# Why Corporations?

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ABSTRACT

This Article suggests that reform of the governance of publicly held firms might appropriately include a move from the corporate to the partnership form. The corporate form is susceptible to regulation, rigidly centralized and not readily adaptable to firms' varying circumstances. These features are unsuitable for new economy firms that rely on markets and networks rather than integration. Partnership's greater flexibility and freedom from government interference arguably makes it a better choice than corporation for many publicly held firms. Thus, the persistence of incorporation may owe more to politics and regulation than to efficiency. The rigidity of the corporate form makes it easier to regulate and therefore provides more rent-seeking opportunities for politicians and interest groups than if parties could freely choose their business form. Taxation of corporate distributions reduces owners' incentives to take control of corporate earnings. Also, by protecting managers' power, preserving the corporate form co-opts the interest group that is best able to lobby for change. However, new corporate tax rules, increased federal regulation of corporate governance, and the changing nature of U.S. business may give firms new incentives to use the partnership form. Lawyers may be the agents of change, as they have been in promoting partnership-based business forms for closely held firms.

INTRODUCTION

Calls for reform of the governance of publicly held firms are phrased in terms of corporate governance, though the corporate form is just one of several embodied in state statutes. The accepted wisdom is that firms generally divide into closely held and publicly held, with the partnership form being suited to the former and the corporate form to the latter.\(^1\)

This Article challenges the assumption that the corporate form is optimal for publicly held firms. In general, the Article views choice of standard form as one of the dimensions in which governance terms are formulated, together with customized contracts, exchange listing agreements, and federal and state law.

\(^1\) In this Article, unless otherwise noted, "partnership" refers not only to general partnership, but also to limited partnership, limited liability company, limited liability partnerships and other non-corporate business forms based on partnership.
This Article focuses on what is at stake in standard form contracting.

At first glance, it seems that not much is at stake. Since both partnership and corporate standard forms deal with similar governance problems and since many of those problems are common to all firms, it is not surprising to find many of the same features in both types of standard forms. For example, both provide a mechanism for segregating piles of assets and dedicating them to the firm as distinguished from the firm’s owners. This means that neither the firm’s owners, nor their heirs or creditors, can deal with the property as if it were owned individually. In order to avoid a conflict of interests, someone needs to manage these assets separate from the affairs of the individual owners. In other words, any firm, whether a corporation or partnership, is to some extent a distinct “entity.” Also, standard forms are mostly default rules and in that respect matter only to the extent of the costs of drafting around the rules.

To some extent the differences between the corporate and partnership forms are based on making the forms suitable for the distinct contexts of publicly held firms, in which there is an active market for the firm’s shares, and closely held firms, where there is no such market. In the absence of a securities market, exit must be provided by buyout or dissolution rather than trading. Limited liability of corporate shareholders makes an active market feasible, but also involves costs, including the moral hazard of letting people conduct business without full responsibility.

Other differences between these forms are more subtle but still important. In particular, the corporation has always been burdened by the “concession” theory, which originally made it a quasi-public entity. Corporate governance is rigidly centralized and not readily adaptable to firms’ varying circumstances.

The greater flexibility and freedom from government interference of partnership-based business forms make these forms better choices than a corporation for many publicly held firms. The persistence of incorporation therefore may be attributable more to politics than to efficiency. The rigidity of the corporate form makes it easier to regulate and therefore provides more rent-seeking opportunities for politicians and interest groups than if the parties to firms could freely choose a legal framework for their business form. An important regulatory aspect is taxation of corporate distributions which reduces owners’ incentives to take control of earnings. Also, by protecting managers’ power, regulation of the corporate form co-opts the interest group that is best able to lobby for change.

The Article is organized as follows. Part I discusses potential efficiency explanations for the corporate form. Part II discusses some defects in these efficiency explanations. The distinctive aspects of the corporate form,

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particularly including the corporate type of centralized management, have costs even for publicly held firms, particularly “new economy” firms that are becoming leaner and more market-based.

By contrast, as discussed in Part III, partnership-based forms are fully contractible and not burdened by the legacy of the concession theory. Partnership flexibility also offers firms opportunities to avoid regulation of governance. Part IV considers a political explanation for why, despite partnership’s advantages, publicly held firms continue to adopt the corporate form. Specifically, corporate inflexibility and the concession theory serve both politicians’ interests, by making it easier to regulate business and managers’ interests, by protecting their power. The important question, therefore, is how long these groups can hold off pressures for change. Part V considers other possible explanations for the continued dominance of the corporate form, including network effects. Part VI concludes.

I. AN EFFICIENCY-BASED EXPLANATION FOR CORPORATIONS

This Part discusses a potential efficiency-based explanation for the dominance of the corporate form for publicly held firms. Section A provides a brief introduction to the functions of business forms. Section B discusses the suitability of the corporate form for publicly held firms.

A. The Role of Standard Forms

There is an initial question of why it matters whether a firm is a corporation or a partnership. In other words, why are not all of the significant issues concerning the governance of business associations resolved by specific contracts among the participants in the firm or between the participants and the firm itself as a nexus of contracts?³

Statutory standard forms serve at least three general functions.⁴ First, they provide default rules that conserve on contracting costs. These rules obviously are more important as contracting costs increase. Thus, a small and stable group of owners, as in the typical closely held firm, can contract relatively cheaply for most governance rules that bind them. However, it is relatively costly to contract for rules that bind creditors’ claims, such as those that confine creditors’ claims to the assets owned by the debtor firm or to those of the debtor owners.⁵ Moreover, there are distinctions within these broad categories

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3. As to the role of the firm as a nexus of contracts, see, e.g., Stephen M. Bainbridge, The Board of Directors as Nexus of Contracts, 88 IOWA L. REV. 1 (2002); R.H. Coase, The Nature of the Firm, 4 ECONOMICA (N.S.) 386 (1937); G. Mitu Gulati et al., Connected Contracts, 47 UCLA L. REV. 887 (2000).


5. See Hansmann & Kraakman, supra note 2 (discussing affirmative and defensive asset
of default rules. Among the owners, it may be costly to foresee the circumstances in which the parties will want to break up the firm, and therefore to provide the terms that govern in these circumstances. With respect to creditors, it is less costly for the firm to contract with a few large individual creditors than with many trade creditors.

