

THE NEED FOR FEDERAL PRE-EMPTION OF EXECUTIVE COMPENSATION REFORM: HOW CORPORATE GOVERNANCE AND ECONOMIC JUSTICE OBJECTIVES ARE ONLY ACHIEVABLE THROUGH COMPREHENSIVE FEDERAL REGULATION OF EXECUTIVE COMPENSATION

ARTICLE

*Cory Howard\**

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*Since the beginning of the most recent economic turndown, there has been an increase in the level of attention on the pay that executives at publically traded companies receive. Numerous reforms, including the Dodd-Frank Act and the Troubled Asset Relief Program (TARP), imposed mostly transient, although they included some permanent, limitations on executive compensation packages. However, given the importance of executive compensation reform to both corporate governance and economic/social justice initiatives, it is imperative that the federal legislature do more.*

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\* J.D. Candidate Class of 2014, Wake Forest School of Law. The issues presented in this article were originally outlined in an essay published by The Student Appeal on May 6, 2013. This essay further elaborates on that essay and identifies new challenges and solutions pertaining to the ongoing debate about executive compensation reform. The author would also like to thank Sara White for her continued support, without which this article would not have been possible.

*This article will explore some of the patchwork of regulations that the federal government has enacted and the methods that the states use to control executive compensation. After examining the failure of the states to curb excessive compensation, and noting the problems that will prevent them from ever doing so, the author asserts that comprehensive federal regulation is the only way to ensure that this very important challenge is tackled. By exploring some potential ways that Congress could do so, this article will show the practical, social, and legal benefits of wholesale federal regulation.*

## I. Introduction

Executive compensation has been a persistent problem in corporate law<sup>1</sup>, not only because of the drastic impact it has on corporate governance efforts, but also due to concerns over economic justice and societal fairness<sup>2</sup>. However, during the most recent economic crisis gave rise to a particularly heated polarizing debate over the issue of executive remuneration, especially when there was a perceived gap between executive pay and corporate performance. Although high executive compensation has been justified by the belief that it is designed to reflect corporate performance, that it simply rewards leaders of successful companies with high pay, during the past two decades executive compensation has dramatically increased without any corresponding relationship to a company's performance.<sup>3</sup> Due to the stagnation in proportionality, policy makers and academics began to increase their calls for reforms to executive compensation programs, and the movement has been gaining strength for some time. However, regulation, especially direct control by the federal government, has received mixed support at best.<sup>4</sup> While academic and

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<sup>1</sup> Richard A. Booth, *Executive Compensation, Corporate Governance, and the Partner-Manager*, 2005 U. Ill. L. Rev. 269, 269 (2005) (noting that concerns over executive compensation are persistent and unavoidable in corporate law).

<sup>2</sup> Thomas Prosser, *Executive Compensation and the Economic Crisis*, Negotiating Out of the Crisis 2 (Nov. 25, 2009), <http://forum2009.itcilo.org/en/thematical-papers/executive-compensation-and-the-economic-crisis> (last visited on May 14, 2013).

<sup>3</sup> See Steven H. Kropp, *Corporate Governance, Executive Compensation, Corporate Performance and Worker's Rights in Bankruptcy: Some Lessons from Game Theory*, 57 Depaul L. Rev. 1, 5 (2007) (noting that in recent history executive compensation has ridden without a corresponding increase in corporate profits, thus removing the traditional rationale for the issuance of high executive compensation packages.)

<sup>4</sup> 17% Favor Government Regulation of Executive Pay, Rasmussen Reports, [http://www.rasmussenreports.com/public\\_content/business/general\\_business/april\\_2012/17\\_favor\\_government\\_regulation\\_of\\_all\\_executive\\_pay](http://www.rasmussenreports.com/public_content/business/general_business/april_2012/17_favor_government_regulation_of_all_executive_pay) (last visited Apr. 23, 2012), (noting that although 95% of people polled thought that executive compensation was too high, just 17% supported federal regulation of corporate pay).

popular criticism over executive pay and failed reforms demonstrates that faith in the current system is a minority belief, there is little consensus as to which reforms would most effectively rein in extravagant executive pay packages,<sup>5</sup> or even who should be implementing these reforms. In the post-recovery period, states have begun to target executive pay, albeit as it pertains to executives in the non-profit sector, and it is only a matter of time before political pressure forces governors and state legislators to tackle the issue of pay in the for-profit sector.<sup>6</sup> As it stands, federal regulations concerning executive compensation create nothing more than a patchwork of checklist regulations that do little to force corporation to seriously address underlying issues.

Given the success that temporary federal regulation has had on combating problems associated with executive compensation,<sup>7</sup> there is no better alternative to manage executive pay than permanent and complete regulation of this area. This article will argue that since controlling executive pay is essential to corporate governance efforts and necessary to tackle broader social and economic problems, it should therefore be under the direct control of lawmakers in Washington. By looking at the current state law approach to the regulation of executive compensation, this article will show that states are simply inadequately prepared to reform the rising level of pay, while recent federal government has begun to adequately address the issue. Additionally, this author will propose potential solutions to the executive compensation problem, focusing not only on reigning agency costs, but also on using executive compensation to further broader social and economic policy agendas. Ultimately, this article will argue that aligning executive and shareholder interests through regulation at the federal level is the most effective way to control the increasing rates of executive compensation, and that this objective serves as a

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<sup>5</sup> Randall S. Thomas and Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting and Officer's Fiduciary Duty*, 95 Minn. L. Rev. 846, 848 (2011). (explaining that while there is a general consensus in public opinion and academia, there is no consensus as to the best reforms to implement to control executive compensation).

<sup>6</sup> John Eligon, *Cuomo Limits State Money for Salary of Contractors*, [http://www.nytimes.com/2012/01/19/nyregion/cuomo-limits-state-money-for-salaries-of-contractors.html?\\_r=0](http://www.nytimes.com/2012/01/19/nyregion/cuomo-limits-state-money-for-salaries-of-contractors.html?_r=0) (May 13, 2013), (explaining that Gov. Andrew Cuomo's Executive Order limits the pay of non-profit executives at companies with state contracts); Harvy Lipman, *State Efforts to Cap Non-Profit CEO Pay Drawing Attention*, NorthJersey.Com (last visited May 12, 2013), [http://www.northjersey.com/news/160206715\\_New\\_attention\\_directed\\_at\\_non-profit\\_CEO\\_pay.html?page=all](http://www.northjersey.com/news/160206715_New_attention_directed_at_non-profit_CEO_pay.html?page=all) (noting that Gov. Cuomo of New York introduced legislation to limit the pay of non-profit executives to \$199,000 in companies that have state contracts). However, Gov. Cuomo's executive order only limits how much tax-payer money can be spent towards executive compensation of for-profit companies, which leaves those corporations free to use other income sources to bolster high executive compensation.

