORPORATE GOVERNANCE

"The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."
-- Delaware Chancellor William Allen

The problems of executive compensation arrangements, we have seen, are rooted in the failure of boards to bargain at arm's length with executives. Greater transparency, improved board procedures, additional shareholder approval requirements, and a better understanding by shareholders about the desirability of various compensation arrangements, can all help improve the situation. But these remedies cannot be a complete substitute for effective decision-making by directors striving to serve shareholder interests.

In the end, executive compensation requires case-specific business decisions and thus is best designed by informed decision-makers who have some discretion and use it to enhance shareholder value. That is why the problems discussed in this book would be fully, or at least best, addressed by improving the incentives of directors. We need to turn the official story, which assumes directors are the dedicated guardians of shareholder interests, from fiction into reality.

Directors that guard shareholder interests are needed not only to address executive compensation problems but also to address corporate governance problems beyond those connected to executive pay. The failure of boards to deal with executives at arm's length on compensation matters reflects systemic problems in corporate governance. Executive compensation problems arise because, under current arrangements, boards cannot be relied upon to effectively scrutinize and monitor CEOs' decisions and activities. If this is the case in the context of executive compensation, it is likely to be the case in other contexts as well. For example, boards are unlikely to prevent managers from engaging in empire building or from impeding acquisition offers that would benefit shareholders.

Thus, improving boards' performance in monitoring and supervising management is critical not only for executive pay but for corporate governance in general. The foundation of the board-monitoring model of corporate governance is the existence of directors who select, supervise, and compensate executives with shareholder interests in mind. Shareholders' ability to rely on such shareholder-regarding directors is, so to speak, the Archimedean point on which our corporate governance system stands.

The critical question, then, is how to make directors more focused on shareholder interests -- and thus better able to carry out their role under the board-monitoring view of corporate governance. The most promising approach for doing so is to change the current allocation of power between boards and shareholders.[9]

The Limits of Director Independence

The main way in which the corporate governance system has responded to the business scandals that have erupted in the past two years is by trying to bolster board independence. Recent reforms have sought to make nominally independent directors more independent and to expand the presence and role of such independent directors on the board. Director independence is now widely believed to be key to the effectiveness of the board-monitoring model. Past governance problems are attributed to insufficient director independence. Strengthened independence, it is believed, will prevent such governance problems in the future.

As we discussed in chapter two, the recent wave of corporate scandals has led to new rules aimed at reinforcing the long-standing trend toward increased use of independent directors on boards and compensation committees. Most notably, the NYSE and NASDAQ last year adopted listing standards that tighten the definition of independence and require boards of listed companies to have a majority of independent directors. In addition, under these listing standards, compensation and nomination committees must be comprised solely of independent directors.

Supporters of management have been relying on these reforms as a basis for arguing that no more changes are necessary.[10] In their view, even if

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[9] Our arguments in this chapter draw on Lucian A. Bebchuk, "The Case for Shareholder Access to the Ballot," *The Business Lawyer* 59 (2003): 43-66, reprinted in Lucian A. Bebchuk, ed., *Shareholder Access to the Corporate Ballot* (Harvard University Press, 2004); and Lucian A. Bebchuk, "The Case for Empowering Shareholders," Working paper, Harvard Law School, April 2003.

[10] For two recent comprehensive statements by supporters of the current allocation of power between management and shareholders, see Martin Lipton and Steven A.

the official model of board oversight on management has not worked well in the past, these reforms adequately address concerns about the quality of board decision-making. The rules strengthen board independence, and such strengthening is all that is necessary.

We agree that recent reforms are likely to be beneficial. But we see no basis for complacency. The adopted rules, and the increased attention to director independence accompanying them, cannot by themselves ensure that boards properly carry out their critical role. Rules governing director independence cannot deliver nearly as much as their enthusiastic supporters claim.

To begin with, there are some preliminary reasons for skepticism about how much independence the new requirements can deliver. Clearly, for any given public company, they will exclude some individuals from the board, but a vast number of individuals will still qualify as an independent director. The independence requirements do not resolve which few individuals will be selected from this vast pool of "independent" candidates.