Second, business associations provide for distinct sets of default terms. This indicates why the law not only provides default rules for business associations, but also groups these terms into separate statutes. Grouping default terms aids planning by combining complementary terms. For example, a term providing for personal liability of owners is efficiently combined with terms providing for direct and equal management rights, per capita profit sharing and dissolution at will. Grouping default terms also aids in interpreting the firm's governance contracts and applying regulation to the firm. The fact that a firm has chosen a particular set of complementary terms better indicates what terms the owners wanted to apply in areas where the standard form and customized contracts are silent than if the parties selected terms from a single menu of default rules. Similarly, using coherent sets of default terms signals to regulators and judges the type of firm that has opted into a particular form. Both of these attributes of coherent sets of terms facilitate the development of interpretive case law associated with distinct business associations rather than simply with individual contract terms. Finally, coherent sets of default terms signal the firm's type to third parties dealing with the firm.

Third, distinct business associations provide for a mix of types of mandatory rules. If there were only a single set of terms, business association terms would be either default or mandatory. Multiple business associations permit associating mandatory rules with particular standard forms, thereby permitting an intermediate form of opting out through form selection.6

B. The Suitability of Corporate Features

The corporate form fits publicly held firms particularly well. First, corporations are managed by or under the control of a centralized board of directors. Delegating power to a relatively small group of people enables more efficient decision-making than dispersing power among many owners. Moreover, the corporate form of centralized management involves dividing management between professional full-time executives who manage the firm day-to-day and directors who oversee the board and set policy. The board partitioning).

6. An example is the limited partnership control rule. See REVISED UNIF. P'SHIP ACT § 303 (1985) [hereinafter RUPA] (amended 2001). The National Conference of Commissioners on Uniform State Laws promulgated a revised version of the limited partnership act in 2001. However, since few states have adopted that revision, this article will rely mainly on RUPA (1985) as a better reflection of current law.
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theoretically permits better monitoring of managers than dispersed shareholders alone can provide.  

Second, corporate shareholders are not, like general partners, personally liable for the firm’s debts. Shareholders’ limited liability does more than simply transfer risks to creditors—it can create wealth by facilitating freely transferable stock and therefore the development of informationally efficient stock markets. Commentators have considered limited liability to be an important justification for taxing and regulating corporations.

Third, corporate shareholders can freely transfer both their financial and control interests in the firm. By contrast, partnership-type firms by default let members transfer only their economic interests in the firm and not control. Free transferability of management rights is important to the development of a market for control, which provides effective monitoring of managers.

Fourth, while each partner has, by default, the power to dissolve a partnership or seek a buyout by the firm, corporations can be dissolved only by action of the board of directors followed by a vote of a majority of the owners. Margaret Blair has argued that this corporate feature is particularly important in order to protect corporate assets from breakup. She relies on Alfred Chandler’s account of the development of modern corporations, specifically on how they were able to create organizations that capitalized on developments in transportation and communication beginning in the mid-19th century. As Oliver Williamson and others have theorized, these firms involved the bringing together of bundles of assets each of which was essential to the others’ value—in other words, whose joint value was “asset specific.” Blair views partnership law as unsuited to this bundling because a partnership might be subject to dissolution at the will of any partner, thus giving any

7. See Bainbridge, supra note 3, at 28.
11. See UPA §§ 27; RUPA § 503; REVISED UNIF. LTD. P’SHP ACT § 704 [hereinafter RULPA]; UNIF. LTD. LIAB. CO. ACT § 503 (1996) [hereinafter ULLCA].
12. See UPA §§ 29, 31; RUPA § 801.
partner potential holdup power,\(^\text{16}\) or on a partner's death, subjecting partnerships to the vagaries of succession and inheritance.\(^\text{17}\) Blair supports her story by providing accounts of 19th-century firms that sought incorporation in order to lock in firm-specific assets.\(^\text{18}\)

Fifth, the corporate form protects creditors' ability to rely on corporate assets, which is important in sustaining limited liability. Investors have no right to a dividend, and the firm's assets are committed to its creditors before payout to shareholders.\(^\text{19}\)

The corporation thus provides a coherent set of terms that enable efficient gap-filling and regulation, consistent with the functions of standard forms discussed in Part I.A. For example, the fiduciary duties of corporate managers can be designed to fit firms in which managers have substantial power, but also are constrained by owners' ability to exit by freely transferring their shares. Moreover, a firm's selection of the corporate form signals that management is separated from ownership, and therefore that the firm may be appropriately subject to regulation that protects investors or employees from powerful managers.

II. THE COSTS OF INCORPORATION

This Part discusses some questions about the explanations for the corporation's widespread use discussed in Part I. As discussed in Part II.A, it is not clear why these features must be provided by incorporation rather than alternative partnership forms. A potential answer is that it is efficient to lock publicly held firms into the specific features that are available in the corporate form, particularly including centralized management. But Parts II.B and II.C show that corporate centralized management is excessively rigid and, indeed, may not be well suited to many modern firms.

A. The Choice Between Corporation and Partnership

Although the above story explains why corporate features are important for publicly held firms, it does not explain why such firms need to be corporations in order to obtain these features. More specifically, the discussion in Part I.B

\(^{16}\) See Blair, Locking in Capital, supra note 13, at 409-13. Blair also points out that individual partners might own business assets. See id. But questions regarding ownership of assets arise in any firm. Partnership law is distinct in providing presumptions that help determine what belongs to the firm. See UPA § 8; RUPA § 203.

\(^{17}\) See Blair, Locking in Capital, supra note 13, at 420-21.

\(^{18}\) See id. at 416-22 (discussing Lehigh Coal); id. at 442-49 (discussing example of I.M. Singer, showing need to ensure that Singer's messy estate would not break up the Singer business); id. at 449 (discussing need for incorporation in companies like Proctor and Gamble, incorporated in the 1880's that relied on branded consumer products and Duke Tobacco).

\(^{19}\) See id. at 429-33.
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does not explain why publicly held firms cannot be publicly traded partnerships. Indeed, it is not clear why the corporate form was ever used. Since partnerships antedated corporations,\(^20\) they could have been adapted for use by publicly held firms had the corporation never been invented.