<sup>7</sup> See Jeremiah Thomas, *TARP'S Hard Line on Executive Compensation: Misaligned Incentives and Constitutional Hurdles*, 70 Ohio State L. J. 1307, 1312-1314 (2010) (noting the restrictions and limitations that the EESA and TARP placed on the structure and make-up of executive compensation packages at corporation's that accepted bail out funds).

stepping-stone, although an integral one, to broader, social, economic and corporate governance reforms.

## **II. The Importance of Limiting Executive Pay to Reinforce Corporate Governance Mechanisms**

Some academics have underplayed the importance of serious resource allocation to executive compensation reform, arguing that overemphasizing it has served as a “blue pill” for lawmakers, that is, as a diversion that pulls attention away from more important economic, social and corporate governance issues.<sup>8</sup> However, reforming executive compensation is an essential element for subsequent, and more meaningful changes in social and economic issues as well. Even beyond corporate governance, reforming executive compensation is a vital step for lawmakers who wish to address more pressing economic issues, such as socio-economic inequality.<sup>9</sup> Additionally, since a corporation’s executives possess a substantial amount of political power, not just because of their personal income, but more importantly because of their ability to direct their corporations’ immense resources,<sup>10</sup> executive compensation must be reformed to ensure that corporations do not merely become a vehicle for executives’ power wielding.<sup>11</sup> This section of the article will examine the goals of corporate governance, identify the primary objectives of reforming executive compensation, and will ultimately conclude that executive compensation is an integral goal not just for corporate governance scholars, but for those concerned with broader social and economic justice.

### **A. How Executive Compensation is Important to Corporate Governance**

Corporate governance is focused on processes, most notably “the process by which business decisions are made and the process by which the persons who will

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<sup>8</sup> See generally Omari Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. Rev. 299, 306 (2009) (explaining that overemphasis on the issue of executive compensation is a distraction from issues like healthcare, minimum wage and social security that are more relevant to ordinary Americans).

<sup>9</sup> Daniel J. Morrissey, *Executive Compensation and Income Inequality*, 4 W&M Bus. L. Rev. 1 (2012) ; See AFL-CIO, *Nation of Inequality: Exorbitant CEO Pay is a Festering Problem*, <http://www.post-gazette.com/stories/opinion/editorials/nation-of-inequality-exorbitant-ceo-pay-is-a-festering-problem-632933/> (last visited May 13, 2013), (noting that the problem with income inequality begins with tackling excessive pay at the top of corporations).

<sup>10</sup> Brett H. McDonnell, *Two Goals for Executive Compensation Reform*, 52 N.Y.L. Sch. L. Rev. 585, 594 (2008) (explaining that executive compensation should be of concern to scholars and lawmakers who wish to address not just economic inequality, but political inequality as well).

<sup>11</sup> By regulating excessive executive compensation to further ensure that executives were placing shareholders’ interests first, non-essential political activities, traditionally undertaken to further executives’ desire for power, can be controlled. See James A. McConvill, *Positive Corporate Governance*, 6 J. of Bus. & Sec. L. 51, 51 (2006).

make those decisions are chosen”,<sup>12</sup> or in this case, compensated. Academics are concerned with corporate governance mechanisms, or systems, that are the legal settings in which the corporation must operate, which include internal corporate rules and norms, shareholder rules, and federal regulations (including securities regulation).<sup>13</sup> Most important to the discussion about corporate governance is the relationship between shareholders and directors. Any discussion about executive compensation will certainly highlight the notion that excessive pay furthers the divide between these two parties.<sup>14</sup> Furthermore, corporate governance is increasingly seen as a way to ensure ethical corporate behavior and commitment to fixing other social and economic issues<sup>15</sup> that the amount and structure of executive compensation can help achieve.

Academics have identified a variety of reasons why reforming executive compensation is essential to the continued efforts of a variety of actors to implement mechanisms of corporate governance. For example, the problem of executive compensation is seen as: 1) a threat to shareholders that “rely on the availability of accurate disclosure of complete compensation data to assess company prospects”,<sup>16</sup> 2) an absence of board independence evidence by a lack of “arms-length” contracting,<sup>17</sup> and 3) a lack of shareholder control over the issuance and later say on executive compensation packages.<sup>18</sup> The first and third purposes of reforming corporate compensation are indicative of a more widespread problem. Directors and executives who approve and receive excessive compensation are not only acting contrary to shareholders’ best interests, but are doing so in a way that not only jeopardizes the firm, but creates systemic

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<sup>12</sup> David C. McBride, *For Whom Does this Bell Toll?: Proposed Regulations in Response to the Financial Crisis Have Some Observers Predicting a Negative Impact on Delaware Corporate Law*, 27-Fall Del. Law. 28, 29-30 (2009).

<sup>13</sup> Amir N. Licht, *The Mother of All Path Dependencies Toward a Cross-Cultural Theory of Corporate Governance*, 26 Del. J. Corp. L. 147, 147 (2001).

<sup>14</sup> Paula J. Dalley, *Shareholder (and Director) Fiduciary Duties and Shareholder Activism*, 8 Hous. Bus. & Tax J. 301, 310-311(2008) (noting that corporate governance is primarily concerned with reducing agency costs). Excessive pay is deemed to further agency costs as executives are paid more than is necessary for their services (a diminishing return on shareholder’s investment), money that the shareholders would rather see directed on activities that produce more profit per dollar invested.

<sup>15</sup> U.N. Global Compact and the Global Corporate Governance Forum, *Corporate Governance: The Foundation for Corporate Citizenship and Sustainable Business 1* (2011) (explaining that corporate governance is increasingly concerned with corporate citizenship, sustainability and other non-traditional issues).

<sup>16</sup> Jennifer S. Martin, *The House of Mouse and Beyond: Assessing the SEC Efforts to Regulate Executive Compensation*, 32 Del. J. Corp. L. 481, 485-486 (2007).

<sup>17</sup> *Id.* (noting that if executives are using their influence over directors to negotiate excessive compensation packages, this could be an indication of a more significant problem, generally referred to as board capture).