Furthermore, even though the independence requirements may eliminate some forms of managerial influence over individual directors, they hardly ensure that the directors are dedicated to shareholder interests. The independence requirements rule out some "bad" incentives, but they hardly determine what the incentives of directors will be.

When filling other high-level positions, companies generally recognize that selecting the right person for the job and providing that person with appropriate incentives is very important. This should be no less true with respect to directors, especially given their critical roles. Thus, the fact that director independence alone ensures neither the selection of the best people nor good incentives for those selected should be disconcerting.

The fundamental problem is that independence requirements do not themselves provide affirmative incentives for directors to enhance shareholder value. Two problems follow. First, as long as these requirements merely reduce but do not fully eliminate incentives and inclinations to favor

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Rosenblum, "Election Contests in the Company's Proxy: An Idea Whose Time Has not Come," *The Business Lawyer* 59 (2003): 67-94, reprinted in Lucian A. Bebchuk, *Shareholder Access to the Corporate Ballot* (Lucian Bebchuk, ed., Harvard University Press, 2003); and John J. Castellani and Amy L. Goodman, "The Case Against the SEC Director Election Proposal," in Lucian A. Bebchuk, ed., *Shareholder Access to the Corporate Ballot* (Harvard University Press, 2003).

executives, any residual tendency among directors to favor executives may have a substantial impact in the absence of any strong affirmative incentive to enhance shareholder value. Second, even in the hypothetical situation where directors are completely insulated from managerial influence, the absence of strong pro-shareholder incentives may cause directors to pursue their own narrow interests at the expense of shareholders.

Let us begin with the first problem. Recent reforms have in some ways weakened executives' power vis-à-vis the board, but they do not eliminate directors' incentives and inclinations to favor executives. First, the reforms do not change the reality that remaining on the company's slate is the key to re-election. As long as director positions are well compensated and prestigious, independent directors will have an incentive to be re-elected. The CEO and his or her director allies may not fully control board nominations in the future, but remaining on good terms with them will likely continue to increase a director's chances of being re-nominated.

Second, even though the recent reforms place considerable limits on the power of CEOs to buy off directors, they certainly do not eliminate it. Indeed, it would be difficult to prevent a CEO from rewarding board members as long as CEOs retain some influence over director compensation and board seats are not closed to the large set of individuals whose business interests then or later might be influenced by decisions made by the CEO.

Finally, even if reforms could make it impossible for the CEO to reward directors, the latter would still be subject to social and psychological factors inducing them to remain on good terms with the CEO. As long as directors are supposed to act collegially and feel like part of a team of which the CEO is for many purposes the leader, they will feel more comfortable accommodating his or her wishes than opposing them. There is little in the recent reforms to counteract directors' very human tendency to avoid conflict with their colleague and leader.

This last point is worth emphasizing: it suggests that merely reducing managers' ability to reward directors -- without providing significant affirmative incentives to serve shareholders – may not be sufficient to induce directors to focus on shareholder value. Because most directors hold only a tiny fraction of the company's shares, their direct personal costs in cutting executives some slack may be negligible. Thus, economic incentives or social ties of even modest magnitude may be enough to tilt directors toward executives.

But what about the hypothetical scenario in which the board is largely made of independent directors who somehow have neither incentives nor inclinations to remain on good personal terms with the CEO? Suppose that a group of such directors somehow comes to control the board and its committees and, by virtue of its control of the company's slate, can self-perpetuate. And suppose that members of this group cannot be moved by whatever the CEO can do to reward them. As long as these directors do not have a strong affirmative incentive to enhance shareholder value, their complete independence of the firm's management does not, by itself, imply that they will serve shareholders. They may pursue their own preferences and interests – say, by seeking to appoint executives they favor for personal reasons, moving the company in self-serving directions by increasing directors' compensation, expanding their empire, or developing pet projects. In short, even in the hypothetical case of totally independent directors, shareholders may still have substantial grounds for concern.

Director Compensation Schemes

Companies have compensated directors with equity for some time, and various observers have called for increased reliance on equity grants in compensating directors.[11] Can equity compensation, perhaps with some increase in the amounts of stock involved, provide independent directors with adequate affirmative incentives to focus on shareholder interests?

