RETURNING FAIRNESS TO EXECUTIVE COMPENSATION

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I. INTRODUCTION

The paradigm shift in corporate governance over the last century has been the removal of categorical restrictions on the board of directors in favor of broad discretionary authority.[1] With discretion, however, came risks. Boards could use the authority to promote their own interests, rather than the interests of shareholders. To limit this possibility, the law purported to subject directors to strict fiduciary obligations. Discretion had to be exercised only in a manner that benefited shareholders. In particular, the duty of loyalty triggered duties described as strict and unrelenting.[2]

The approach is, however, a myth—at least today. The discretion remains, but the strict and unrelenting nature of fiduciary duties has not. The duty of care evolved into a system of process, with form replacing substance.[3] The duty of loyalty ceased to be about fairness. Boards merely needed to show the presence of a majority of independent directors, a

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1. An early example was the authority to issue new classes of shares so long as the authority existed in the articles. The changes have included the right to buy votes and to discriminate against shareholders of the same class of stock. *See* J. Robert Brown, Jr., *Speaking with Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty*, 54 HASTINGS L. J. 641, 644 n.12 (2003) (discussing examples of increases in board discretion at the expense of shareholders).

2. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939). As the court in *Guth* stated:

> The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. The occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale.

Id. at 510.

3. J. Robert Brown, Jr., *Disloyalty without Limits: "Independent" Directors and the Elimination of the Duty of Loyalty*, 95 KY. L.J. 53, 57 (2006-07). Any residual content to the duty of care was eliminated with the universal adoption of waiver of liability provisions. *See* J. Robert Brown, Jr. & Sandeep Gopalan, *Opting Only In: Contractarians, Waiver of Liability Provisions, and the Race to the Bottom*, University of Denver Legal Studies Research Paper No. 08-02 (2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1087404 (discussing the provisions and their impact on fiduciary obligations).

standard largely rendered meaningless through judicial legerdemain. Fairness, in short, was reduced to a rote head count.[4]

The result has been unchecked discretion. Moreover, the discretion is not exercised randomly. Boards are typically "captured" by top officers, particularly the CEO.[5] Board authority is often better described as exercised in the best interests of management rather than shareholders.[6] This can be seen most clearly in the context of executive compensation, where amounts paid to top officers have continued to escalate upward in an out-of-control fashion.[7]

Some portions of the North Dakota Publicly Traded Corporations Act (NDPTCA/Act) address this problem.[8] The Act attempts to reduce capture by enhancing the ability of shareholders to elect their own candidates to the board. The Act limits advance notice bylaws[9] and allows large shareholders access to the company's proxy statement for their nominees.[10] Shareholders have the right to mandatory repayment of proxy expenses when their candidates are elected.[11]

The provisions in the NDPTCA, however, are modest and unlikely to result in significant change to board composition. For the foreseeable future, boards of public companies, including those incorporated under the NDPTCA, will remain captured by management. As a result, it leaves in place a system of broad board discretion and weak fiduciary principals that do not adequately protect the interests of shareholders.[12]

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4. *See* Brown, *supra* note 3, at 62; *see also infra* note 64 and accompanying text.

5. *See* JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 51-68 (2008) (discussing ways in which a CEO "captures" the board of directors).

6. *See, e.g.*, *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. On Oversight and Gov't Reform*, 110th Cong. (2008) (statement by Alan Greenspan) ("I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms."). Managerial self interest could sometimes benefit shareholders, particularly by providing an incentive to maintain share prices in the short term, but as the recent turmoil in the financial markets illustrates, reliance on management self interest to protect shareholders has failed dismally. *Id.*

7. *See* Joann S. Lublin, *Persistent Pay Gains: A Survey Overview*, WALL ST. J., Apr. 14, 2008, at R1, *available at* http://online.wsj.com/article/SB120793930504508449.html?mod=2_1565_leftbox (study of compensation paid to CEOs).

8. N.D. CENT. CODE Ch. 10-35 (2007).

9. *See id.* § 10-35-07 (limiting advance notice bylaw to no longer than ninety days).

10. *See id.* § 10-35-02(8) (defining "qualified shareholder" as also including a two-year holding period for the shares).

11. *Id.* § 10-35-10. This is particularly important given the Delaware Supreme Court's decision in CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227 (Del. 2008).

12. *See* J. Robert Brown, *The North Dakota Publicly Traded Corporations Act and the Delaware Advantage*, July 6, 2007, http://www.theracetothebottom.org/shareholder-rights/the-north-dakota-publicly-traded-corporations-act-and-the-de.html?SSScrollPosition=0 (noting the failure of the NDPTCA to address fiduciary obligations of directors). Of course, the interests of

This Article explores the demise of fiduciary obligations, emphasizing executive compensation. Part II examines the duty of loyalty and the traditional interpretation accorded by the courts. Part III discusses the evisceration of the duty, particularly the replacement of fairness analysis with the business judgment rule. Process, as this Article will show, has proved an inadequate substitute for fairness. Finally, Part IV proposes a solution.

II. DECLINE OF THE DUTY OF LOYALTY

In the early days of corporate law, courts considered the risks associated with self-dealing by officers and directors so great that they treated the transactions as voidable.[13] Excessively narrow, the approach threatened to prevent a class of transactions that could often benefit the corporation. In response, courts gradually opted for a less restrictive test allowing the transactions, but only if substantively and procedurally fair.[14] Procedural fairness meant approval by shareholders or disinterested directors.[15] By the mid-twentieth century, however, it was enough to show substantive fairness irrespective of the process used,[16] although the burden remained with the board.[17]

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shareholders may themselves be fragmented. *See* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577 (2006). The point is a fair one but largely beyond the scope of this Article. Whatever differences may exist among shareholders, the need to determine executive compensation in a manner that is designed to be fair would likely be a widely shared view.

13. Brown, *supra* note 3, at 54; *see also* Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991) ("At common law, a corporation's stockholders did have the power to nullify an interested transaction, although considerations of the transaction's fairness appear to have played some part in judicial decisions applying this rule.") (internal citations omitted). Not everyone agrees with this early characterization. *See generally* Norwood P. Beveridge, Jr., *The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction*, 41 DEPAUL L. REV. 655, 659-62 (1992) (asserting that interested director contracts were not always voidable); *see also* Norwood P. Beveridge, *Interested Director Contracts at Common Law: Validation Under the Doctrine of Constructive Fraud*, 33 LOY. L.A. L. REV. 97, 98-99 (1999) (noting that Professor Marsh's assertion has come under attack).