<sup>18</sup> *Id.* (explaining that shareholders lack a significant voice before or after the issuance of executive compensation packages).

risks to the economy.<sup>19</sup> Excessive executive compensation poses a grave threat to corporate governance, not only because it threatens to create risk-prone executives, but also because it furthers agency costs by incentivizing executives and directors to diverge from shareholder interests, one of the fundamental problems that corporate governance is intended to address.<sup>20</sup>

Additionally, federal reform of executive compensation should be an essential part of corporate governance because it further empowers shareholders to remove underperforming executives. There is a wealth of anecdotal and statistical evidence that compensation reforms, especially *say-on-pay* votes, are widely successful in forcing corporate boards to listen to shareholders, even if they were initially skeptical.<sup>21</sup> Although these votes on compensation are not (yet) binding, losing a vote would be embarrassing for a company<sup>22</sup> and often times may signal, or hasten the departure of C-Sweep executives.<sup>23</sup> It is apparent that executive compensation votes have gone beyond merely passive expressions of board actions that can be easily ignored by corporate executives. Even non-binding votes have become powerful tools for shareholders to annually show their displeasure with the direction that the corporation is headed and pressure the boards to change the composition of the executive slate. While *say-on-pay* votes are now a federally mandated requirement for corporations<sup>24</sup>, in order to effectively control executive compensation, stronger (read: binding) votes are drastically needed. Binding votes

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<sup>19</sup> John C. Coffee, Jr., Symposium, *The Political Economy of Dodd-Frank: Why Financial Reform Tends to be Frustrated and Systemic Risk Perpetuated*, 97 Cornell L. Rev. 1019, 1049 (explaining that there is a hypothesis that excessive compensation, including equity-based compensation, induced risky decision making by corporate executives).

<sup>20</sup> Zenichi Shishido, *Japanese Corporate Governance: The Hidden Problems of Corporate Law and their Solutions*, 25 Del. J. Corp. L. 189, 193 n. 6 (2000) (noting that although the theory of corporate governance can be broken down into two distinct parts, the primary one is concerned with the shareholder-agent relationship).

<sup>21</sup> Joann S. Lublin, *Firms Feel 'Say on Pay' Effects*, <http://online.wsj.com/article/SB10001424052748704473104576293140070753066.html> (last visited May 13, 2013) (noting that *say on pay* votes has “sparked boardroom debate on executive pay practices that were [previously] just rubber-stamped”).

<sup>22</sup> *Id.*

<sup>23</sup> David Henry and Ross Kerber, *Citigroup Loses Advisory Vote on Executive Compensation*, <http://www.reuters.com/article/2012/04/17/us-citi-vote-idUSBRE83G15U20120417> (last visited May 13, 2013), (noting that Citigroup’s shareholders voted down the executive pay package for perceived failure of Chief Executive Vikram Pandit); David Henry and Ross Kerber, *Citigroup Bows to Shareholder Pressure, Overhauls Pay*, <http://news.yahoo.com/citigroup-bows-shareholder-pressure-overhauls-pay-031048164-sector.html> (last visited May 13, 2013) (noting that the shareholder vote of no confidence in Citigroup’s executive compensation package helped hasten the) departure of Vikram Pandit).

<sup>24</sup> Bruce J. McNeil and Littler Mendelson, *The Evolving Say on Dodd-Frank’s ‘Say on Pay’*, Society for Human Resource Management (May 4, 2012) (noting that § 951 of the Dodd-Frank Act requires corporations to put their executive compensation plans up for a non-binding vote at least once every three years).



not only given shareholders more hard power (in the form of control over business decisions), but will also result in an increase in shareholder “soft power”, further strengthening their bargaining power with management.

### **B. How Limiting Executive Compensation Furthers More Important Social and Economic Justice Initiatives**

Although reforming executive compensation is essential to the more traditional goals of corporate governance, it is also a focal point from which lawmakers can address more serious social and economic issues. Some academics see politicians’ overemphasis on executive compensation as a “blue pill”, or an unnecessary distraction from other, more pressing social and economic issues.<sup>25</sup> Although executive compensation could be an example of political grandstanding to curry favor from an electoral base, some reforms have attempted to address important social issues, such as income inequality.<sup>26</sup> Currently, a chief executive officer makes about 400 times more than the average worker in the company, which is offensive not only to the dynamism of capitalism, but to broader social justice concerns.<sup>27</sup> These statistics are used to tell us what social scientists have just begun to realize: that the gap between the top 10% of workers and the other 90%, a gap which has grown since the end of World War II, has been driven primarily by increases in pay to corporate executives and financiers.<sup>28</sup> As a result, this article directly rejects the assertion that “the reduction of executive pay for a few individuals at the top of the wealth pyramid may ameliorate populist outrage, but does not necessarily put money back in the hands of ordinary Americans”.<sup>29</sup> It is clear that the upward trend of executive compensation, when left unchecked, exacerbates an already dangerous problem by increasing the wage gap. CEOs and other executives receive annual raises, sometimes in the double digits, while companies fail to add employees to their payrolls.<sup>30</sup> Reducing the amount paid to executives may free up capital that

<sup>25</sup> Simmons, *supra* n. 8, at 305 (noting that too much attention on executive compensation directs lawmakers’ attention away from more pressing issues).

<sup>26</sup> Steven Balsam, *Taxes and Executive Compensation*, Economic Policy Institute Report, <http://www.epi.org/publication/taxes-executive-compensation/> (last visited May 13, 2013),

<sup>27</sup> Steven C. Caywood, Note, *Wasting the Corporate Waste Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation*, 109 Mich. L. Rev. 111, 112 (2010).

<sup>28</sup> Morrissey, *supra* n. 9, at 5 (2012).

<sup>29</sup> Simmons, *supra* n. 8, at 205 (stating that the preoccupation with reducing executive compensation in the name of economic inequality makes it a blue pill as it would have little effect on the broader problem).

<sup>30</sup> Matt Krantz and Barbara Hansen, *CEO Pay Rises Again in 2011, while Workers Struggle to Find Work*, <http://usatoday30.usatoday.com/money/workplace/story/2012-03-28/ceo-pay-executive-compensation/53839786/1> (last visited May 13, 2013), (explaining that executive pay is rising at a time when pay rolls are shrinking).

corporations can use to hire more employees or increase salaries company-wide.

But reforming executive compensation goes beyond merely trying to close the gap in pay; it has the potential to bring executives back in touch with the employees hired to their payroll and whose jobs hang in the balance of executives' decisions. This concern is exacerbated by the fact that executive compensation packages often reward risky business decisions. The equity based compensation packages made popular in the 1990s enabled executives to focus on the market and to "physiologically distance themselves from their employees".<sup>31</sup> This created serious risks, as executives failed to properly consider stakeholder objectives in their decision making and lead to large-scale layoffs, liquidation, and pay cuts in order to achieve the financial objectives tied to compensation bonuses.