As long as director compensation remains within the existing range, the financial cost to directors of various value-reducing steps (though not all) would remain small even if more or most of their compensation is equity-based. Consider a compensation scheme under which directors each year receive restricted stock awards worth $100,000 for their services. And consider a director who has accumulated stock worth $300,000. Surely, such holdings might provide directors with substantial incentives to fight (or even push out) the CEO over a decision that could halve the value of shareholders' (and directors') holdings. However, it would provide a very small incentive – less than they get for participating in one board or committee meeting – to fight the CEO over a compensation arrangement or a pet project that would reduce shareholder value by, say, 1 percent.

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11 See, e.g., Charles M. Elson, "The Duty of Care, Compensation, and Stock Ownership," *University of Cincinnati Law Review* 63 (1994): 690-692. \

Furthermore, increasing the size of equity grants to directors may also have unintended negative consequence. The larger the level of compensation, the greater the incentive to be re-elected. In such a situation, the value-maximizing strategy for a director may be to focus not on the difficult task of increasing share value but rather on that of remaining on the board and enjoying the increased stream of compensation, as well as obtaining (now more lucrative) directorships on other boards. As long as board appointments depend not on the preferences of shareholders but on those of nominating committees, increased motivation to get re-elected is not the same as increased motivation to enhance share value. In addition, in such a state of affairs, independent directors may be more concerned with finding ways to justify increasing the number of options or shares granted than with improving the per share value of the company.

This last point reveals a basic difficulty about trying to solve the problem of director incentives with an equity-based compensation scheme. At first glance, on might hope that such a scheme can, by aligning the interests of directors and shareholders, –induce directors to carry out their oversight duties well and, in particular, to bargain with executives at arm's length and solely with shareholder interests in mind. But closer inspection suggests that this approach simply recreates, one level up, the very problem about executive compensation with which we began.

Under the arm's length bargaining model, executive compensation is assumed to address the agency problem between managers and shareholders. Managers' interests can be aligned with shareholders', so the argument goes, by an incentive compensation scheme that induces managers to use their discretion in shareholders' interest. But the problem, we have seen, is that someone other than the managers must come up with the right pay package, and there are reasons to believe that directors have not been designing this compensation with shareholders' best interests in mind.

Could we address this agency problem between directors and shareholders by providing the directors themselves with well-designed equity-based compensation schemes? Well, someone would need to design the directors' incentive compensation. Currently, directors set their own compensation, subject to the same outrage constraint that limits executive compensation. As long as the compensation re-nomination of directors is in the hands of directors themselves, legitimizing the provision of large equity-based compensation might not eliminate, and could even worsen, the agency problem in the relationship between the board and shareholders. In this state of affairs, directors might focus more on justifying and legitimizing generous compensation schemes to themselves than on enhancing share value.

Should we then have another independent group of "super-directors" set the compensation of the independent directors? And to make sure that the super-directors exercise their discretion in shareholder interest, should they be given an incentive scheme set by super-super-directors, and so forth and so on …? The futility of such an infinite regress chain is patent. It illustrates the key point: independence, even coupled with incentives schemes, cannot secure shareholder interests unless there is some mechanism at the end of the chain that makes those choosing the incentive schemes accountable to shareholders. This basic point highlights the importance of making directors dependent on shareholders.

Making Directors Dependent on Shareholders

The problem with an approach that focuses on the independence of directors is that, by itself, it maintains the insulation of directors from shareholders. As long as directors' election and compensation ultimately depends on other directors, even if not on the firm's executives, the corporate governance system lacks an anchor that would securely tie board decisions to shareholder interests.

In our view, the most effective way to improve board performance is to increase the power of shareholders vis-à-vis directors. We should make directors not only more independent of executives, but also less independent of shareholders. That second step will give directors better incentives to serve shareholder interests.

Although such shareholder-dependence could also be created by giving shareholders a key role in setting director compensation, we will focus on increasing their role in the appointment and re-appointment of directors to the board. We should replace the current system under which the key to a board seat is pleasing those on the board who make nomination decisions. The appointment of directors should substantially depend – in fact and not only in theory – on the shareholders.