14. The voidable nature of the contracts lasted until the 1960s, when many states adopted statutes that clarified their legality. Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36 (1966). If either substantively fair or approved through the proper process, the transactions would cease to be voidable. That did not mean, however, that the transactions were otherwise consistent with a board's fiduciary obligations.

15. *Id.* at 39-40.

> [T]he general rule was that a contract between a director and his corporation was valid if it was approved by a disinterested majority of his fellow directors and was not found to be unfair or fraudulent by the court if challenged; but that a contract in which a majority of the board was interested was voidable at the instance of the corporation or its shareholders without regard to any question of fairness.

Id. (footnote omitted).

16. *See* Harvey Gelb, *Corporate Governance and the Independence Myth*, 6 WYO. L. REV. 129, 130-31 (2006) ("The general rule by the mid-twentieth century would uphold the validity of a

Substantive fairness in many cases amounted to a straightforward approach. The board had to show that the conflict of interest transaction retained the "the earmarks of an arm's length bargain."[18] In other words, the transaction could be no more favorable than what would have been negotiated with anyone devoid of the conflict. To establish fairness, boards could look to reliable markets that provided a neutral and arms length price or rely on a history of comparable transactions and payments.[19]

Fairness, however, was not always so easily determined. Some transactions had a unique price and were not susceptible to analysis under the traditional tests.[20] In those circumstances, the courts developed a relatively complex approach that necessitated examination of the whole transaction.[21] Appropriately labeled "entire fairness," the review took into account the factors and the method used to determine price.[22] Specifically, fair price required examination of "the economic and financial considerations" relied

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transaction even in the absence of a disinterested director majority vote unless it was found by the court to be unfair to the corporation.").

17. *See* Emerald Partners v. Berlin, 726 A.2d 1215, 1222 (Del. 1999) ("Once the entire fairness standard has been implicated, as here, the defendants, at least initially, bear the burden of demonstrating the two basic aspects of fair dealing and fair price.") (internal citation omitted); Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) ("When faced with such divided loyalties, directors have the burden of establishing the entire fairness of the transaction to survive careful scrutiny by the courts."); Keenan v. Eshleman, 2 A.2d 904, 908 (Del. 1938) ("In the second place, dealing as they did with another corporation of which they were sole directors and officers, they assumed the burden of showing the entire fairness of the transaction.").

18. Byelick v. Vivadelli, 79 F. Supp. 2d 610, 629 (E.D. Va. 1999) (quoting Moneta v. Willard Building Supply Co., 515 S.E.2d 277, 287 (Va. 1999)). As one commentator noted, fairness represented what "would have been approved by a disinterested board negotiating at arm's length with a stranger." Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 7 (1993).

19. *See* Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 750 (Del. Ch. 2007) ("The price terms obviously cannot be justified by reference to any reliable market. Nor is there proof in the record of substantial comparable transactions to which the court might look to find support for the payment of bonuses of this size.").

20. This is particularly true in the context of mergers between companies and their controlling shareholders. *See Emerald*, 787 A.2d at 94-95.

21. *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1179 (Del. 1995) ("Rather, it is a standard by which the Court of Chancery must carefully analyze the factual circumstances, apply a disciplined balancing test to its findings, and articulate the bases upon which it decides the ultimate question of entire fairness. In some instances, however, price may predominate."); *see also In re* TD Banknorth S'holders Litig., 938 A.2d 654, 667 (Del. Ch. 2007) ("Equally fundamental is the notion that fair price and fair dealing are not viewed in isolation,' but rather in conjunction, and that fairness as to one prong will not necessarily sterilize a transaction or immunize a defendant from liability.").

22. *Cinerama*, 663 A.2d at 1163 ("In this case, because the contested action is the sale of a company, the 'fair price' aspect of an entire fairness analysis requires the board of directors to demonstrate 'that the price offered was the highest value reasonably available under the circumstances.'").

upon by the board.[23] Fair dealing, in turn, "embrace[d] questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[24]

An objective test, neither prong entirely controlled the analysis.[25] Nonetheless, as a practical matter, process was a less important component. Fair process was only relevant to the extent it related to the fairness (or unfairness) of the price.[26] Even with a flawed process, the amount paid could still be fair.[27]

Executive compensation implicates the duty of loyalty and the obligation of fairness. In almost all large public companies, the CEO sits on the board and is in a position to influence the amount authorized.[28] The presence of the interested influence imposes on the board the obligation of showing fairness. Two recent Delaware cases illustrate the application of the entire fairness standard in the context of executive compensation.

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23. *Valeant Pharms. Int'l*, 921 A.2d at 746 (quoting Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983)). Fair dealing could demonstrate fair price. *Id.*

24. *Weinberger*, 457 A.2d at 710.

25. Entire fairness requires a review of "all aspects" of the transaction. *See In re TD*, 938 A.2d at 667 ("Equally fundamental is the notion that fair price and fair dealing are not viewed in isolation, but rather in conjunction, and that fairness as to one prong will not necessarily sterilize a transaction or immunize a defendant from liability."); *see also* Int'l Telecharge, Inc. v. Bomarko, Inc., 766 A.2d 437, 440 (Del. 2000) (determining entire fairness "without focusing on one component over another").

26. *Valeant Pharms. Int'l*, 921 A.2d at 746. Fair dealing "informs the court as to the fairness of the price obtained through that process." *Id.*

27. *See id.* at 748 ("It is possible that the pricing terms were so fair as to render the transaction entirely fair."). *See also* Oliver v. Boston Univ., No. 16570-NC, 2006 Del. Ch. LEXIS 75, at *25 (Del. Ch. Apr. 24, 2007).

> [T]hus, the only harm suffered by the Plaintiffs was a procedural one. Therefore, although the BU Defendants did breach their duty of loyalty and were unable to demonstrate the entire fairness of the Series B and C transactions, for purposes of assessing the fiduciaries' treatment of these claims in the context of negotiating the Accord Agreement, the Court does not find it appropriate to assign anything but nominal damages to these breaches.