### **III. The Race to the Bottom: Why Pre-Emption of Executive Compensation Guarantees Actual Reform**

#### **A. Executive Compensation as an Issue for the States**

Although the federal government extended its reach over executive compensation regulation during the immediate aftermath of the most recent financial crisis, states still have a significant interest in regulating executive compensation.<sup>32</sup> Since many states have not passed updated statutes to curb excessive executive compensation, there is a significant body of state case law governing the relation between management and shareholders, which is normally how shareholder derivative suits frame the issue when seeking reform.<sup>33</sup> However, leaving the issue of executive compensation to the states has proven a hopeless measure for academics and policy makers who wish to see real reform. In order to effectively explore the possibility of state regulation, this article will look at how Delaware has traditionally handled executive compensation, paying special attention to the means and methods that the Court of Chancery has used to address the issue. This case-study will also show that the integral problem with allowing states to regulate compensation is a

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<sup>31</sup> Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 Iowa J. Corp. L. 265, 321 (2012) (explaining that current executive compensation packages allow executives to distance themselves from employees, which, in turn, allows them to pursue actions inimical to the good of employees).

<sup>32</sup> See Jennifer S. Martin, *The House of Mouse and Beyond: Assessing the SEC's Efforts to Regulate Executive Compensation*, 32 Del. J. Corp. L. 481, 537 (2007) (noting that since corporations are the creation of state law it is states, not the federal government, that have an interest in and the capability of policing executive compensation).

<sup>33</sup> T. Leigh Anenson & Donald O. Mayer, "Clean Hands" and the CEO: *Equity as an Antidote for Excessive Compensation*, 12 U. Pa. J. Bus. L. 947, 970 (2010) (noting that states have a well-developed body of law surrounding the interactions and duties between shareholders and management, which makes shareholder derivative suits challenging compensation of special interest to the states).



phenomenon known as the “race to the bottom”, where state courts and legislators make director favorable decisions in order to attract business charters at the expense of shareholder and stakeholder protection.

### B. How States Attempt to Limit Executive Compensation

Although recent legislation has shown the federal government’s dedication to reforming executive compensation itself, it is still important to look at how states have historically attempted to limit executive compensation. By examining the actions taken by Delaware courts, we can begin to see how even in a state with business laws that are as developed as Delaware’s, the mechanisms put in place to curb excessive pay are completely inadequate. In Delaware, “directors have the power, authority and wide discretion to make decisions on executive compensation”.<sup>34</sup> Delaware courts have traditionally imposed two duties on directors, the duty of care and the duty of loyalty,<sup>35</sup> which also extends to their decisions on executive compensation. Both are historically deferential standards, with the business judgment rule governing the duty of loyalty and the doctrine of waste governing the duty of care. These flexible standards have given directors a wide berth to set varying, yet legally acceptable levels of compensation.<sup>36</sup>

Although both duties are challengeable for executive compensation decisions, most shareholder suits concerning excessive compensation packages traditionally have invoked the corporate waste doctrine.<sup>37</sup> In an action alleging corporate waste, shareholders allege that the level of executive compensation amounted to a waste of corporate resources.<sup>38</sup> However, given the deferential rules governing these types of actions and the impossibly high standards for proving waste,<sup>39</sup> the doctrine is rarely used and fails to serve as a practical limit on executive compensation. A prime example of the state’s inability to effectively curb compensation under this scheme is the Delaware Court of Chancery’s decision in both the *Disney* cases. There is simply no state law or legislation that imposes duties of disclosure, claw-back provisions or shareholder say in the compensation process, all reforms which have proven effective at regulating excessive compensation. Thus, the current state-

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<sup>34</sup> *Brehm v. Eisner*, 746 A.2d 244, 262 (Del. 2000).

<sup>35</sup> Gregg M. Galardi and Bruce Grohsgal, *Executive Compensation and the Great Recession*, 28-Fall Del. Law. 24, 25 (2010) (explaining that Delaware has traditionally only imposed the duty of care and loyalty on directors of corporations).

<sup>36</sup> *Id.* (noting that both doctrines are extraordinarily deferential to the directors of corporations).

<sup>37</sup> Caywood, *supra* n. 27, at 114-115 (explaining that the corporate waste doctrine is traditionally the action under which shareholders challenge executive compensation packages).

<sup>38</sup> *Id.* at 114 (2010). (explaining how a shareholder would challenge a compensation package under the corporate waste doctrine).

<sup>39</sup> *Id.* at 115 (noting that the corporate waste doctrine is rarely used because of the high standards that plaintiff/shareholders must meet).

law mechanisms are inadequate when compared to current federal regulations.

Some reformers have suggested relying on shareholder derivative suits in order to reign in compensation. But even if state courts were responsible for policing executive compensation, there are many practical impediments that prevent courts from enacting this duty efficiently. In instances where courts have ruled in favor of or defendant boards, they have not necessarily done so under the firm belief that the compensation was reasonable, rather “courts are ill-equipped to solve or even to grapple with [the] entangled economic problems”<sup>40</sup> that comparing compensation would entail. This defendant friendly attitude extends to other states as well. In a New York State case the court explicitly rejected the notion that the judiciary should serve as the primary gatekeeper of executive compensation and instead believed that this was an issue for the shareholders.<sup>41</sup> Even today, 70 years after the New York State court’s decision, state courts are no more equipped to determine an adequate compensation level.<sup>42</sup> As a result, too many derivative waste suits are dismissed at a premature stage in the litigation process and are still subject to the rigorous hurdles, such as derivative demand requirements.<sup>43</sup>

### C. The “Race to the Bottom”

Even if states were to develop legislation that could effectively regulate executive compensation, leaving regulation to the states is still an ineffective way of bringing about real reform. When discussing reforms in corporate governance, commentators have to account for the concept of “regulatory competition” in state law. Colloquially known as the “race to the bottom”, regulatory competition concerns the effects of state corporate chartering, with companies electing to charter in states whose body of law is more management friendly (race to the bottom) versus states whose laws favor shareholders (race to the top).<sup>44</sup> If executive compensation becomes the domain of state lawmakers, another race could occur, this time with management making strategic decisions to charter or re-charter the corporations they run and maximize their compensation packages without fearing government interference.

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<sup>40</sup> *Heller v. Boyland*, 29 N.Y.S.2d 653, 680 (1941).

<sup>41</sup> *Id.* (stating that “their [shareholders] solution is not within the judicial province... what is reasonable compensation for its [corporation’s] officers is primarily for the shareholders).