1. Chandler and Standard Forms

Chandler's history of the modern firm does not support the need for incorporation. Chandler devotes little attention to the legal form of business, focusing instead on institutional innovation. In fact, Chandler notes that increasing use of incorporation in the early 19th century did not itself bring institutional innovation.\(^21\) Moreover, the modern firm did not "mature," in Chandler's view, until well into the 20th century, long after the major developments in corporate law.\(^22\) To the extent that legal form mattered at all in Chandler's story, it was as a response to regulation rather than as a reaction to inherent transaction cost problems. Chandler sees antitrust regulation in the late 19th century as encouraging use of the holding company form pioneered in New Jersey,\(^23\) and notes that in the absence of such legislation cartels might have survived in the U.S. as they did in Europe.\(^24\)

2. Fundamental Similarities of Corporation and Partnership

The partnership standard form is not as different from the corporate form as Blair and other commentators assume. In both cases, the firm rather than its individual owners owns property. This includes the firm's reputation and goodwill attached to the firm's name.\(^25\) The property therefore is not directly reachable by the owners' personal creditors\(^26\) or by the owners' heirs.\(^27\)

Partnership law is admittedly misleading in this respect since it traditionally provides for ownership by the individual owners through something called "tenancy in partnership."\(^28\) But this peculiar tenancy systematically negates all

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20. Partnership is one of the oldest forms of business association. See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP, § 1.02 (Aspen Publishers, 2004); See also CHANDLER, supra note 14, at 36 (noting that partnership was the standard legal form until well after 1840).

21. See CHANDLER, supra note 14, at 48.

22. Id. at 415-83.

23. Id. at 318-34.

24. Id. at 375.

25. The issue in partnership law is not whether the firm can have a name or whether the name has value, but the extent of that value, particularly in professional firms where the value of the firm's name must be distinguished from that of the partners' individual names. See In re Brown, 150 N.E. 581 (N.Y. 1926).

26. The creditors can reach the property by charging order in a partnership, which is comparable to garnishing corporate shares. See UPA § 28; RUPA § 704.

27. See infra text accompanying note 50 (discussing rights of heirs on dissolution).

28. See UPA § 25 (describing the features of the tenancy in partnership).
individual rights, including possession, transferability, rights of inheritance, and so forth, so that the partner's individual rights are nominal only.

Since corporations and partnerships own discrete property committed to the firm, it follows that firms' agents manage the firm's property separate from the property of the individual owners. Also, as long as the firm, whether corporation or partnership, is a going concern, the power these agents have over the firm's property includes the power to decide when the property is distributed to the owners, subject to any agreements the owners have made.29 Thus, in the absence of contrary agreement, the owners commit their investments to the firm until it dissolves.

There are four apparently significant differences between the corporate and partnership standard forms.30 First, partners are liable directly or indirectly for the firm's debts while corporate shareholders have limited liability. Second, partnerships by default are managed directly by the partners rather than centralized in executives and directors as in corporations. Third, while corporate shareholders can, by default, freely transfer management rights, new partners by default can be admitted only by unanimous member vote. This reflects the potentially high costs of freely transferring management rights where members have unlimited liability, as well as the smaller benefits of free transferability in closely held partnerships as compared with publicly held corporations. Fourth, and most importantly according to Blair, partnerships by default are dissolved by the will or exit of any member, while the corporate entity survives member dissociation. On dissolution, in the absence of contrary agreement, the partnership's assets are sold and divided among the members or their heirs.

These differences are not, however, as striking as may first appear. To begin with, partnerships always have been able to contract for features that differed from the partnership standard form, including centralized management, free transferability, and continuity.31 Accordingly, it is useful to distinguish between features that are contractible at substantial cost, such as limited liability, and those that are contractible at lower cost, such as decentralized

29. Note also that in partnerships, as in corporations, owners have no statutory right to distributions from an ongoing firm. See, e.g., ULPA § 601 (1985).
30. Blair also stresses the "trust fund" theory, or duty to fund the entity for creditors' protection, as an important entity aspect of the corporation. See Margaret M. Blair, Why Markets Chose the Corporate Form: Entity Status and the Separation of Asset Ownership from Control, Bus., Econ. and Regulatory Policy (Georgetown Univ. Law Ctr., Working Paper No. 429300, 2003). However, shareholders' supposed obligation to provide minimum capitalization survives today only as a marginal factor in veil piercing. See Robert B. Thompson, Piercing the Corporate Veil: An Empirical Study, 76 CORNELL L. REV. 1036 (1991). Moreover, the "trust fund" theory actually connects corporations and partnerships, since shareholders' financing obligation arguably substitutes for partners' personal liability for the firm's debts.
31. The contractibility of partnership rights, with limited exceptions, is now reflected in uniform laws. See ULPA § 103; see also ULLCA § 103.
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management, continuity, and free transferability.

Moreover, partnerships long ago could get the benefit of having these defaults plus limited liability by forming subcategories of partnerships, notably including the joint stock company, which provides for centralized management and free transferability, and the limited partnership, which provides for centralized management and limited liability of passive investors. Limited liability company statutes now provide for a flexible variant on centralized management.

Limited liability is the hardest corporate feature to obtain by contract. While firms can make non-recourse contracts with creditors, tort liability is imposed on owners without regard to contract. Even non-recourse contracts have been restricted in various ways, though explicit contracts are now enforced. Thus, it has been said that "limitation or elimination of liability of the shareholders is not merely the chief single advantage of a business corporation but it is the advantage which in the estimation of legislatures and also in the estimation of the public is of more importance than all the other advantages put together. It is the main thing." Prior to the development of enterprise liability, limited liability probably was not an important corporate feature. When limited liability did become important, its identification with the corporate form may help explain the move to incorporation.