Making directors dependent on shareholders can counter some of the factors that incline directors to pursue other interests, whether their own or those of the executives. It could make the desire to be re-elected a positive force rather than a negative one. It could provide directors with an incentive to develop a reputation for serving shareholders. It could perhaps instill in directors a sense of loyalty toward shareholders, especially if institutional investors were to take an active role in getting a director on the board.

For this reason, we support removal of the barriers that have thus far insulated directors from shareholders. Because of shareholders' collective action problem, increasing their power vis-à-vis directors would hardly be a perfect solution. But movement in this direction has substantial potential for improving the incentives and performance of boards.

The Myth of Corporate Elections

Shareholders' power to replace directors plays a critical role in the accepted view of the corporation. Although this power is not supposed to be used regularly, it is expected to provide a critical safety valve. "If the shareholders are displeased with the action of their elected representatives," emphasizes the Delaware Supreme Court in its well-known opinion in the case of *Unocal*, "the powers of corporate democracy are at their disposal to turn the board out."[12]

In reality, however, this safety valve is largely a myth. Indeed, the incidence of attempts by shareholders to replace incumbents with a team that would do a better job running the company – the type of cases referred to in the *Unocal* opinion above – are even more rare than is commonly recognized.

Some defenders of the status quo rely on the fact that there have been about forty contested proxy solicitations per year in the last several years.[13] A large fraction of these contests, however, was conducted in the context of an acquisition attempt. Because hostile bidders have an interest in acquiring

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[12] See Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946, 949 (Del. 1985) (quoting Aronson v. Lewis, 473 A. 2d 805, 811 (Del. 1984).

[13] See, e.g., Letter from Wachtell, Letter from Wachtell, Lipton, Rosen & Katz, to Jonathan G. Katz, Secretary, SEC (June 11, 2003), *at* http://www.sec.gov/rules/other/s71003/wachtell061103.htm. (Visited March 16, 2004).

the target, their incentives to bear the costs of a contest are different from those of challengers that seek to improve a firm's performance as a stand-alone entity.

A recent study by one of us documents the dearth of electoral challenges.[14] During the seven-year period 1996-2002, 215 contested proxy solicitations took place, an average of about 30 per year. The majority of the contested solicitations, however, did not involve attempts to replace the board with a new team that would run the firm differently. About a quarter of the cases did not involve the choice of directors at all, but other matters, such as proposed bylaw amendments. Among the cases that did focus on elections for directors, a majority involved a fight over a possible sale of the company or over a possible opening or restructuring of a closed-end fund. Among the thousands of publicly traded firms, contests over who would run the (stand-alone) firm in the future occurred in only about 80 companies during the same seven-year period.

Furthermore, most of the firms in which these contests occurred were small. Only about 10 firms had a market capitalization exceeding $200 million in the year of the proxy fight over control. Thus, for firms with a market capitalization exceeding $200 million, the incidence of such contests was practically negligible – less than two per year on average.

This means the safety valve of potential ouster via the ballot—on which our corporate governance system is supposed to rely — has been all but shut off, The risk of being removed in a proxy contest is far too remote to provide strong incentives for directors to be fully focused on shareholder interests.

To be sure, it is difficult determine precisely the optimal incidence of electoral challenges – the one that would provide directors with sufficient incentives without imposing excessive costs. But there are strong reasons to doubt that this optimal incidence is, essentially, zero. The case for reforms that would make the electoral threat more meaningful than it has been so far is thus very strong.

[14] See Bebchuk, The Case for Shareholder Access to the Ballot, note 1.

Invigorating Corporate Elections

The SEC's Mild Step under Fire

The SEC is now considering a rule that seeks to reduce, in a narrow range of cases, the hurdles impeding electoral challenges to incumbents. The rule would enable shareholders in some special circumstances to place candidates on the corporate ballot for a small number of board seats. Although it is very mild and likely to have a rather limited practical effect, the rule has been strongly resisted by management groups. For example, the Business Roundtable, the influential association of CEOs of leading companies, has mounted a strong attack on the proposal.[15]

Several aspects of the proposed rule make it a very mild first step toward making electoral challenges more viable. First, the direct access procedure would be available in a corporate election only if a triggering event occurred in the preceding annual meeting. There are two possible triggering events: (1) a majority vote in favor of a shareholder proposal in favor of shareholder access; or (2) a 35 percent vote to withhold support from one of the directors. In addition, even if a shareholder access procedure becomes operative, shareholders still need to satisfy substantial ownership and holding requirements to be able to use it.