<sup>42</sup> Caywood, *supra* n. 27, at 115 (noting that there has been little reform and development of the corporate waste doctrine due to its relatively infrequent use and little accompanying academic literature).

<sup>43</sup> *Id.* at 120 (noting that the failure to properly develop the doctrine of waste has lead the Delaware Court of Chancery to dismiss too many derivative lawsuits and that the Chancery Rule 23.1 requires demand of waste derivative claims).

<sup>44</sup> Corporate Governance: *Law, Theory and Policy*, 91 (John Yoo. Ed, 2004) (noting that in the discussion about corporate chartering, states engage in the races to attract companies based on their pro-management or shareholder corporate laws).

Even if states could toughen fiduciary duties through judicial rulings, there would likely be significant pressure not to do so in order to retain and attract corporate charters.<sup>45</sup> Although there is currently little threat of state entities changing their application of legal mechanisms used to check executive compensation (such as the doctrine of waste), lawmakers' attention to the issue in different states could produce increasingly deferential legislation governing the limits on compensation. An even greater problem would arise if states permitted Delaware to take the lead, as it often does so regarding corporate legal issues, as there is little incentive for Delaware to get corporate governance right.<sup>46</sup>

Although state legislatures and judiciaries are not viable bodies that can be entrusted to manage executive compensation, handing over control to the federal government does not have to be the next logical step. One possibility could be to increase corporate self-governance, allowing companies and shareholders to regulate the type and level of compensation that is given, without governmental interference. However, one cannot trust that corporations and shareholders will effectively implement executive compensation changes. Corporations are currently reluctant to turn to common-law for relief from executives who have breached their fiduciary duties and shareholder derivative litigation is often unsuccessful.<sup>47</sup> Self-governance is already in place to some extent, as corporations have been tasked with assessing their own compensatory practices to determine if they can have a "material adverse effect on the institution".<sup>48</sup> However, there are still too many ways for the corporation to submit the necessary disclosure form without taking a serious look at their compensation practices,<sup>49</sup> thus proving that self-governance is

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<sup>45</sup> See J. Robert Brown, Jr., *Corporate Governance and the Problem of Executive Compensation: Introduction*, <http://www.theracetothetbottom.org/executive-comp/2012/6/28/corporate-governance-and-the-problem-of-executive-compensati-2.html> (last visited May 13, 2013) (hypothesizing that states, in an effort to retrain corporate charters, would not participate individually in executive compensation reform efforts).

<sup>46</sup> Steven A. Ramirez, *The Special Interest Race to CEO Primacy and the End of Corporate Governance Law*, 32 Del. J. Corp. L. 345, 347 (2007) (noting that although Delaware has historically been recognized as the base for legal decisions of business issues which other states then follow, this is a significant problem for corporate governance because Delaware lacks sufficient interest making pro-shareholder laws).

<sup>47</sup> Matthew A. Melone, *Adding Insult to Injury: The Federal Income Tax Consequence of the Clawback of Executive Compensation*, 25 Akron Tax J. 55, 61 (2010) (suggesting that corporations and shareholders are often unsuccessful, or unwilling, in their attempt to recover compensation under clawback provisions).

<sup>48</sup> Jeff Capwell et al., *SEC Revises Executive Comp and Governance Disclosure for 2010*, Business Law Today 2 (Apr. 19, 2010) (noting that beginning in 2009, the SEC enacted a Final Rule which required companies to address its compensation policies and practices to determine if they could materially impact the institution).

<sup>49</sup> Patricia O. Lowry, *Directors Under Fire: Recent and Proposed SEC Regulations that Could Change the 2010 Annual Meeting Landscape*, 2010 WL 894702 7 (2010) (explaining that there is no requirement requiring an affirmative statement that the issue be considered and that the regulation can be circumvented with a one-sentence explanation).

almost completely ineffective. The two primary actors in this battle are either not interested in reforming executive compensation or unable to do so. It is this kind of stalemate that has contributed to the skyrocketing level of executive compensation and therefore requires another actor, in this case the federal government, to be solely responsible for regulating executive pay.

#### IV. Current Federal Reforms to Executive Compensation

Federal reforms enacted in response to the most recent economic downturn contain a high number of provisions that seek to reform executive compensation through a variety of mechanisms.<sup>50</sup> In fact, through the imposition of these limitations the federal government has effectively seized the issue of executive compensation.<sup>51</sup> Several pieces of legislation passed by Congress as a response to the economic turmoil of 2009, contained key provisions that attempted to limit executive compensation. The Emergency Economic Stabilization Act of 2008 (the “EESA”) and the Dodd-Frank Act (Dodd-Frank) included various provisions that showed lawmakers’ commitment to tackling the issue, and not merely to curry favor with their constituents, but instead to reign in corporate behavior via reforms to executive compensation. However, before anointing the federal government as the new source of executive pay reform and regulation, it is important to examine recent reforms that Congress has passed in response to the most recent economic downturn to see if they can effectively reform compensation better than the states. Reforms and regulations imposed through Dodd-Frank, the EESA and Sarbanes-Oxley all point to the federal desire to create a system that ensures a pay structure that properly aligns the executive and shareholder interests, reduces long-term systemic risk and alleviates social and economic disparities,<sup>52</sup> further lending credence to the belief that the federal government is better equipped to handle this issue than the states.

Although most legislation that tackles executive compensation focuses on one type of control (direct cap, tax incentives, or severance limitations), the Emergency Economic Stabilization Act (EESA) implemented a wide variety of reforms on corporations that accepted government funds. The act, which was passed in order to allow the Treasury to access over \$700 billion in funds to ensure stability in financial

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<sup>50</sup> Much of the legislation passed during the recession contained some provisions to address executive compensation. The Emergency Economic Stabilization Act, the Dodd-Frank Act and TARP all imposed limitations and regulations on executive compensation, in addition to those already imposed by Sarbanes-Oxley and state common law.

<sup>51</sup> Renee M. Jones, *The Role of Good Faith in Delaware: How Open-Ended Standards Help Delaware Preserve its Edge*, 55 N.Y.L. Sch. L. Rev. 499, 519 (2011) (noting that the imposition of federal reforms on executive compensation via the Dodd-Frank Act had effectively placed executive compensation into the realm of federal control).