Id. Thus, in Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1287 (Del. 1989), the Delaware Supreme Court indicated that a board's obligations under Revlon, Inc. v. Macandrews & Forbes Holdings, 506 A.2d 173 (Del. 1985) could be met where "the directors possess a body of reliable evidence with which to evaluate the fairness of a transaction." *Oliver*, No. 16570-NC, 2006 Del. Ch. LEXIS 75, at *25. In those circumstances, they "may approve that transaction without conducting an active survey of the market." *Id.*

28. SHEARMAN & STERLING LLP, CORPORATE GOVERNANCE AND COMPENSATION SURVEY 26 (2008). The presence on the board enables the CEO to influence the compensation process. Nonetheless, this does not necessarily mean that the CEO in fact always exercises that authority. *See* Steven M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1642-43 (2005) ("At the same time, however, their more ambitious claim that managerial power is 'pervasive,' and thus broadly explanatory of executive compensation practices remains contested.").

Julian v. Eastern States Development[29] involved a dispute among three brothers conducting business together.[30] Two sat on the board of Benchmark and, after a meeting of "less than a half an hour" attended by "no legal or financial advisors," they voted themselves substantial bonuses.[31] In the ensuing litigation, the directors had the burden of showing the fairness of the payments.[32]

The directors argued that bonuses were ordinary and that the amounts were in return for the company's "good year."[33] The court conceded a pre-existing practice of paying bonuses but viewed the amounts as uncharacteristically large.[34] The court found that:

> From 1999 through 2004, [Company's] bonuses as a percentage of adjusted income hovered between 3.30% and 3.36%. In contrast, the challenged 2005 bonuses constituted 22.28% of adjusted income. Additionally, 2005 marked the first time [the non-brother director] received a bonus beyond the performance-based compensation set forth in his Employment Agreement.[35]

These amounts were not sufficiently explained by the company's "good year."[36] "Regarding the reward for a good year, Benchmark had a better year in 2004 than 2005, and the bonuses in 2004 were still only 3.36% of adjusted income."[37] The court held that the board had not met its burden of showing fairness.[38]

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29. No. 1892-VCP, 2008 Del. Ch. LEXIS 86 (Del. Ch. July 8, 2008).
30. *Julian*, 2008 Del. Ch. LEXIS 86, at *1.
31. *Id.* at *5.
32. *Id.* at *17. Without a majority of independent directors, the board retained the burden of establishing fairness. Had there been a majority, the court would have reviewed the bonuses under the duty of care.
33. *Id.* at *5.
34. *Id.* at *19.
35. *Id.*
36. *Id.*
37. *Id.* *See* J. Robert Brown, *Pangloss, Delaware Law, and the Duty of Loyalty: Julian v. Eastern States Development Co.*, Aug. 25, 2008, http://www.theracetothebottom.org/preemption-of-delaware-law/pangloss-delaware-law-and-the-duty-of-loyalty-julian-v-easte.html (discussing *Julian*).
38. The court also indicated concern with process. *Julian*, 2008 Del. Ch. LEXIS, at *18.

> The circumstances of the Benchmark Bonuses give rise to suspicion about their fairness. Eleven days after Gene submitted his letter of retirement and resignation from ESDC and ESCS, the Benchmark board approved the Benchmark Bonuses. Francis initiated the process just days after Gene's notice of retirement. He approached Richard before the December 20, 2005 [,] board meeting and proposed making the bonuses. The brothers discussed the concept for fifteen minutes, and consulted no one else. Francis and Richard concede that they knew any bonus would decrease the net book value of Benchmark, consequently decreasing the value of the shares they contemporaneously were trying to force Gene to sell back.

Id.

Similarly, in *Valeant Pharmaceuticals International v. Jerney*,[39] the board of ICN Pharmaceuticals, Inc. voted to pay its directors large bonuses in connection with a corporate restructuring.[40] ICN earned a substantial portion of its earnings from royalties on the sale of Ribavirin, an antiviral drug.[41] Following pressure from an activist shareholder, the board opted to spin off the Ribavirin assets and scheduled an initial public offering (IPO) for the subsidiary.[42] Estimates indicated that the offering would yield a market value for the subsidiary of between $2.25 billion and $3 billion.[43] In fact, the IPO proved less successful than anticipated, with the market value at approximately half that amount.[44]

The compensation committee authorized bonuses for the responsible officers and directors totaling more than $50 million.[45] Problems existed with both the process and the factors used to compute the bonuses.[46] It was the CEO, rather than the committee, who largely determined the size of the bonus pool.[47] The compensation consultant was chosen by the board[48] and employed what turned out to be incorrect valuations.[49] Finally, the directors on the committee shared in the bonuses and, during the same

39. 921 A.2d 732 (Del. Ch. 2007).

40. *Valeant Pharms. Int'l*, 921 A.2d at 735.

41. *Id.* at 736.

42. *Id.* at 737.

43. *Id.* at 737-38.

44. *Id.* at 738. The second step spinoff never occurred. ICN eventually repurchased the shares sold in the IPO through a $6.25 per share tender offer. *Id.* at 742.

45. *Id.* at 738. In addition, two of the three directors had ties to the CEO. *Id.*

46. *Id.* at 739. "Self-interested compensation decisions made without independent protections are subject to the same entire fairness review as any other interested transaction." *Id.* at 745.

47. *Id.* at 746-47. The court described the process as "designed simply to justify a predetermined outcome." *Id.* at 747; *see also id.* at 748-49.

> The committee did not examine afresh the question of whether any bonus arrangement was appropriate and, if so, how much and what form of bonus to award. This can be seen in the April 2 meeting minutes where the committee began their consideration by discussing '[t]he question of what rationale is appropriate to support the award . . . .' The other minutes are replete with suggestions by Moses, in particular, of possible explanations both for awarding sizeable bonuses and for paying a large portion of any award to Panic.

Id.

48. *Id.* at 739. The report also did not consider certain other recent compensation studies performed for ICN. These studies, relied on by the plaintiff, indicated that the CEO's total direct compensation was twenty-seven percent higher than the 75th percentile and fifty-one percent higher than the median among CEOs in ICN's peer group. *Id.* at 740-41.