3. Problems with the Continuity Theory of Incorporation

Blair emphasizes continuity as a central explanation for the use of the corporate form. Indeed, Blair views this greater continuity of the corporate form as "critically important to the creation of complex, productive commercial enterprises." However, the continuity inherent in the partnership form has long been recognized. There was traditionally no power to dissolve a

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32. See Bromberg & Ribstein, supra note 20, § 1.01(b)(3); Paul G. Mahoney, Preparing the Corporate Lawyer: Contract or Concession? An Essay on the History of Corporate Law, 34 GA. L. REV. 873, 885 (2000).
33. See Bromberg & Ribstein, supra note 20, § 1.01(b)(3). For a further discussion of limited partnership rules, see infra text accompanying notes 133-136.
34. See infra text accompanying note 137.
35. See Ribstein, supra note 4.
36. See id. at 369-432.
39. See Blair, Locking in Capital, supra note 13, at 419 (noting that many early corporation statutes did not grant limited liability); Mark L. Weinstein, Share Price Changes and the Arrival of Limited Liability in California, 32 J. LEGAL ST. 1 (2003) (noting that California first adopted limited liability in 1931 and showing no share price effect of adoption).
40. See Blair, supra note 30, at 27.
41. See, e.g., Arthur J. Jacobson, The Private Use of Public Authority: Sovereignty and
partnership prior to an agreed term, at least without just cause. Moreover, partnerships long have been able to agree to continuation of the business and payoff in cash of deceased partners. By adjusting both the amount and terms of payoff, partnerships can achieve significant continuity. Accordingly, it is misleading to focus unduly on partnership default rules in arguing the defects of partnership. Although Blair cites Baldwin Locomotive as a situation where corporate continuity would have been beneficial, the partnership agreement in that case facilitated continuity through slow pay-off of the estate.

To be sure, customized drafting around default rules may require extra expense. But lawyers have considerable experience with continuation agreements in partnerships. Moreover, early in their history corporations were not used widely enough to give them a clear advantage in predictability. Thus, it is not surprising that firms at first drafted for corporate features rather than incorporating. Indeed, Blair discusses a prominent example of effective use of continuity provisions in a partnership agreement—Andrew Carnegie’s “iron clad” agreement providing, among other things, for gradual buyout of deceased and retired partners.


42. See BROMBERG & RIBSTEIN, supra note 20, § 7.03(a) n.4; JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP § 273-76, at 410-420 (2d ed. 1846).

43. See BROMBERG & RIBSTEIN, supra note 20, § 7.11(e); see also STORY, supra note 42, § 199 (discussing clauses for continuation notwithstanding partner death in order to be sure that the business is “steadily carried on”); id. § 207 (discussing clause providing for purchase of other partner “at a valuation” if “express stipulation”). The modern exception is the ipso facto provisions of bankruptcy law. See 11 U.S.C. § 365 (2004); see Larry E. Ribstein, Partner Bankruptcy and the Federalization of Partnership Law, 33 WAKE FOREST L. REV. 795 (1998).

44. Indeed, even the default rules are changing. In her conference paper, Blair carries the analysis of default rules through to modern partnership and LLC statutes. See Margaret M. Blair, Corporate Governance Reform Puzzle: What History Can Teach Us, 1 BERKELEY BUS. L.J. 1, 19-30 (2004). However, she focuses on uniform laws, which misses a significant evolution away from dissolution at will in state limited partnership and LLC statutes. See BROMBERG & RIBSTEIN, supra note 20, § 17.02(d)(2) n.19 (listing state limited partnership provisions); LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES app. 11-1 (Thomas/West, 2004) (summarizing state limited liability company statutes). Blair also notes that limited liability encourages partner exit from failing firms. See Blair, supra (citing Susan Saab Fortney, High Drama and Hindsight: The LLP Shield, Post-Andersen, 12 BUS. L. TODAY 46 (Jan.-Feb. 2003)). But this is not a function of the relative continuity of the partnership and corporate form, since one always can sever an agency relationship regardless of form. Rather, it focuses on the traditionally corporate feature of limited liability as an incentive for severing the relationship.

45. See Blair, Locking in Capital, supra note 13, at 452-54.

46. Thus, Blair cites the Schuylkill charter to the effect that Schuylkill was seeking incorporation because “plain men of business” have difficulty making the right agreements. See Blair, Locking in Capital, supra note 13, at 420-23. Note that the couple of corporate charters Blair relies on do not necessarily indicate the real reasons for incorporation. The charters were public documents being presented to state legislators, and could be expected to emphasize considerations that would be politically acceptable, as distinguished, for example, from the desire to avoid owner responsibility for corporate debts.

47. In other words, network externalities, which now are said to help entrench the corporate form (see infra Part IV.B) might initially have worked against it.

48. See Blair, Locking in Capital, supra note 13, at 451-52. She notes that the agreement worked
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Blair also suggests that the continuity of the corporation was necessary to protect the going concern from claims of partners’ heirs. But partnership law provides that partners’ heirs have no interest in partnership property. On a partner’s death, the firm by default is wound up, which includes paying off the deceased partner’s estate. If the partnership agreement provides for continuation, then the firm can be, in effect, wound up by cashing out the estate. The heirs might fight until doomsday about who gets what, but the firm need not be involved in this squabble. Thus, while Blair emphasizes the problems that might have resulted if I.M. Singer got tangled up in Singer’s potentially messy estate and even suggests that Singer’s success was attributable to resolving these problems by incorporating, these problems might easily have been avoided by an agreement providing for cashing out the estate on Singer’s death.

An additional reason for skepticism about Blair’s historical account of incorporation is that many of the firms that turned to the corporate form during the Industrial Revolution were closely held. The distinctive features of the corporate form discussed in Part I would seem to be most useful for publicly held firms. In particular, the continuity of the corporate form is particularly disadvantageous for closely held firms since members need an exit route in the absence of a public market for the firm’s shares. Moreover, partnership-type buyout rules are least likely to be a problem in publicly held firms with many small shareholders because the firm is unlikely to be forced to liquidate if it has to cash out the shareholders. Thus, the Singer scenario may be idiosyncratic or, at most, a problem in a small subset of cases involving a couple of large shareholders.

4. The Unanswered Question: Why Require Incorporation?

Assuming that certain valuable features, including limited liability or, in Blair’s theory, continuity, were available only in the corporate form, the important question for present purposes is why firms should have had to

so well partners were locked in and caused trouble. This illustrates the trade-off between continuity and the need for exit to avoid lock-in in closely held firms. See infra text accompanying note 81.

49. See Blair, Locking in Capital, supra note 13, at 420-23 (discussing Schuylkill); id. at 442-49 (discussing Singer); id. at 452-54 (discussing Baldwin Locomotive). As for reliance on charter provisions in explaining incorporation, see supra note 46.

50. See UPA § 25(2)(d); RUPA § 501. The only difference is that some states provided that the heirs got legal title if the property was not needed for winding up. See BRONBEMG & RIBSTEN, supra note 20, § 3.05(1).