<sup>52</sup> See generally Michael Faulkender et al., *Executive Compensation: An Overview of Research on Corporate Practices and Proposed Reforms*, 22 J. of Applied Corp. Finance 107 (2010) (exploring the public policy behind reforming executive compensation in light of the most recent financial crisis).

markets during the recession, contained provisions that allowed the Treasury to impose compensation restrictions on participating institutions.<sup>53</sup> In an effort to align the incentives of shareholders and taxpayers with executives, the Treasury imposed hard caps on compensation, limited tax deductions that corporations can claim for executive compensation, regulated golden parachutes and implemented clawback provisions.<sup>54</sup> These regulations, though unpopular in the financial industry, clearly influenced corporations such as Bank of America and Citigroup, who made it a priority to pay back the assistance they received through the Troubled Asset Relief Program (TARP) in order to shed the restrictions on executive compensation for fear of losing top talent.<sup>55</sup> If implemented on a wide scale, whether that be to companies whose executives' pay is not proportional to their success or where shareholders have voted the compensation excessive, these kinds of sweeping reforms can have serious effects on corporate behavior.

Dodd-Frank is another example of the federal government's intent to create an executive compensation system that more closely aligns the interests of executives with those of shareholders, or at least make directors who set compensation packages accountable to the corporation's shareholders. In fact, Section 951 of the Dodd-Frank Act created the "say on pay" clause in an attempt to give shareholders a somewhat active voice in the compensation process.<sup>56</sup> The "say on pay" provisions give shareholders a chance to "comment on the reasonableness of CEO compensation".<sup>57</sup> Although it is not binding, the "say on pay" provision has drastically increased the voice of shareholders. As a result of even non-binding say-on-pay votes, companies have created separate websites to receive comments from shareholders and directors. This enables them to regularly communicate with shareholders instead of just during proxy season.<sup>58</sup> While this does not in itself

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<sup>53</sup> Davis, Polk & Wardwell, *New Executive Compensation Restrictions Under the Emergency Economic Stabilization Act of 2008*, available at <http://www.davispolk.com/1485409/clientmemos/2009/02.05.09.ec.pdf> (last visited May 14, 2013).

<sup>54</sup> *Id.* at 2-5 (listing and explaining the limitations to executive compensation that the Treasury individually negotiated with institutions who received funds via the EESA).

<sup>55</sup> Michael S. Melbinger, *Executive Compensation and Risk: TARP Rules for Financial Institutions Trigger Broader Risk Assessment of Compensation Policies*, 14 N.C. Banking Inst. 59, 60-61 (2010) (explaining that corporations who were subject to the executive compensation restrictions imposed by the Treasury ensured that the loans were paid back quickly so that they would no longer have to abide by the compensation regulations).

<sup>56</sup> Dallas, *supra* n. 31, at 352 (noting that the "say on pay" provision of Dodd-Frank was an attempt to give shareholders an advisory role in the compensation process).

<sup>57</sup> J. Robert Brown, Jr., *Dodd-Frank, Compensation Rations, and the Expanding Role of Shareholders in the Governance Process*, 2 Harvard Business Law Review Online 91, 97 (2011) (noting that the shareholder advisory role created by the Dodd-Frank Act gives shareholders the ability to voice their opinion on executive compensation levels).

<sup>58</sup> Katayun Jaffari and Josh D. Bobrin, *Dodd-Frank: Effects of Say-on Pay Two Years Later*, <http://www.law.com/jsp/pa/PubArticlePA.jsp?id=1202574990615&slreturn=20121106152542> (last visited May 14, 2013) (noting that the say-on-pay requirement has dramatically increased communication between shareholders and directors).



ensure that shareholders can effectively voice their concerns over a wider range of issues, it does give directors and shareholders a new forum, and a new reason to maintain year-long communication, which could lay the groundwork for the discussion of other issues.

Additionally, Section 953(b) of Dodd-Frank required all publically traded corporations to disclose the compensation ratio documenting the ratio that the CEO is paid relative to other employees.<sup>59</sup> This idea of proportionality, that executive compensation should be in proportion with employee salaries, has long been recognized by key government figures such as Federal Reserve Chairmen Ben Bernake, who has previously stated that it is as an integral component of executive compensation.<sup>60</sup> Not only is proportionality an important aspect of reducing agency costs by increasing stock prices,<sup>61</sup> but it also helps to address income inequality. There is little evidence to show that the income gap can be changed through an increase in employee wages; the more feasible solution is a reduction of executive compensation.<sup>62</sup> Therefore, making the workers aware of the gap will increase team discontent and office strife and lead to calls for reform.<sup>63</sup> Although it is possible that a corporation could increase the average wage, it is much more likely they will reform executive compensation to reduce the perceived pay gap and quiet the discontent.

Another significant attempt to align shareholder and executive interests came in the claw-back provisions contained in Sarbanes-Oxley. Under Section 304 of Sarbanes-Oxley, executives who were involved in illegal activity risk having portions of their compensation earned through fraudulent means stripped from them.<sup>64</sup> This reform became increasingly important during the most recent

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<sup>59</sup> Karen M. Kroll, *The Growing Backlash Over CEO 'Pay Ratios'*, [http://www.cio.com/article/699333/The\\_Growing\\_Backlash\\_Over\\_CEO\\_Pay\\_Ratios](http://www.cio.com/article/699333/The_Growing_Backlash_Over_CEO_Pay_Ratios) (last visited May 14, 2013) (explaining the new disclosure requirement imposed by Dodd-Frank).

<sup>60</sup> Ryan Grim, *Sign of the Times: Bernake Endorses Executive Compensation Reform*, [http://www.huffingtonpost.com/2009/03/24/sign-of-the-times-berank\\_n\\_178537.html](http://www.huffingtonpost.com/2009/03/24/sign-of-the-times-berank_n_178537.html) (last visited May 14, 2013), (noting Ben Bernanke's opinion that proportionality between executive and employee pay is integral to any pay structure).

<sup>61</sup> Charles M. Elson and Craig K. Ferrere, Investor Responsibility Research Center, *Executive Superstars, Peer Groups and Over-Compensation- Cause, Effect and Solution*, 47 (2012) (noting that excessive and un-proportional executive compensation, paid to the top 10% of executive earners, has a negative effect on stock value in the long-term).

<sup>62</sup> Dylan Matthews, *Research Desk: How Has the CEO/Employee Pay Gap Changed?*, [http://www.washingtonpost.com/blogs/wonkblog/post/research-desk-how-has-the-ceo-employee-pay-gap-changed/2011/07/22/gIQANgoaYI\\_blog.html](http://www.washingtonpost.com/blogs/wonkblog/post/research-desk-how-has-the-ceo-employee-pay-gap-changed/2011/07/22/gIQANgoaYI_blog.html) (last visited May 14, 2013) (reasoning that the income gap is currently too large to be bridged by an increase in employee wages; rather, executive compensation will have to be lowered).