49. *Id.* "Finally, and perhaps most perniciously, the board, the compensation committee, and outside experts were given and relied on inflated and misleading information provided by management led by a recalcitrant CEO who stood to benefit most from the transaction." *Id.* at 748.

period, were negotiating with the CEO over future consulting arrangements.[50]

Problems likewise existed with the factors used to calculate the bonuses.[51] ICN had a history of incentive payments for "extraordinary transactions."[52] The restructuring bonuses were, however, unusually large.[53] They were computed using what turned out to be wildly inaccurate valuations.[54] Neither the board nor the compensation consultant could point to similar sized bonuses in comparable transactions.[55]

The board was unable to point to any source of value that justified the payments.[56] According to the court:

> Thus, the bonuses were awarded essentially for taking the biggest piece of an already public company and reissuing it as a new public stock. Moreover, the bonuses in question were being paid to parent company managers who would have no further involvement in the "spun" company. When viewed from this perspective, it is difficult to see how such large bonuses could be justified. Thus, it is not surprising that Towers Perrin was unable to find comparable grant data.[57]

The court, therefore, found that the board had not met its burden of showing fairness.[58]

Both *Valeant* and *Julian* illustrate the salutary benefit of applying the entire fairness standard to compensation decisions. The approach imposed modest but meaningful limits on board discretion. In both cases, the courts had no objection to the payment of bonuses. They merely required that the board show consistency with past practice or provide a reasonable

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50. *Id.* at 747.

51. *Id.* at 749. Even with unfair process, the price still could have been fair. *See id.* at 748 ("The court's finding that ICN's management and board used an unfair process to authorize the bonuses does not end the court's inquiry because it is possible that the pricing terms were so fair as to render the transaction entirely fair.").

52. *Id.* at 749.

53. *Id.* at 750.

54. *Id.* The use of the $3 billion valuation alone made "the bonuses not entirely fair." *Id.*

55. *Id.* The next day, UBS told ICN that the IPO would have to be re-priced to $10 per share. *Id.* Panic was advised by two Fried Frank lawyers to have the board revisit the bonus scheme authorization in light of the change in pricing. *Id.* Panic ignored this advice. *Id.* Although the board met to authorize the IPO pricing, it never reconsidered the amount of the bonus award. *Id.*

56. *Id.*

57. *Id.*; *see also id.* at 749 ("Thus, while some bonus might have been appropriate, the amount of the bonus should have been calculated with reference to the value added to ICN by the IPO and spin-off and not the total value of Ribavirin or other assets contributed by ICN to Ribapharm.").

58. *Id.* at 750.

explanation for any deviation, something both were unable to do. In other words, in those two cases, entire fairness merely prevented the payment of executive compensation that lacked the discipline of a contemporaneous justification.

III. ELIMINATION OF FAIRNESS FROM THE DUTY OF LOYALTY

Julian and *Valeant* are, unfortunately, unusual cases. Compensation and other conflict of interest transactions rarely receive the scrutiny of entire fairness. The mild obligation for boards to justify unusually large compensation awards is not typically part of the analysis. Instead, the Delaware courts extend to compensation decisions the absolute protection of the business judgment rule.[59] The standard makes the substantive terms essentially irrelevant. The number of options, the amount of salary, and the size of the bonuses are not generally part of the analysis.[60] Instead, the matter turns on the number of "independent" directors on the board.

The Delaware courts came to this position through legerdemain. The business judgment rule represents an over-inclusive protection designed to protect risk taking by directors.[61] Boards know that even if they take risks that prove in hindsight to be mistaken and harmful, they will escape liability. The presumption is not, however, designed to protect decisions motivated by a conflict of interest.[62]

The Delaware courts avoided this traditional approach largely by ignoring the existence of the conflict of interest in the decision-making process.[63] Without any real analysis, they extended the presumption of the business judgment rule to boards containing a majority of independent directors.[64] It was as if the presence of this majority caused the taint of the

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59. The halcyon days of *Van Gorkom*—when there was at least some possibility that the Delaware courts would accord content to the business judgment rule—are over. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, *passim* (Del. 2008). Moreover, waiver of liability has all but eliminated any remaining vestiges of the duty of care. *See* Brown & Gopalan, *supra* note 3 at 3, 11 n.38.

60. One need only look to *Disney* to see how the case turned not on the $160 million awarded to Michael Ovitz but on the process used by the compensation committee and the board in approving the contract. *See In re Walt Disney Co.*, 906 A.2d at 37-41, 51-55.

61. Brown, *supra* note 3, at 55.

62. *See* Lewis v. S. L. & E., Inc., 629 F.2d 764, 769 (2d Cir. 1980) ("But the business judgment rule presupposes that the directors have no conflict of interest.").

63. Hokanson v. Petty, No. 3438-VCS, 2008 Del. Ch. LEXIS 182 (Del. Ch. Dec. 10, 2008); *see also* Eliminating Fairness from the Duty of Loyalty: Hokanson v. Petty (2009), http://www.theracetothebottom.org/home/eliminating-fairness-from-the-duty-of-loyalty-hokanson-v-pet.html (discussing the presence of conflicts of interest in the decision-making process).

64. The courts have left open the possibility that a plaintiff can show that an interested party actually exercised control over independent directors. *See* Cinerama, Inc. v. Technicolor, Inc.,

conflict to dissipate. The courts, however, did not accompany the extension with any obligation to eliminate[65] or quarantine the interested influence.[66] Indeed, the business judgment rule applied even if the interested directors participated in the decision and voted on the final outcome.[67]

There are many problems with this approach. First, it makes a mockery of the underlying rationale for the business judgment rule. By leaving the conflict in the decision-making process, the Delaware courts have extended the over-inclusive presumption beyond the traditional goal of protecting risk taking to encompass decisions motivated by a conflict of

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663 A.2d 1156, 1170 n.25 (Del. 1995) ("Similarly, the manipulation of the disinterested majority by an interested director vitiates the majority's ability to act as a neutral decision-making body.") (internal citation omitted); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 364 (Del. 1993) ("We agree with defendants that the question of when director self-interest translates into board disloyalty is a fact-dominated question, the answer to which will necessarily vary from case to case."). Given obvious difficulties in proof and heightened pleading standards, this rarely occurs. *See In re* LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 179 (Del Ch. 2005) (refusing to dismiss a suit against individual directors in which plaintiff made allegations that the controlling shareholders negotiated the terms of the merger).

65. *See Cede & Co.*, 634 A.2d at 366 n.35 ("Examples of techniques which can restrict the influence an interested director may exert include: recusal of the interested director(s) from participation in board meetings.") (internal citations omitted).