Furthermore, those shareholders (or groups of shareholders) eligible to place a candidate on the ballot would still bear their own "campaign costs," even if they win, whereas incumbents' costs would be fully borne by the company. This financing disadvantage both strongly discourages challenges and makes those occurring less likely to succeed.[16] Without such reimbursement, challenges to incumbents will still confront excessive impediments.

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[15] See Letter from Henry A. McKinnell, Ph.D., Chairman and CEO, Pfizer Inc., and Chairman The Business roundtable, to Jonathan G. Katz, Secretary, SEC (Dec. 22, 2003), at http://www.sec.gov/rules/proposed/s71903/s71903-381.pdf (Visited March 16, 2004). The main points of this comment letter are put forward in a subsequent paper by the President of the Business Roundtable and one of its lawyers. See Castellani and Goodman, note 2.

[16] See Lucian Bebchuk and Marcel Kahan, "A Framework for Analyzing Legal Policy Towards Proxy Contests," *California Law Review* 78 (1990): 1071-1136.

Finally, the proposed rule makes only a small minority of board seats available to candidates nominated by shareholders and then elected by a majority vote. Only one shareholder-nominated candidate may be placed on the ballot when a board has up to nine seats, and only two when a board has between ten and nineteen seats.

Putting the above together, shareholders dissatisfied with incumbents' performance would have to (i) muster sufficient support from normally passive fellow shareholders to reach one of the triggering thresholds; (ii) wait for the next election, (iii) satisfy the substantial ownership and holding requirements for nominating a candidate, (iv) bear the costs involved in persuading other shareholders to vote for their candidates in a campaign against incumbents who are fully financed by the company itself, and (v) win majority support for their candidates. And if they are successful in each demanding step of the long and costly process, they will be able to place on the board only a relatively small number of shareholders; these directors might have influence by virtue of their presence at board meetings, but will have far from a decisive say.

Conversely, from the perspective of incumbent directors, the proposed change does not expose them to a substantial risk of replacement in the event of dismal performance. Even in the face of widespread dissatisfaction, they would have to fare badly in two votes spaced at least a year apart and, as incumbents, they would have the advantage of being able to outspend their challengers using corporate funds in each of those votes. In any event, only a limited fraction of the current board is vulnerable to replacement in this way. Thus the proposed rule produces only limited pressure on directors to be attentive to shareholder interests.

For all of the above reasons, the proposed rule would be a very mild step. Why has it become the subject of a fierce battle between management groups and some institutional investors and shareholder activists? The reason may well lie in its symbolic significance, rather than its practical consequences: it will be a step toward relaxing management's powerful hold on the proxy machinery. We very much support this rule, mainly because we hope it will facilitate additional steps in this direction in the future.[17] By itself, however, the SEC's shareholder access proposal is unlikely to make directors sufficiently accountable to shareholders.

What Should be Done

What, then, should be done? First, shareholder access to the ballot should be made much easier than it is under the SEC's proposed rule. When a significant group of shareholders wishes to place a candidate on the ballot, there is absolutely no reason to force them to win a victory of sorts in one election and then to wait a year until the next election. Indeed, in some cases where past board performance makes shareholder intervention especially necessary, a long delay may be particularly costly to shareholders. Therefore, in each board election, access to the ballot should be granted to any group of shareholders that satisfies some ownership and threshold requirements (say, ownership of 5 percent of the shares for at least one year prior to the election).

In addition, access should not be limited to attempts to elect a "short slate" that will constitute a small minority on the board. Shareholders satisfying threshold requirements should be able to elect to the board a slate that would replace all or most of the incumbent directors. Such a "long slate" should be accompanied by more expansive disclosure than a "short slate," whose potential impact on the company and shareholders is more limited. But the dearth of electoral challenges outside the hostile takeover context calls for lowering the current impediments to "long slate" challenges.