<sup>63</sup> Elson, *supra* n., at 61 (noting that there is a directly proportional relationship between the rise in the income gap and employee discontent, agitation and flight from the firm).

<sup>64</sup> Spencer C. Barasch and Sara J. Chesnut, *Controversial Uses of the "Clawback" Remedy in the Current Financial Crisis*, 72 Tex. B.J. 922, 923 (2009) (explaining how clawback provisions are theoretically employed against executives engaging in illegal behaviors).



economic downturn, as companies receiving TARP were required to include claw-back provisions in executive pay contracts that would enable the government to recoup even performance bonuses if they were based on manipulated financial data.<sup>65</sup> This was an attempt to stem the risk-taking and fraudulent behavior of executives that was fueled by the wide-spread adoption of performance bonuses based purely on financial benchmarks. Sarbanes-Oxley and the bailout programs forcibly introduced multiple industries to claw-backs, which could be one of their greater achievements, as studies tend to show that when corporations voluntarily place claw-back provisions in executive compensation contracts, the quality of their financial reporting improves.<sup>66</sup> Reduction in fraud is not just a benefit for the financial sector, as the drop in risky behavior could prevent another recession, which is clearly an important social and economic goal for legislators.

### V. Suggested Reforms

Executive compensation can be used to tackle some of the most daunting political, economic and social realities that face our society today. Instituting reforms to executive pay is essential, not just as a “blue pill” for lawmakers who prefer to substitute caps on pay for real reform to income inequality, but because of the broader impact that such reforms may have. Corporate governance attempts to address agency costs, to ensure that corporate managers and executives act in the shareholder’s best interests and by reforming executive pay to meet these goals. Lawmakers can close the income inequality gap, break down the psychological walls that executives and directors have placed between them and their employees and reduce systemic risks to the economy by reforming executive compensation. Therefore, when considering potential reforms to corporate pay, lawmakers and academics must be certain that their proposals ensure that executive pay is structured in such a way as to reinforce these objectives.

First, the doctrine of waste should be recognized as a failure and abandoned by state courts. There are three main reasons why an executive’s may be challenged in a derivative waste action: “(1) self-dealing, (2) lack of consideration and (3) excessive compensation”.<sup>67</sup> However, the first two have largely been dealt with and the third has proven impracticable for the courts to handle. Recent strides in implementing

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<sup>65</sup> Miriam A. Cherry and Jarrod Wong, *Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes*, 94 Minn. L. Rev. 368, 380-381 (2009) (noting that TARP bailouts contained claw-back provisions in them for the government to recoup executive pay that was given on falsified financial records).

<sup>66</sup> Ed Dehann et al., *Does Voluntary Adoption of a Claw-Back provisions Improve Financial Reporting Quality?*, Contemporary Accounting Research (forthcoming 2013) (manuscript at 3), available at [http://www.bus.miami.edu/\\_assets/files/faculty-and-research/conferences-and-seminars/finance-seminars/Shevlin%20Paper.pdf](http://www.bus.miami.edu/_assets/files/faculty-and-research/conferences-and-seminars/finance-seminars/Shevlin%20Paper.pdf).

<sup>67</sup> Executive Compensation § 10.04 (d) (1996).

independent boards and using performance-based bonuses have largely eliminated the potential for a shareholder to bring a derivative claim to challenge the first two. Additionally, state courts have time and time again stated their inability to properly handle questions of the level of compensation. Therefore, states should completely abandon the doctrine altogether and prevent boards and executives from harboring any illusion that their compensation packages will be upheld by state judiciaries.

One way to achieve this is to require all bonuses, which usually account for a substantial portion of executive's yearly compensation, to be stock bonuses and require a long-term holding period before maturation.<sup>68</sup> The idea of composing a large portion of executive bonuses is not a particularly novel idea and is seen as a way "to align the incentives of executives with those of the shareholders".<sup>69</sup> However, these bonuses could also be predicated on long-term performance by executives, which would further disincentive short-term executive risk taking that could create systemic threats to the firm and company.<sup>70</sup> Although executive bonuses usually use financial measurements such as revenue produced, operating profit and total shareholder return to calculate the level of bonus compensation an executive should receive,<sup>71</sup> it is possible to include tangible, stake-holder centric goals as part of the bonus evaluation formula. By including statistics such as job creation, wage and benefit raising initiatives, as well as purely financial bench marks, corporate compensation could not only align the interests of shareholders with executives, but could also break down the physiological wall executives have created and allow for real change in social and economic issues.

Another potential reform is to extend the power that shareholders were given in Section 951 of the Dodd-Frank Act. Although Dodd-Frank explicitly notes that say-on-pay votes are non-binding,<sup>72</sup> there is already significant legal discord over what weight corporate directors need to accord to compensation packages that shareholders have voted down.<sup>73</sup> The United Kingdom has recently proposed legislation that would require, among other things, binding shareholder votes on

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<sup>68</sup> Troy S. Brown, *Legal Political Moral Hazard. Does the Dodd-Frank Act End Too Big to Fail?*, 3 Ala. C.R. & C.L. L. Rev. 1, 84-85 (2012) (noting that requiring a holding period for stock-based bonuses

<sup>69</sup> Harwell Wells, "No Man Can be Worth \$1,000,000 a Year": *The Fight Over Executive Compensation in 1930s America*, 44 U. Rich. L. Rev. 689, 701 (2010).

<sup>70</sup> *Id.* at 85 (explaining that a holding period for stock bonuses incentives long-term thinking instead of short-term

<sup>71</sup> Mark A. Borges and Ronald O. Mueller, *Executive Compensation: Strategy, Design and Implementation*, SM095 ALI-ABA 367, 369 exb. A (2007) (explaining the factors that General Electric considers in determining executive bonuses).

<sup>72</sup> Michel J. McNamara, *Occupying the Boardroom: Increasing Government Regulation and Growing Public Anger*, 2012 WL 697218 2 (2010).

<sup>73</sup> *Id.* (noting that several lawsuits have been filed alleging that directors who approved executive compensation packages that shareholders voted down breached their fiduciary duty).

executive compensation at least every three years.<sup>74</sup> If the United States were to adopt a similar provision for publically traded corporations, shareholders could be given a significant role in the compensation process not only to voice their concerns over excessive compensation, but to change it.