66. A disinterested and independent committee would be one possible mechanism for quarantining a conflict of interest. This has been the approach used, for example, in the context of board consideration of derivative suits. *See* Zapata Corp. v. Maldonado, 430 A.2d 779, 786 (Del. 1981).

> We do not think that the interest taint of the board majority is per se a legal bar to the delegation of the board's power to an independent committee composed of disinterested board members. The committee can properly act for the corporation to move to dismiss derivative litigation that is believed to be detrimental to the corporation's best interest.

Id. Whether the conflict could ever be eliminated, even with a rigorous quarantine, remains an open question. *See* Marsh, *supra* note 14, at 37-38 (discussing an early case that found it "impossible to measure the influence" of interested directors on the board and, as a result, courts gave little weight to disinterested approval). Delaware, however, has rejected this view. *See Cede & Co*., 634 A.2d at 363.

> This Court has never held that one director's colorable interest in a challenged transaction is sufficient, without more, to deprive a *board* of the protection of the business judgment rule presumption of loyalty. Provided that the terms of 8 *Del.C.* § 144 are met, self-interest, alone, is not a disqualifying factor even for a director.

Id.

67. *See* Brown, *supra* note 3, at 55; *see also* E. Norman Veasey and Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 BUS. LAW. 761 n. 40 (2008). Whatever the source, the courts seem to view majority independent boards as having cleansed the "taint" of the conflict of interest, but the standard does no such thing. There is no Delaware court that requires quarantine of the conflict of interest. Directors with the conflict can participate in the debate and even vote on the matter. *See* Nebenzahl v. Miller, No. 13206, 1996 Del. Ch. LEXIS 113, at *10-11 (Del. Ch. Aug. 26, 1996) ("Compliance with Section 144 provides the protection of the business judgment rule and removes the taint of director self-interest in a transaction."); *Cede & Co.*, 634 A.2d at 365 ("Section 144(a)(1) appears to be a legislative mandate that, under such circumstances, an approving vote of a majority of informed and disinterested directors shall remove any taint of director or directors' self-interest in a transaction.").

interest. The mere presence of a majority of "independent" directors in no way establishes that the decision was unaffected by the interested influence.[68]

Second, whatever benefits flow from the presence of independent directors, the Delaware courts have done little to ensure that directors are in fact independent. They routinely ignore facts that suggest a lack of independence, employing excessive pleading standards and inconsistent tests.[69] The courts categorically decline to consider relationships arising from structural bias and largely ignore friendship as a basis for finding a disqualifying relationship.[70] Boards characterized as independent, therefore, may in fact have a majority of directors subject to the control and influence of the CEO.

Third, the business judgment rule requires that directors be informed.[71] A growing body of evidence suggests that, in the context of executive compensation, the decisions are uninformed. To support compensation decisions, boards (or compensation committees) typically rely on reports from consultants.[72] Compensation consultants often are not neutral, independent advisors, but advocates for the CEO. In those circumstances, their role may be less about fairness and more about providing a post hoc justification for

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68. Said another way, the independent directors are not hermetically sealed from the interested directors. *See* William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1308 (2001).

> [A]lthough most public company boards have a majority of independent directors, those directors are not hermetically sealed off from the inside directors. It is commonplace for outside directors to have social, and in some cases business, relationships (e.g., a partner in the company's outside law firm or investment bank serving as a director).

Id.

69. Delaware courts use a subjective standard but typically refuse to allow plaintiffs to use discovery to explore each director's unique circumstances with respect to independence.

70. This type of "structural bias" has been summarily rejected by the Delaware Supreme Court. *See* Beam v. Stewart, 845 A.2d 1040, 1050 (Del. 2004) (characterizing arguments based upon "structural bias" as presupposing that "the professional and social relationships that naturally develop among members of a board impede independent decision-making."). Foreign regulators, however, take a different view and often specify that a director loses his or her independence after a particular number of years on the board of directors.

71. *See* Smith v. Van Gorkam, 488 A.2d 858, 885-88 (Del. 1985) (discussing the facts relied upon by trial courts in finding boards of directors made informed business judgments).

72. According to one report, 207 out of the Fortune 250 used compensation consultants in 2006. STAFF OF HOUSE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM, EXECUTIVE PAY: CONFLICTS OF INTEREST AMONG COMPENSATION CONSULTANTS 7 (Comm. Print 2007), *available at* http://oversight.house.gov/documents/20071205100928.pdf [hereinafter EXECUTIVE PAY]; *see also* Brian D. Cadman, Mary Ellen Carter & Stephen A. Hillegeist, *The Role and Effect of Compensation Consultants on CEO Pay* (2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1103682 (noting that 86% of 880 companies studied used compensation consultants).

predetermined amounts of compensation.[73] In addition, they may have other business relationships with the company that impairs neutrality. As one study of compensation practices noted:

> The concern arises from the fact that many compensation consultants work for diversified human resources consulting firms that have developed strong ties to management by providing other non-compensation-related services to their corporate clients, including actuarial services, information technology services, risk management and insurance underwriting, health and welfare services, tax and legal advice and outsourcing. The fees earned for these services are often significantly higher than the fees earned for executive compensation consulting services provided to the compensation committee.[74]

Hearings in Congress on the role of compensation consultants produced a report suggesting wide spread conflicts of interest. According to the Committee Report: "The fees earned by compensation consultants for providing other services often far exceed those earned for advising on executive compensation."[75] At the same time, over two-thirds of the Fortune 250 companies analyzed in one study hired compensation consultants with conflicts of interest and did not disclose the conflicts in their SEC filings.[76]

Yet companies need not disclose the reports or significant information about their relationship with the consultants, including possible conflicts of interest.[77] Similarly, companies have no obligation to reveal the CEO's role

73. The court in *Valeant* stated that the role of the compensation consultant was to "justify a predetermined outcome." Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 748 (Del. 2007). Similarly, this seemed to be the case at Countrywide. *See* William Garehime, *Congress, CEO Pay and the Use of Compensation Consultants*, Mar. 17, 2008, http://www.theracetothebottom.org/executive-comp/2008/3/17/congress-ceo-pay-and-the-use-of-compensation-consultants.html (discussing how the CEO of Countrywide used the consultant to achieve "maximum opportunity").