51. See UPA §§ 38, 40; RUPA §§ 801, 807.

52. See Blair, supra note 30.

53. To be sure, a buyout right may be a problem if many shareholders seek to leave at the same time, but a mass exodus is arguably a signal that the firm should liquidate. In other words, partnership-type buyout, far from being a problem, is arguably an overlooked solution to the accountability problems that have plagued the corporate form. See infra Part II.B.2.
incorporate in order to obtain these features. To be sure, the particular device the law used for creating limited liability was to characterize the corporation as a separate legal entity against which creditors' claims could be made. But the law might from the beginning have recognized that partnership-type firms could be such entities. Perhaps the law should protect creditors from the moral hazard inherent in limited liability by restricting the types of firms that have limited liability and the terms of limited liability contracts or regulating disclosures to creditors. But it is not clear why the law should require formal incorporation to protect creditors. Limited liability might from the beginning have been offered in partnerships coupled with mandatory constraints such as limits on distributions, as is now the case in limited liability companies and limited partnerships. These rules forbid distributions by insolvent firms, analogous to the rules that preserve bundles of corporate assets for creditors.

In short, the dominance of the corporate form cannot be explained on the basis that it facilitated the growth of industrial firms. The partnership form always could have been adapted to the needs of these firms. Although adaptation would have involved the development of novel types of agreements, it is unlikely that this would have presented more problems than the evolution of the corporate form from a quasi-public to a private entity. The most that can be said about the importance of the corporate form is that it is arguably better suited than the partnership form to the publicly held firms that eventually emerged from the Industrial Revolution. Yet there is some doubt even about this conclusion, as discussed in the next subpart.

B. The Problems of Corporate-Style Governance

This Section shows that the most distinctive feature of the corporation—centralized management by a board of directors—is, in fact, too rigid to achieve the right balance between discretion and accountability for many firms. Part II.B.1 gives an overview of corporate-type centralized management. Parts II.B.2 and II.B.3 discuss the main corporate governance problems of accountability and inflexibility.

1. Overview of Corporate Governance: "Director Primacy"

Corporate governance is best characterized as based on "director primacy." This model features hierarchical decision-making by a small

54. See Mahoney, supra note 32.
55. See Ribstein, supra note 4.
56. See RULPA §§ 607-608; ULLCA §§ 407-408.
57. See supra text accompanying note 20.
58. See Stephen M. Bainbridge, Corporation Law and Economics ch. 5 (Foundation Press, 2002).
collective group (the board of directors), which coordinates the nexus of contracts with capital contributors, employees, and others. This approach to decision-making has obvious benefits in light of the decision-making costs involved in reaching consensus among large numbers of people and between groups with disparate interests. The board, in turn, monitors managers and sits atop a broader hierarchy reaching down to semi-autonomous divisions. This structure provides monitoring to deal with managerial agency costs and allows for specialization at lower levels of the hierarchy to deal with the vast amounts of information that flow through the large publicly held corporation.

Director primacy includes the following principal elements. First, directors have broad power both to make all management-type decisions, including the day-to-day operation of the company, managerial compensation, and distributions to shareholders, and to initiate major decisions, including amendment of the charter, or sale, dissolution or merger of the firm.

Second, shareholders lack the power to make management-type decisions or to initiate major decisions. Shareholder power is essentially limited to voting on major decisions and electing and removing directors. Thus, the directors are not really the shareholders' agents in the traditional sense of being under the shareholders' direct supervision and control.

Third, and perhaps most importantly, the balance of power between directors and shareholders described in the preceding two paragraphs is not effectively subject to contrary agreement. A basic principle of corporate law has long been that the firm cannot "sterilize" the board—that is, seriously impair its basic functions. Though corporate statutes provide that management by the board can be qualified to some extent by contrary provisions in the articles of incorporation, these provisions do not clarify how far such restrictions may go. The existence of some limitation is supported by the fact that corporate statutes explicitly permit reduction or elimination of board functions only in special provisions applying to closely held corporations.


61. See Clark v. Dodge, 199 N.E. 641 (1936) (enforcing agreement concerning dividends among other things because the agreement did not unduly restrict director discretion); See also Galler v. Galler, 203 N.E.2d 577 (Ill. 1964) (enforcing close corporation agreement including dividend distribution provision where the provision was conditioned on a minimum earned surplus of $500,000).


63. See id. §§ 341-356. To be sure, the Delaware statute also expressly provides that its close corporation subchapter does not invalidate provisions authorized under other sections. See id. § 356. This implicitly refers back to the general authorization of contrary charter provisions. But an open-ended interpretation of this provision to permit publicly held firms to significantly dilute board power would be unwarranted as inconsistent with the statute's explicit distinction between closely held and publicly held
Fourth, the board's power is constrained principally by broad fiduciary duties. This enables courts to fill what they perceive as gaps in corporate governance ex post at the time of litigation. In other words, courts rather than contracts determine the limits on board power.

2. Accountability

The central problem in the director primacy model is finding ways to ensure that the board, having been given exclusive power to manage the firm, exercises this power consistently with the firm's interests rather than in their own interests or in those of the executives who most immediately control the board's selection, tenure, and information. In other words, there is a question whether "board primacy" adequately deals with agency costs. As Stephen Bainbridge has said, "[e]stablishing the proper mix of discretion and accountability... emerges as the central corporate governance question."64

The important initial question is to whom the directors owe their primary allegiance. The board needs to have some specific set of interests in mind or else it will not easily reach decisions, and its decisions cannot easily be monitored, thereby exacerbating agency costs. In other words, the fact that the directors hold significant power does not necessarily answer the question of to whom the directors are accountable in exercising this power.65

Most corporate scholars assume for various reasons that the interests that should matter to directors of most publicly held corporations are those of shareholders.66 An alternative view is that directors have responsibilities to multiple constituencies.67 In the most fully developed alternative account, Blair and Stout view the board as "mediating hierarchs" who respond to the interests of the various parties to the corporate contract, including creditors, suppliers, and workers.68 Blair argues that the corporate separation of ownership and control is designed in order to ensure that neither the shareholders nor any other party to the corporate contract controls the board.69

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64. See BAINBRIDGE, supra note 58, at 207.
67. For a recent article contrasting the "entity" and "property" theories of board governance, see Leo E. Strine, Jr., The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There Any "There" There?, 75 S. CAL. L. REV. 1169 (2002).
69. See Blair, supra note 13, at 46-47.
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These two views of corporate governance mesh to some extent because efficiency demands joint maximization of the interests of all contracting parties and because parties such as workers who associate with a firm primarily as non-shareholders also own shares in the firm. Markets internalize costs, since a firm cannot ignore the interests of non-shareholders with whom it deals or these parties may take their business elsewhere. Firms accordingly may make promises to non-shareholder constituencies in order to induce reciprocal commitments.