To effectively address a more pressing issue, such as income inequality and the rising pay gap between employees and executives, legislation could take Section 935 of the Dodd-Frank Act further and set acceptable proportionality between executive compensation and employee wages. Although disclosure of executives' salaries has done little to combat excessive pay, setting a limit on proportionality would go beyond mere transparency.<sup>75</sup> Closing the gap, or at least setting an acceptable outer limit for growth, would not by itself stop income inequality, but it may slow it down, or call attention to the issue. Since the companies with the highest gaps tend to have a larger percentage of their operations overseas, where labor is less expensive,<sup>76</sup> reducing the wage gap could further additional corporate social responsibility objectives. While this could be seen as a back-door way to create a hard cap on compensation, idea that is often rejected as a method that is "overly intrusive, decouples pay from performance and fails to effectively stem rising compensation",<sup>77</sup> it is demonstrably different. A proportionality restriction would allow corporations to pay executives as much as the directors see fit as long as the rising tide lifted all boats. Therefore, focusing on limiting executive pay does not "function as a blue pill or diversion form other socio-economic issues",<sup>78</sup> but rather as a legitimate way to begin the process of ending income inequality.

Reforming executive compensation could also serve as a method to change corporate culture and create an ethical business environment. Creating a strong ethical environment is an extraordinarily important aspect for policymakers concerned about executive compensation, as too frequently performance based bonuses are seen as an entitlement, achieved by manipulating the numbers.<sup>79</sup> This

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<sup>74</sup> Edward F. Greene, *Binding Shareholder Say-on-Pay Vote in the UK*, The Harvard Law School Forum on Corporate Governance and Financial Regulation, <http://blogs.law.harvard.edu/corpgov/2012/07/31/binding-shareholder-say-on-pay-vote-in-uk/> (last visited May 14, 2013) (detailing the recent proposals in the UK to institute binding say-on-pay provisions on private corporations).

<sup>75</sup> Caywood, *supra* n. 27, at 128 (noting that transparency of executive compensation alone has done little to curb excessive pay).

<sup>76</sup> Ashley Seager and Julia Finch, *Pay Gap Widens Between Executives and Their Staff*, <http://www.guardian.co.uk/business/2009/sep/16/guardian-executive-pay-survey-ratios> (last visited May 14, 2013), (noting that executive wage gaps are highest in corporations that have a majority of their operations overseas).

<sup>77</sup> Caywood, *supra* n. 27, at 127 (explaining that hard caps on compensation are not only intrusive, but destroy pay for performance incentives and often do not work as hard-caps on cash considerations can be circumvented by granting a larger portion of the pay in equity measures).

<sup>78</sup> Simmons, *supra* n. 8, at 363-364.

<sup>79</sup> Ethics Resource Ctr., *Ethical Leadership and Executive Compensation: Rewarding Integrity in the C-Suite 6* (2010) [hereinafter *Compensation White Paper*], available at <http://www.ethics.org/files/u5/execComp.pdf>.

concern was echoed by the 2009 G20 Summit in London, where one of the three recommendations issued by the heads of state in attendance was that executive compensation packages should be created in accordance with long-term growth objectives and prudent risk taking.<sup>80</sup> Including ethical objectives in executive compensation packages could be an extraordinarily effective means of changing corporate culture, as it may lead executives to set new attitudes towards ethical behavior that will only permeate an organization if they are adopted through a top-down approach.<sup>81</sup> This kind of ethical “role modeling” provides for a widespread change in corporate culture via differential association.<sup>82</sup> Therefore, by requiring clawback provisions in executive compensation packages, executives will be forced to heavily weigh the ethical dilemma of manipulating numbers, as their very large equity based compensation could be forfeited in the case of a major ethical breach.<sup>83</sup> Also, much as executive compensation could include tangible, non-financial benchmarks that benefit employees, they could also include tangible objectives other than allowing for recoup in the case of a major ethical breach. By requiring periodic, regular cultural audits,<sup>84</sup> corporations will have a bright line benchmark to decide if their executives are adequately implementing an ethical culture in the company.

## VI. Conclusion

There is no denying that executive compensation is a controversial topic for policy makers and elected officials. However, devoting significant time and resources to effectively reforming a system that has greatly increased income inequality and drained corporate coffers should not be seen as a “blue pill” for lawmakers to divert attention from more pressing issues. Although reforming executive compensation may not drastically reduce the systemic risks that still plague the United States’ economy,<sup>85</sup>

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<sup>80</sup> Prosser, *supra* n.2, at 15-16.

<sup>81</sup> *Organizational Factors: The Role of Ethical Culture and Relationships*, in *Business Ethics: Ethical Decision Making & Cases* 179 tbl 7.2 (O.C Ferrell et al., ed., 2010) (noting that a majority of ethics norms are communicated through executive behavior).

<sup>82</sup> *Id.* at 182 (explaining that differential association is the idea that people learn what constitutes ethical behavior from people in similar role-sets).

<sup>83</sup> Compensation White Paper, *supra* n. 79, at 12 (noting that claw-backs are one possible ethical incentive that would force executives to weigh the effects of unethical behavior against their receipt of a large compensation package).

<sup>84</sup> Corporate culture audits give “a comprehensive diagnostic of the current culture as well as a detailed understanding of the culture that the employer is aiming for”. Manueal Pardo-del-Val et al., *Cultural Audit as a Tool to Increase Employee Involvement in Small Firms: A Case Study*, 12 *Comportamento Organizacional E. Gestao* 243, 246 (2006). These types of audits can be combined with ethics audits to ensure that the corporation is on track to have, or currently has, an ethical culture.

<sup>85</sup> Phil Ciciora, *Executive Pay Reform Unlikely to Reduce Systemic Risk in Economy*, Illinois News Bureau, [http://news.illinois.edu/news/11/0714compensation\\_christinehurt.html](http://news.illinois.edu/news/11/0714compensation_christinehurt.html). (last visited July 14, 2011)

especially those that exist in the financial sector, reform is integral to reach other corporate governance objectives and address economic and social inequalities.

The most recent economic downturn has brought the issue of executive compensation to the forefront, beginning with populist outrage at large executive compensation packages awarded during a time when the average employee salary fell and unemployment rates rose. Congress and other lawmakers attempted, through financial bailout legislation, to extend the ideals originally contained in Sarbanes-Oxley by holding executives accountable for fraud and their wallets hostage. The financial meltdown legislation also attempted to give shareholders a greater voice in the compensation process, even if it can still be ignored.

While these reforms are promising, academics and lawmakers still have significant distance to cover before executive compensation is truly reformed. However, if new legislation or common law standards were to include non-financial benchmarks when creating performance based bonuses, or place greater emphasis on executives' role in creating an ethical corporate culture, executive compensation reform could truly become a tool in the ever-expanding corporate governance toolbox, not just to reign in agency costs, but to truly alleviate important social and economic injustices.