74. SHEARMAN & STERLING, *supra* note 28, at 10. The Shearman and Sterling report noted that only a small number of companies have adopted a policy requiring compensation consultant independence, including Wachovia Corporation, The Procter & Gamble Company, Pfizer, Inc., Sprint Nextel Corporation, The Home Depot, Inc., and Verizon Communications Inc. *Id.* at 13.

75. *See* EXECUTIVE PAY, *supra* note 72, at i; *See also* SHEARMAN & STERLING, *supra* note 28, at 12 ("The fees earned by compensation consultants for 'other services' often far exceeded fees earned for compensation consulting. In 2006, consultants received fees for 'other services' ($2.3 million) from each client that were more than ten times greater than fees for executive compensation consulting services ($220,000)").

76. *See* EXECUTIVE PAY, *supra* note 72, at i-ii. The report concluded that there "appears to be a correlation between the extent of a consultant's conflict of interest and the level of CEO pay." *Id.* at ii.

77. 17 CFR § 229.407(e) (2007). Item 407(e) of Regulation S-K. Companies must disclose the role of the compensation consultant:

> [I]n determining or recommending the amount or form of executive and director compensation, identify such consultants and state whether such consultants are

in selecting the firm.[78] It is shareholders that have the burden of demonstrating the uninformed nature of the decision. The shareholders must do so without affirmative disclosure by companies or the benefit of discovery.[79] In other words, the compensation decision may well be uninformed but pleading burdens prevent adequate exploration of the issue.

How this works in practice can be seen from the analysis in *Valeant*. Because of the unusual application of the entire fairness standard, the board, rather than shareholders, retained the burden.[80] As a result, the discovery process uncovered substantial problems with the method of selecting the consultant and the consultant's report.[81] The consultant had largely been foisted on the committee[82] and relied on data that ultimately proved to be wildly inaccurate.[83] A discussion draft was apparently shown to management before the compensation committee, resulting in changes.[84] The report's conclusions about the compensation paid to the CEO of ICN did

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> engaged directly by the compensation committee or any other person; and describe the nature and scope of their assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement.

Id.

78. There is no requirement to disclose the method used to select the consultant, including the CEO's role in the process. Indeed, in adopting the requirement, the SEC deleted a requirement that would have required companies to identify "the executive officers of the company that the compensation consultants contacted in carrying out their assignment." Exchange Act Release No. 54302A (August 29, 2006). This requirement would have at least put into the public domain information about the CEO's contacts with the consultant.

79. In narrow circumstances, shareholders may be able to obtain the materials through an exercise of inspection rights. The standards, however, are high and the costs significant. *See* Cronin v. AmBase Corp., No. 342-N, 2005 Del. Ch. LEXIS 131, at *15-17 (Del. Ch. Aug. 22, 2005) (discussing a narrow set of circumstances in which the plaintiffs were able to inspect a corporations books and records).

80. Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 740 (Del. 2007).

81. *Id.*

82. *See id.* at 739-40 (noting that one ICN executive noted that the consultant "had looked specifically at this issue and determined it was justified in this instance"). Indeed, language in the opinion suggested that the consultant had prejudged the bonus issue. *Id.*

83. *Id.* at 737. The consultant relied on a $3 billion market value. *Id.* The ultimate value was about half that amount. *Id.* When the true value was ascertained, lawyers for the CEO recommended that the board reconsider the bonuses. *See id.* at 739-40 ("[The CEO] was advised by two Fried Frank lawyers to have the board revisit the bonus scheme authorization in light of the change in pricing. [The CEO] ignored this advice. Although the board met to authorize the IPO pricing, it never reconsidered the amount of the bonus award.").

84. *Id.* at n.9.

> Interestingly, an April 5, 2002 discussion draft of the Towers Perrin report, apparently shared with management but not with the compensation committee, suggested a reduction in the proposed grant to [the CEO] from 5 million to 3 million options. This suggestion led to a meeting . . . at which [the CEO] described his contributions to the success of ICN and Ribavirin, in particular. The final [consultant] report supports and award to [the CEO] at the [$]5 million option level.

Id.

not take into account his recently amended compensation agreement.[85] Had shareholders retained the burden, much of this information would never have become available and the opinion of the compensation consultant would have been entitled to deference.

IV. RETURNING FAIRNESS TO EXECUTIVE COMPENSATION

Where does this leave executive compensation? Because of the approach taken by the Delaware courts, entire fairness is rarely used in assessing compensation decisions. Entire fairness is not an onerous burden, at least in the compensation context. As *Julian* and *Valeant* illustrate, fairness merely requires the board to justify its decision.[86] Fairness could be established by reference to a reliable market (perhaps a study of peer companies) or a meaningful explanation of the value added by the CEO or other relevant officer.

Even this modest standard, however, has been eliminated and replaced by the process-driven business judgment rule. The business judgment rule leaves the burden on shareholders. It is shareholders that must somehow show a flawed decision making process by the board, and must do so without adequate disclosure or discovery. In other words, findings that directors are independent and informed are less a product of examination of what actually happened inside the boardroom than denial of access to the information that shareholders need to address the issue.

In these circumstances, shareholders are wholly unprotected from self-serving behavior. Boards need not establish fairness. They need not justify their decisions. Indeed, had this standard been applied to the bonuses in *Julian* and *Valeant*, both would have been upheld. The main concern of the courts in the two cases was the amount of the bonus. Amount is irrelevant

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85. *Id*. at 740.

> [The compensation report] reviewed past compensation practices of the company. The report concludes that the compensation for the company's executives, specifically [the CEO], was within the median range of similarly situated executives. However, the report did not consider [the CEO's] recently amended compensation agreements. The report also did not consider certain other recent compensation studies performed for ICN. These studies, relied on by the plaintiff, indicate Panic's total direct compensation was 27% higher than the 75th percentile and 51% higher than the median among CEOs in ICN's peer group.

Id.

86. *See id*. at 746-51; Julian v. Eastern States Dev., No. 1892-VCP, 2008 Del. Ch. LEXIS 86, at *58 (Del. Ch. July 8, 2008) ("The record indicates no coherent, credible reason for the bonuses other than in reaction to Gene's retirement.")

when determining the availability of the business judgment rule. The effective result is compensation without limits.[87]

Reforms need to be implemented to ensure that, in the case of conflicts of interest and executive compensation in particular, the interests of shareholders are adequately protected. To do so requires two broad changes to existing fiduciary standards. First, steps must be taken to ensure the efficacy of the process surrounding the approval of conflict of interest transactions, including executive compensation. Second, fairness must again become part of the duty of loyalty.