The meshing, however, is not complete. At some point, directors must choose whose interests to serve. Moreover, the law must define managers' duties or they will have no effective duties at all. In other words, the most persuasive argument against the multiple constituencies view is based on agency costs. The reasons discussed immediately above for making shareholders the residual claimants provide a strong normative argument for making directors responsive primarily to shareholders as a default rule, although firms should be able to contract for an alternative structure.

The main question regarding corporate governance, then, is whether powerful corporate managers are adequately accountable to shareholders' interests. Theoretically, accountability is provided by, among other things, judicial review under the business judgment rule, shareholder litigation, stock-based compensation, the market for corporate control and activist shareholders. There are, however, reasons to conclude that the corporate structure outlined above, which gives substantial power to managers and little direct power to shareholders, may not be optimal for many firms because shareholders' powers to approve manager-initiated actions and to remove the directors may not be adequate to police agency costs.

Lack of shareholder power is particularly problematic where managers' interests most directly conflict with those of the shareholders, as in the case of

71. This point is illustrated by Chancellor Strine's effective "James Trains" takeover defense hypothetical. See Strine, supra note 67.
72. See Lynn A. Stout, Bad and Not-So-Bad Arguments for Shareholder Primacy, 75 S. CAL. L. REV. 1189, 1202 (2002). Stout says that the answer to this argument is ultimately empirical, based on shareholders' "revealed preferences," and these are embodied in rules such as directors' significant protection from hostile takeovers. But this confuses directors' powers and their duties in exercising these powers. See Bainbridge, supra note 58. It is also a somewhat Panglossian view that assumes corporate governance rules are optimal. As discussed below, this may not be the case, at least in part because of the law's bias toward the corporate form.
73. See infra text accompanying note 141 (discussing use of the partnership form for this purpose). To the extent that managers' responsibilities to non-shareholder constituencies are legally imposed on firms, the normative argument in the text suggests that these rules may be politically motivated. See infra text accompanying note 223.
74. See Bainbridge, supra note 58, at 206.
managerial compensation. Shareholders lack any direct control over the design of compensation. Accordingly, shareholders must rely on board supervision of managerial compensation, the managerial labor and control markets, and their power to approve or reject compensation plans that are submitted to them. But as long as managerial compensation generally meets prevailing standards, boards lack incentives to second-guess compensation of powerful executives who are otherwise performing well. Also, again as long as compensation is loosely acceptable, managerial compensation is unlikely significantly to affect the firm’s capital costs or product prices, make the firm a likely takeover target, or diminish an executive’s attractiveness to other firms. Shareholders’ voting power does them little good because it gives them the poor choice of either denying compensation to well-performing executives or acquiescing in an overly generous pay package. This leaves shareholders with their usual last resort of judicial supervision. But executive compensation is protected by the business judgment rule, and even if a court intervenes, derivative procedures are costly.

Bebchuk suggests remediying the above problems by empowering shareholders to change corporate governance arrangements, merge or sell the company, or order distributions. But this may trigger the high decision-making costs that the hierarchical corporate structure is intended to avoid. These actions involve complex business planning that cannot effectively be done by a large group, particularly given the need for vast amounts of information. Although shareholders can get guidance from experts, they must coordinate around a particular plan, and decide which experts to rely on. It is not clear what shareholders would gain by hiring more experts, who bring their own agency costs.

An alternative way to ensure more accountability to owner interests would be to give owners the power to cash out of the firm. Such a right might be given not only in response to major transactions, as under current law, but at will.


77. Managers can promote acceptability by “camouflaging” compensation – for example, by using compensation consultants. See id.


80. See Bebchuk, supra note 75.
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This would give owners significantly more than they would get from merely being able to sell their interests on the market, since the price would be determined by the value of the underlying assets—that is, without the discount resulting from mismanagement. This is, of course, essentially the right that partners have, the rejection of which marks corporate law's significant advance over partnership law according to Blair. That is not to say that partnership-type dissociation rights are better in all, or even many, circumstances than corporate-type lock-in, but only that the appropriate choice between the two approaches involves sensitive tradeoffs and is not obvious.

3. Inflexibility

Because corporate governance requires balancing the benefits of delegation and hierarchy against the need for accountability, no single solution is likely to work for every firm. Reducing delegation by empowering shareholders may raise decision-making costs for some firms more than it lowers agency costs. The solution lies in enforcing firm-specific governance contracts rather than in the rigid corporate framework. For example, where ownership structure is relatively concentrated in the hands of institutional shareholders, the dangers of meddling by unsophisticated shareholders or of incoherent decision-making might be less than the agency costs of delegating significant power to managers. Also, specific limits on managers' discretion might work better in some firms than a general allocation of governance powers.

The problem of corporate governance lies not in the default allocation of power to strong centralized managers, but in the rigidity of managers' power. As discussed above, corporate law limits the extent to which the firm can qualify the board's power. Although the board's power is not plenary, it is subject mainly to court-imposed fiduciary duties rather than firm-specific arrangements. Corporate statutes generally restrict opting out of these fiduciary duties.

Corporate inflexibility is particularly evident in takeover defense cases. These cases involve a sensitive balancing process. On the one hand, enforcing takeover defenses may compromise the viability of the market for corporate control as a constraint on agency costs. On the other hand, there are many

81. The greater accountability of managers in the limited partnership form is illustrated by the fact that it was limited partnerships' move to a corporate-style structure in which assets were locked in that triggered the most extensive federal regulation of partnerships to date. See infra text accompanying notes 213-216 (discussing regulation of limited partnership rollups).
83. See supra text accompanying note 61.
84. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2004) (prohibiting opting out of breach of the duty of loyalty, acts not in good faith or involving intentional misconduct, or transactions from which the director received an "improper personal benefit").
reasons why the parties to a firm might want to give the board ultimate say on takeovers. Shareholders may want to preserve management continuity or to empower managers to bargain for a high price. They also might be concerned that invalidating takeover defenses would force managers to defend against takeovers by engaging in value-reducing strategies that cannot effectively be regulated. And giving the shareholders the ultimate say in takeovers might be inconsistent with "team production" and other theories that stress the need to protect non-shareholder interests in order to maximize overall firm value.