Beyond providing shareholders with easier access to the corporate ballot, additional measures to invigorate corporate elections should be adopted. Under existing corporate-law rules, incumbents' "campaign" costs are fully covered by the company—a great advantage over outside candidates, who must pay their own way. To lower the financial barrier for challengers, companies should be required to distribute proxy statements by independent nominees who have sufficient initial support and wish to have such materials distributed. Furthermore, companies should be required to

[17] See Letter of Lucian A. Bebchuk to Jonathan G. Katz, Secretary, SEC (Dec. 22, 2003), at http://www.sec.gov/rules/proposed/s71903/labebchuk122203.htm (Visited March 16, 2004)

reimburse reasonable costs incurred by such nominees, at least when they garner sufficient support in the ultimate vote.

These measures could be opposed, of course, on grounds that they would be costly to shareholders. But an improved corporate-elections process would be in the interests of companies and shareholders at large. The proposed measures would not expend corporate resources on nominees whose initial support and chances of winning are negligible; the limited amounts expended on serious challenges would be a small and worthwhile price to pay for an improved system of corporate governance.

Incumbent directors are currently protected from removal not only by the substantial cost to challengers of putting forward a competing slate, but also by staggered boards. In a staggered board, only one third of the members come up for election each year. As a result, no matter how dissatisfied shareholders are, they must prevail in two annual elections to replace a majority of the incumbents and take control way from current management. A majority of public companies now have such an arrangement.

Staggered boards offer insulation not only from proxy contests over the governing team but also against any hostile acquisition of a large block in their company. Corporate-law rules now allow incumbent directors to maintain a "poison pill" defense that practically precludes a potential buyer from acquiring without management's consent a block of shares larger than that specified by the terms of the pill (commonly 10 to 20 percent). As a result, a buyer can purchase a large block of shares over the incumbents' objection only after inducing shareholders to replace the incumbents with a team of directors who favor the acquisition. When the target has a staggered board, supporters of an attractive acquisition offer must win two annual elections—longer than a hostile bidder can typically afford to wait.

The entrenching effect of staggered boards is costly to shareholders. In a recent empirical study, Alma Cohen and one of us find that, controlling for other relevant company characteristics, companies with a charter-based staggered board have a lower market value, with an economically significant median reduction of 4 to 6 percent. Legal reform that would require or encourage firms to have all directors stand for election together could contribute significantly to shareholder wealth.

Setting the Rules

Another way to reduce the extent to which boards of directors can ignore shareholder interests is to take away the board's existing veto power over changes to the company's governance arrangements. These arrangements are set forth either in the rules of the state in which the company is incorporated or in the company's charter. Under long-standing corporate-law rules, only the board – not any group of shareholders, however large -- may initiate and bring to a shareholder vote a proposal to change the state of incorporation or to amend the corporate charter.

The federal securities laws give shareholders the power to express their sentiments in precatory shareholder resolutions, but these resolutions are nonbinding. In recent years, for example, shareholders of companies with staggered boards have increasingly initiated proposals recommending annual election of all directors. Such proposals now commonly attract a majority of the shareholder vote, yet boards often choose to ignore their passage.

Directors' control over the corporate agenda is often justified on grounds that the U.S. corporation is a completely "representative democracy" in which shareholders can act only through their representatives, the directors, never directly. In theory, if shareholders could easily replace directors, that power could be sufficient to induce directors not to stray from corporate wishes on major corporate issues.

As we have seen, however, the removal of directors is rather difficult under existing arrangements, and is unlikely to be easy even under a reformed election process. Furthermore, shareholders may be pleased with management's general performance but still wish to put in place governance arrangements that restrict management. Shareholders should be able to make a change in corporate governance arrangements without concurrently having to replace the board.

The absence of shareholder power to initiate and approve changes in firms' basic corporate governance arrangements has, over time, tilted these arrangements excessively in management's favor. As new issues and circumstances have arisen, firms have tended to adopt charter arrangements that address them efficiently only when they were favored by management, not otherwise. And states seeking to attract corporate incorporation have had incentives to give substantial weight to management preferences, not only to shareholder interests.