With respect to process, there are some modest changes that would improve but not fix the system. The excessive pleading standards employed by the Delaware courts must be reduced.[88] Allegations of friendship from national magazines[89] or evidence of large payments to an organization employing the director[90] ought to be enough to survive a motion to dismiss.[91] Shareholders should be allowed to use discovery to uncover the true state of affairs.[92]

The same should be true of informed decision-making. Even modest evidence that the directors rushed the decision or lacked neutral advisors should allow shareholders to escape a motion to dismiss and obtain discovery.

More importantly, the burden should be shifted to the board to show the presence of independent and informed decision-making. After all, it is the board that is relying on proper process to obtain the protections of the business judgment rule. This would significantly change the approach in the executive compensation area. The board would need to show that the interested influence was excluded from the process. Boards would almost

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87. *See* Brown, *supra* note 3, at 58 (noting that there is a theoretical limit: waste). The standard for establishing waste is so difficult that it has no real bearing on compensation decisions. *Id.*

88. *See id.* at 85-93 (discussing excessive pleading standards employed by Delaware courts in derivative suits).

89. *See* Beam v. Stewart, 845 A.2d 1040, 1050 (Del. 2004) (evidence of friendship of director in part derived from interview in national magazine).

90. *See* Brown, *supra* note 3, at 76-78 (discussing difficulty in showing that directors materially benefited from payments to an organization).

91. *See id.* at 99 ("Moreover, the test for independence and the restrictive (indeed, in some cases, impossible) pleading standards all but ensures that these "independent" majorities will in at least some instances not be independent at all. The result is that the almost insurmountable presumption of the business judgment rule applies to transactions approved by interested boards. Therefore, in the context of the duty of loyalty, fairness no longer matters.") (footnote omitted).

92. Of course, the test for independence should be applied consistently. To the extent looking to the materiality of a financial relationship with the company, there is no reason to exclude consideration of fees. *See* Brown, *supra* note 3, at 72 (noting that Delaware courts do not apply materiality analysis to fees paid to directors).

certainly need to follow the special litigation committee model and rely on an approval process that involved independent directors with independent advisers.[93] Directors with a conflict of interest would no longer be allowed to participate in the decision-making process.[94]

The shift would also require the board to demonstrate that the decision was informed.[95] In any subsequent litigation, it would be the board that would have to produce the consultant report, disclose any conflicts, and justify the informed and neutral nature of the advice.[96] The burden would push boards to use compensation consultants who were free of conflicts of interest with the CEO or the company.

These changes, however, would only go so far. As the special litigation committee context has shown, courts can still make it difficult for shareholders to establish a lack of independence and informed decision-making. In other words, even with the benefit of discovery and a shift in the burden, there is no guarantee that the process will function properly to protect shareholders.

The more radical change, therefore, needs to be an explicit return of fairness to the analysis. No matter what procedures are employed, it is simply not possible to entirely insulate a board from the influence of the CEO or other interested directors.[97] If for no other reason than directors know that they will have to interact together in the future, independent committees will always hesitate to take positions antagonistic to the CEO.[98]

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93. *See In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 925-28 (Del. Ch. 2003) (discussing the stricter requirements imposed in connection with a special litigation committee). Stock exchange traded companies already must have compensation committees consisting entirely of independent directors. *See* NYSE Rule 303A.05, *available at* http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/nyse/1101074746736.html&displayPage=/lcm/lcm_subsection.html. Delaware and the exchanges, however, do not use the same definition of "independent." *See* Brown, *supra* note 3, at 70. Moreover, the exchanges do not exclude the CEO from participation or require neutral advisors. *See* NYSE Rule 303A, *available at* http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/nyse/1101074746736.html&displayPage=/lcm/lcm_subsection.html.

94. *See Beam*, 845 A.2d at 1055 ("Unlike the demand-excusal context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be 'like Caesar's wife'—above reproach.").

95. *See* Sutherland v. Sutherland, No. 2399-VCL, 2008 Del. Ch. LEXIS 59, at *3 (Del. Ch. May 29, 2008) (finding the board had the burden of establishing reasonableness of process used by special litigation committee).

96. *See* Gesoff v. IIC Indus., 902 A.2d 1130, 1147 (Del. Ch. 2006) ("As has been repeatedly held, special committee members should have access to knowledgeable and independent advisors, including legal and financial advisors.").

97. *See* Brown, *supra* note 3, at 56 (discussing impossibility of entirely excluding interested influence from decision making process on the board of directors); MACEY, *supra* note 5, at 59 (labeling this "cognitive bias").

98. This is the fundamental point made by Jon Macey when he contends that boards have been "captured" by management. *See* MACEY, *supra* note 5, at 51-68.

Recognizing this reality does not mean that special committees and independent approval mechanisms should be avoided. Instead, they should be encouraged. It does, however, make application of the duty of care an inappropriate standard for assessing the conflict of interest. Independent approval of conflict of interest transactions should merely shift the burden of proof. Rather than the board having to establish fairness, shareholders would have to show unfairness. While this would be a tougher standard than the one traditionally applied to the duty of loyalty, it would continue to make the terms of the transaction relevant.

In fact, the Delaware courts have done exactly this. In conflict of interest transactions between the company and a controlling shareholder—something that commonly arises in the context of parent/subsidiary merger—courts allow heightened process to alter the standard of review.[99] Rather than apply the business judgment rule, however, shareholders have the burden of showing the unfairness of the transaction.[100] In other words, fairness and the terms of the transaction continue to matter.

The same standard should be applied to all conflict of interest decisions, including compensation decisions. The approach would likely increase the challenges to board approval of compensation decisions and other conflict of interest transactions. As a practical matter, however,

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99. *See In re* LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 177 (Del. Ch. 2005) ("[T]he business judgment rule does not protect the board's decision to approve a merger (even where a majority of the directors are independent and disinterested) where a controlling shareholder has a conflicting self-interest.").