Firms may choose to place takeover defenses in the corporate governance documents when they are going public, a time when shareholder choice is not obviously infected by shareholder coordination problems. Allocating control in the initial charter may not, however, be an effective strategy in all cases because firms' business and ownership configurations change over time. Thus, corporate statutes must be flexible enough to accommodate adjustments in takeover strategies in going firms.

Despite the need for firm-specific variation and adjustment, the courts have tended to apply fairly rigid rules in takeover cases. In general, they preserve substantial board power to defend against takeovers, coupled with a general fiduciary duty limiting this power that courts apply irrespective of firm-specific background rules. In other words, the courts, and not the parties to the firm, have the last word.

This tendency to restrict board power by general rule rather than specific agreement is illustrated by the Delaware supreme court's decisions in Liquid Audio and Omnicare. Prior to these decisions, the Delaware supreme court had relied mainly on its Unocal line of cases in which the courts required the board to show that in defending against a takeover they reasonably perceived a threat to the corporation and took action proportional to that threat. The court imposed more stringent standards on directors in the Revlon sale-of-control

89. See Ribstein, supra note 85; Kahan & Rock, supra note 85 (observing that firms' arrangements are enforced, but not analyzing the effect of fiduciary duty rules on enforcement).
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setting, and in the Blasius setting, where the board took action that interfered with the shareholders' voting power. But these tests were rarely applied to invalidate a takeover defense.

The Delaware supreme court signaled a shift in Quickturn Design Systems, Inc. v. Shapiro when it invalidated a “delayed redemption provision” because it interfered with a subsequent board’s authority to redeem a pill, thereby unduly restricting the board’s power to manage under DGCL Section 141(a).

Since this case supported the board’s power, it comported with the broad interpretation of that power in previous takeover defense cases. However, it indicated that the board’s power might be limited other than by a Unocal-type fiduciary duty analysis.

Liquid Audio and Omnicare clarified this limit on board power by finding an area of inviolate shareholder control. Both cases invalidated board-approved takeover defenses on the ground that they usurped a basic shareholder function of voting on major corporate decisions. Liquid Audio overturned the directors’ expansion of the board from five to seven members in the face of a hostile bid. The bidder had two nominees for the board, who were elected, as well as a proposal to amend the bylaws to expand the board by four members, which would have given it control irrespective of the incumbent’s expansion move (i.e., six of either nine or eleven members). Since the corporation had a staggered board bylaw provision, the bidder needed to amend the bylaws to take immediate control whether or not the incumbents expanded the board. Institutional Shareholder Services had recommended voting for the bidder’s two nominees, but against giving the bidder immediate control by approving its expansion proposal. The chancery court refused to invalidate the takeover defense under the Blasius and Unocal standards because it did not materially affect the shareholders’ choices. The supreme court reversed, emphasizing evidence that the incumbents’ board expansion was done for the express purpose of preventing a change of control that might occur if the board split were closer and one or two incumbents resigned. The supreme court reasoned that the board’s action violated a basic tenet of corporate governance:

Maintaining a proper balance in the allocation of power between the stockholders’ right to elect directors and the board of directors’ right to manage the corporation is dependent upon the stockholders’ unimpeded right to vote effectively in an election of directors. This Court has repeatedly stated that, if the stockholders are not satisfied with the management or actions of their elected representatives on the board of directors, the power of corporate democracy is available to the

95. See Thompson & Smith, supra note 86, at 286-94 (discussing the “death of Unocal”).
96. 721 A.2d 1281 (Del. 1998).
97. For further discussion of the case, see infra text accompanying notes 250-54.
stockholders to replace the incumbent directors when they stand for re-election.  

Although Liquid Audio's structural analysis was novel, both the chancery and supreme courts relied on the general standards governing takeover defenses under Blasius and Unocal. Neither court was moved by the fact that the bylaws let the incumbents expand the board and could be amended by the shareholders to permit the bidder to take immediate control despite the board expansion. The supreme court quoted the venerable Schnell principle that "inequitable action does not become permissible simply because it is legally possible." That principle may be appropriate in a case like Schnell, which involved clear manipulation of the annual meeting date to entrench incumbents without apparent corporate purpose. But it does not necessarily justify ignoring the shareholders' freely made governance choices.

Kahan and Rock argue in favor of the Liquid Audio result as "understood in the context of the governance structure adopted by the firm" because, although the firm had wanted minimal entrenchment, the board attempted "to confer greater entrenchment than provided for in the firm's governance structure." But the case illustrates the risks of second-guessing the parties' agreement. Unlike in Schnell, the board's move made it only a little more difficult for the incumbents to take control—that is, in the specific case where incumbent directors leave or switch sides. The bylaws arguably contemplated this kind of marginal edge by letting the board add directors.

The judicial tendency to ignore the background contract was even more pronounced in Omnicare. The court refused to enforce a deal protection provision in the NCS-Genesis merger agreement requiring submission of the transaction to the shareholders over a higher Omnicare bid because directors holding two thirds of the stock had agreed to vote as shareholders for the merger. Applying Unocal, the majority reasoned that the deal protection provisions "were designed to... preclude the consideration of any superior transaction" and "completely prevented the board from discharging its fiduciary responsibilities to the minority stockholders when Omnicare presented its superior transaction." The court so held although the Delaware statute explicitly authorized this deal-protection provision. The legislature amended the statute in 1998 to clarify that the board could require a shareholder vote whether or not the directors continued to favor the transaction. This was after Van Gorkom held that a shareholder vote would not validate the transaction if the board withdrew its

98. Liquid Audio, 813 A.2d 1118, 1127.
100. Kahan & Rock, supra note 85, at 515.
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recommendation.\textsuperscript{102} Thus, the statute permitted clarification of the corporate intent in this situation, and the corporation had provided this clarification. The chancery court observed that "it is simply nonsensical to say that a board of directors abdicates its duties to manage the 'business and affairs' of a corporation under section 141(a) of the DGCL by agreeing to the inclusion in a merger agreement of a term authorized by § 251(c) of the same statute."\textsuperscript{103} But the supreme court stated the apparently absolute rule that "[t]he directors of a Delaware corporation have a continuing obligation to discharge their fiduciary responsibilities, as future circumstances develop, after a merger agreement is announced" and the board therefore was "required to contract for an effective fiduciary out clause to exercise its continuing fiduciary responsibilities to the minority stockholders."\textsuperscript{104} This fiduciary out, in the court's view, was necessarily better than letting the shareholders decide where the shareholders were also the directors.