Giving shareholders the power to initiate and approve by vote a proposal to reincorporate or to adopt a charter amendment can produce, in one bold stroke, a substantial improvement in the quality of corporate governance. If shareholders had the power to change governance arrangements, desired changes could be expected to occur within the corporation, reducing the need for intervention from outside the firm by regulators, exchanges, or legislators.

Indeed, if shareholders had the power to set the ground rules of corporate governance, they could address some of the problems we have discussed. They could establish rules that invigorate elections or dismantle staggered boards. Shareholders could also, if they so chose, adopt charter amendments that improve the process by which executive pay is set or place whatever limits they deem desirable on pay arrangements.

Objections to Reducing Board Insulation

Management's supporters object strongly to any proposal that could decrease directors' insulation from shareholders and subject them to the threat of removal. They also oppose giving shareholders the power to initiate and approve by vote amendments to the company's charter.

Adverse Consequences

Opponents warn that giving shareholders the power to replace directors and change the corporate charter would have adverse consequences. They argue that such reforms would lead to large-scale disruptions that would distract corporate management.[18] Should contested director elections become the norm, they suggest, companies would be forced to incur substantial out-of-pocket costs. More importantly, management's effort and attention would be diverted from productive activities.

But giving shareholders the power to intervene does not imply that they will use it on a regular basis. Shareholders will actually use it only on those rare occasions in which management deviates substantially from the

[18] See, e.g., Lipton and Rosenblum, note 2, pp. 83-85.

pursuit of shareholder interests and declines to correct itself despite growing shareholder dissatisfaction. Thus, the costs of actual contests will be incurred only in a small set of all companies.

In contrast to the small number of cases in which costs will be incurred, the benefits of greater shareholder power will be system-wide. Recognizing shareholders' power to intervene, management is likely to be more attentive to shareholder interests in the first instance. Tilting the balance of power in favor of shareholders is thus likely to improve the incentives and behavior of management in many publicly traded firms with dispersed ownership. The very viability of shareholder intervention would commonly make it unnecessary to use it.

Opponents also warn that reforms reducing the board's insulation from shareholders would serve not shareholders' interests but those of "special interests."[19] In their view, greater shareholder power to place directors on the board would lead to the election of "special-interest" directors with labor, environmental, or social activist agendas; shareholder power to amend the charter would similarly operate to the benefit of "special-interest" groups. But shareholder power could be exercised only by a vote of shareholders holding a majority of the voted stock, most of which is held by institutional shareholders. And most such institutions vote against management only on those issues where they feel management is acting in a way that clearly hurts shareholder interests.

In addition, opponents of reform argue that the board has an informational advantage in managing the corporation over even the most sophisticated shareholders.[20] But shareholders are aware of the board's informational advantage; past patterns indicate that institutional shareholders display much deference to boards in their voting decisions. The question is whether shareholders should be prevented from intervening on those rare occasions in which they wish to do so. Paternalistic tying of shareholders' hands seems unwarranted, especially given the concentration of stock in the hands of institutional investors. "Management," said the U.S. Supreme Court in one of its securities cases, "should not attribute to investors a child-like simplicity."[21]

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[19] See e.g., Lipton and Rosenblum, note 2, p. 82.

[20] See e.g., Lipton and Rosenblum, note 2, p. 77.

[21] 485 U.S. 224, 234 (1988) (quoting Flamm v. Eberstadt, 814 F. 2d 1169, 1175 (7th Cir. 1987)).

Yet another objection focuses on the interests of long-term shareholders. Increased shareholder power, opponents argue, might cause management to act in a "myopic" way in order to produce short-term results that would avoid shareholder intervention.[22] This corporate myopia argument has been invoked in the early debates on hostile takeovers, when it was raised to justify insulating management from hostile takeovers.[23] But there is no evidence that the myopia effect is sufficiently significant to justify bearing the costs of board insulation; indeed, the empirical evidence clearly indicates that firms with greater insulation from takeover have lower market value and worse operating performance.[24] In any event, myopia-based objections should at most call for giving shareholders the power to intervene only at certain intervals rather than at any time. Such objections cannot provide the basis for a system in which shareholders never have an opportunity, however long they wait, either to amend the corporate charter or to easily replace the board if they so choose.