100. *See In re* Cysive, Inc., S'holders Litig., 836 A.2d 531, 547 (Del. Ch. 2003) ("Under that standard, the plaintiffs can succeed only if they show that the independent board majority or committee approval was somehow obtained by fraud or coercion on the part of Carbonell or Lund, or that the independent directors violated their duty of care or acted in bad faith."); *In re* Trans World Airlines, Inc. S'holders Litig., No. 9844, 1988 Del. Ch. LEXIS 139, at *20 (Del. Ch. Oct. 21, 1988) (stating that approval by independent negotiating committee results in a "burden shifting effect" with respect to "the entire fairness of the transaction"). This is true whether disinterested approval is by directors or shareholders. *See In re LNR*, 896 A.2d at 178 n.52.

> While the initial burden of establishing entire fairness rests on the defendant party, an approval of the transaction by an independent and disinterested board or Special Committee, as well as an informed majority of minority vote, shifts the burden of proof on the issue of fairness to the challenging shareholder plaintiffs.

Id.; *see also* Rosser v. New Valley Corp., No. 17272-NC, 2005 Del. Ch. LEXIS 81, at *18 (Del. Ch. May 27, 2005).

> On the other hand, if implementation of the Plan is considered to be the result of actions taken by a controlling shareholder group, the effect of approval by fully informed and disinterested shareholders may simply be to shift to the Plaintiff the burden of demonstrating that the transaction was not entirely fair.

Id. A recent Delaware court, however, suggested that the appropriate standard of review for a recommendation by a special committee might be an open question. *See* Krasner v. Moffett, 826 A.2d 277, 286 (Del. 2003) ("Beyond that, it is premature to determine the legal effect—and the resulting standard of review—that would apply if a special committee that operated independently recommended a merger to the full board.").

shareholders would only have a realistic chance of successfully challenging compensation decisions that, like those in *Julian* and *Valeant*, were substantial in amount and not properly justified by the board.

In other words, the standards would increase the risk of liability in a meaningful respect only for outliers, compensation decisions that exceeded all reasonable boundaries. As a practical matter, this would force compensation committees and boards to limit compensation to a more traditional and predictable range, tracking the practices of others in the same industry. It would result in a more cautious approach, bringing compensation decisions into greater alignment with the interests of shareholders.

V. CONCLUSION

The financial turmoil that began in fall of 2008 illustrated the out-of-control nature of executive compensation.[101] The federal government chose to remedy the situation by imposing relatively weak limitations on the compensation paid by the companies participating in the bailout.[102] The provisions were notable for their efforts for the first time in setting federal standards for determining compensation.[103] Nonetheless, they did little to alter the existing dynamic in the boardroom with respect to compensation decisions.[104]

Similarly, the NDPTCA has not tampered with board duties.[105] Instead, the Act has sought to address the issue by including provisions that facilitate the election of directors nominated by shareholders.[106] Ultimately, this may be the only real solution. Legislative changes to fiduciary obligations will only work so well. In places such as Delaware, any legislative

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101. *See* J. Robert Brown, *Excessive Compensation and the Role of the Delaware Courts (Part 1)*, Nov. 21, 2008, *available at* http://www.theracetothebottom.org/executive-comp/excessive-compensation-and-the-role-of-the-delaware-courts-p.html (discussing compensation paid to executives of financial firms and homebuilding firms over a five year period); *see also* J. Robert Brown, *Corporate Governance Failures and the Bailout Bill*, Oct. 22, 2008, http://www.theracetothebottom.org/securities-issues/corporate-governance-failures-and-the-bailout-bill.html (describing limits on executive compensation in financial bailout legislation).

102. Emergency Economic Stabilization Act of 2008, H.R. 1424, 110th Cong. (2008) (enacted); 110 P.L. 343; 122 Stat. 3765.

103. *See* J. Robert Brown, *Corporate Governance, the Bailout and a Lost Opportunity (Part 2)*, Oct. 6, 2008, http://www.theracetothebottom.org/securities-issues/corporate-governance-the-bailout-and-a-lost-opportunity-part-1.html (describing the limited nature of executive compensation reforms in financial bailout legislation). Until these provisions, federal efforts to reign in executive compensation had been limited to changes in the tax treatment of payments rather than efforts to directly affect the amounts involved. *See* 26 U.S.C. § 162(m) (2008).

104. *See* J. Robert Brown, *Delaware Courts and the Influence of Federal Preemption (Part 1)*, Dec. 15, 2008, http://www.theracetothebottom.org/preemption-of-delaware-law/delaware-courts-and-the-influence-of-federal-preemption-part-1.html.

105. *See supra* notes 15-19 and accompanying text.

106. *See supra* notes 16-19 and accompanying text.

change would still have to confront the pro-management bias of the courts.[107] Probably the only way to truly protect the interests of shareholders is to give them the authority to elect their own candidates to the board.[108] This would not only insert shareholder advocates into the boardroom, but also focus the attention of the other directors on shareholder interests as a means of avoiding a proxy fight.

Nonetheless, this is a long-term solution. The hostility and antagonism to the SEC's modest proposal to provide large shareholders of public companies access to the company's proxy statement, a right provided under the NDPTCA, show that changes to the composition of the boardroom will not happen anytime soon.[109] Short term fixes to the board's fiduciary duties through additional, affirmative obligations and increasing the risk of liability are the only meaningful ways to begin the process of limiting executive compensation and protecting the interests of shareholders.[110]

107. *See* J. Robert Brown, *Delaware, the Courts, and the Race to the Bottom*, Mar. 12, 2008, http://www.theracetothebottom.org/preemption-of-delaware-law/delaware-the-courts-and-the-race-to-the-bottom.html (discussing non-legal reasons why Delaware benefits from companies incorporating in state); *see also* J. Robert Brown, *Delaware Judges, Shareholder Rights, and the Appearance of Bias (Part 5)*, Mar. 11, 2008, http://www.theracetothebottom .org/preemption-of-delaware-law/delaware-judges-shareholder-rights-and-the-appearance-of-bia-4.html (discussing views of a Vice Chancellor of the Delaware Chancery Court on corporate governance issues).

108. J. Robert Brown, Jr., *The SEC, Corporate Governance, and Shareholder Access to the Board Room*, 2008 UTAH L. REV. 1339, *available at* http://ssrn.com/abstract=1095032.

109. *Id*. at 1380 n. 224.

110. Even for those recognizing the problem of board capture, this is not the only solution. Jon Macey at Yale sees the solution as an increase in takeovers. *See* MACEY, *supra* note 5, at 51-68.