Finally, the insulation of boards from shareholders, some opponents argue, is necessary so that boards can protect the interests of stakeholders such as employees.[25] But even though board insulation reduces directors' accountability to shareholders, it does not make directors accountable to stakeholders. Rather, it makes directors accountable to no one, protecting them in the event of poor performance that hurts *both* shareholders *and* stakeholders. Those interested in stakeholder protection, therefore, should not support the insulation of boards, but rather seek arrangements tailored specifically to their concerns.

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[22] See, e.g., Lipton and Rosenblum, note 2, p.87.

[23] See, e.g., Martin Lipton, "Takeover Bids in the Target's Boardroom," 35 *The Business Lawyer* 35 (1979):101-134; Jeremy C. Stein, "Takeover Threats and Managerial Myopia," *Journal of Political Economy* 96 (1988): 61-80.

[24] See e.g., Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," *Quarterly Journal of Economics* 118 (2003): 107-155; Lucian Bebchuk andAlma Cohen, "The Costs of Entrenched Boards" (Harvard Law School Working Paper, 2003) available *at* www.law.harvard.edu/faculty/bebchuk/ (Visited March 16, 2004)

[25] See Lipton and Rosenblum, note 2, p. 76.

Not Now

Opponents of giving more power to shareholders also argue that, in any event, now is not the time to consider such a reform.[26] They rely on the 2002 adoption of the Sarbanes-Oxley Act and the 2003 adoption of the new listing standards of the stock exchanges. These reforms, they argue, can be expected to address past problems of corporate governance fully; at the minimum, they suggest, we should wait several years to see the consequences of these reforms before concluding that more is necessary.

As we have shown, however, even though the recent reforms can be expected to improve matters, there is little basis for expecting them in actuality to fully address all the corporate governance problems of the recent past. The 2002 Sarbanes-Oxley Act does place some constraints on boards and executives, but it leaves boards – as it should – with substantial discretion; thus it hardly eliminates concerns about the selection and incentives of directors. Furthermore, as discussed earlier, the director independence requirements cannot, by themselves, be relied on to ensure that directors serve as effective guardians of shareholder interests.

The story that we have told in this book is one that, we hope, will contribute to recognizing the insufficiency of recent reforms. We have shown how directors have been subject to a myriad of economic and social factors that have undermined their effectiveness in carrying out their supposed role. A full appreciation of these factors can enable us not only to understand the practices and outcomes of the past but also to assess the extent to which recent and proposed reforms can be expected to eliminate or outweigh these factors.

Recognition and Reality

We ended chapter fifteen by highlighting the effect that recognizing the problems of executive compensation can have on the reality of executive compensation. We would like to close by emphasizing the importance of the problems resulting from directors' insulation from shareholders. Recognition of these problems is a pre-condition for the reforms necessary to address them.

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[26] See Lipton and Rosenblum, note 2, p. 94.

The power of the board, and its insulation from shareholders, is often viewed as an inevitable corollary of the modern corporation's widely dispersed ownership. But this weakness is partly due to the legal rules that insulate management from shareholder intervention. Changing these rules would reduce the extent to which boards can stray away from shareholder interests and would much improve corporate governance.

Corporate management has for long been a powerful interest group in the politics of U.S. corporate law. The very control that the rules confer on management also gives it substantial power to fight changes in the status quo. As we discussed earlier, supporters of management, led by the Business Roundtable, have been putting up strong resistance even to the extremely mild proposal put forward by the SEC to allow shareholders to place a small number of shareholders on the corporate ballot in some special, and likely rare, circumstances.

For there to be changes in the status quo, the demand for these changes by investors must be sufficient to outweigh the strong power management has to obstruct reforms that chip away at some of its power and private benefits. This can happen only if investors and policymakers recognize the substantial costs that the current arrangements impose, and the extent to which addressing existing problems requires addressing the basic problems of board unaccountability. We hope that this book will contribute to such recognition.

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