The court's disregard of the corporate governance structure cannot be defended as effectuating the shareholders' intent. The board had effectively preserved shareholder value by making a deal with the only promising bidder at the time, Genesis, which had demanded the deal-protection provision. Although Omnicare eventually topped the locked-up Genesis bid, it is unrealistic to ignore the shareholders' benefit from enforcing deal-protection devices.\textsuperscript{105} As dissenting Justice Steele observed: "We should not encourage proscriptive rules that invalidate or render unenforceable precommitment strategies negotiated between two parties to a contract who will presumably, in the absence of conflicted interest, bargain intensely over every meaningful provision of a contract after a careful cost benefit analysis."\textsuperscript{106}

The courts, therefore, engage in a rigid structural analysis that applies equally to all corporations. They have been said to be creating a "sacred space" in which shareholders exercise inviolate rights to vote and sell.\textsuperscript{107} The term aptly conveys the courts' disregard of mundane day-to-day realities and specific governance terms. Moreover, firms may not find relief from these rules through explicit waiver. Since the Unocal rule addresses managers' self-interest in defending against takeovers, it is subject to the self-dealing exception to opting out of fiduciary duties.\textsuperscript{108} The problems of the takeover cases, moreover, are inherent in the corporate form. If the board has inviolate power to run the


\textsuperscript{103} See Omnicare, 818 A.2d 914, 937 (quoting the chancery court).

\textsuperscript{104} Id. at 939 (emphasis added).

\textsuperscript{105} See Kahan & Rock, supra note 85. For an extensive analysis of Omnicare, criticizing the court's refusal to enforce the pre-commitment device, see Sean Griffith, The Costs and Benefits of Precommitment: An Appraisal of Omnicare v. NCS Healthcare, 29 J. CORP. L. 569 (2004).

\textsuperscript{106} Omnicare, 818 A.2d 914, 948.

\textsuperscript{107} See Thompson & Smith, supra note 86.

\textsuperscript{108} See supra note 84 and accompanying text.
company, accountability demands that there must be some equally inviolate way to preserve monitoring by the shareholders.

Thus, the corporate structure is problematic not simply because it tends to facilitate managerial rent-seeking, but also because it is excessively rigid. Firms need to be able to customize shareholders' and directors' powers to deal with firm-specific features such as ownership concentration or the nature of the firm's business. This might include not only variations on management forms, but also on the extent to which assets are locked-in under central management control or subject to partner-like cash-out. As discussed below in Part III, this flexibility is a main advantage of the contract-based partnership form.

C. The Changing Nature of the Firm

Part II.B accepts the need for strong centralized management in publicly held firms but questions the efficiency of the inflexible corporate version of centralized management. This Part shows that there is a more basic question concerning the need for the corporate-type hierarchy in modern firms.

Blair theorizes that the corporate form was used in the late 19th century so that firms could lock assets together in a tightly coordinated firm under strong central management. Blair builds on Chandler's history in which firms capitalized on developments, such as the railroad, that had vastly reduced transportation and communication costs and made large centralized organizations feasible. Firms solved the throughput problem—that is, employing modern industrial processes to ensure that everything got to the right place at the right time, including parts into automobiles and orders from Sears' warehouses to mail order customers. Blair notes that the need for tight coordination could enable owners of critical assets to "hold up" the firm. In order to avoid this problem, firms had to own warehouses, parts suppliers and other assets that were critical to producing the firms' extraordinary returns.

As several recent writers have discussed, however, the Chandlerian firm is being superseded by new technologies and market mechanisms that reduce firms' needs for centralized coordination and to own fixed assets. This is

109. As to the potential advantage of cash-out over lock-in, see supra text accompanying note 82.
110. See Blair, supra note 13.
111. See generally, CHANDLER, supra note 14.
112. See supra text accompanying notes 13-15.
basically consistent with Chandler's story because, while Chandler sometimes seemed to suggest in his 1977 book that he was presenting a complete picture of industrial development, his theory is clearly contingent on prevailing technologies and other economic conditions.\textsuperscript{114} While centrally managed firms are useful in providing a "buffer" that solves the asset specificity problem where markets have not yet developed institutions that can accomplish this task, they become less necessary after the market matures.\textsuperscript{115} Dell, for instance, can assemble computers just in time from parts provided by its network of independent suppliers rather than by Dell-owned factories,\textsuperscript{116} airlines can lease their planes rather than owning them, and Manpower, Inc. can supply temporary workers rather than firms having to permanently hire workers in order to handle peak loads.\textsuperscript{117} Suppliers, in turn, are protected from market uncertainty and holdup by their ability to deal with many customers. All of this is consistent with Coase's original insight that the existence of firms depends on the transaction costs of using markets.\textsuperscript{118}

In general, while the transaction cost balance favored strong centrally managed firms during the Industrial Revolution, it favors looser market-based organizations today.\textsuperscript{119} There is therefore a wide spectrum of firm types ranging from traditional hierarchical firms to firms that rely on spot markets or loose networks of contracts. This means that even the most traditional Chandlerian firms need flexibility to change with the times, and that there are many non-Chandlerian firms for which new approaches to governance may be appropriate. New-economy firms may own minimal hard assets, relying instead on contracts with suppliers such as Infosys (programming) and Flextronics (manufacturing electronics devices). If these firms have lower costs, they will tend to out-compete more traditional firms.

Another important development is firms' greater reliance on skilled workers than on hard assets. Power therefore devolves to the workforce rather than concentrating in middle managers. This produces organizational structures

\textsuperscript{114} See CHANDLER, supra note 14, at 376 (noting that the modern business enterprise was an "organizational response to fundamental changes in processes of production and distribution made possible by new sources of energy and by the increasing application of scientific knowledge to industrial technology"). See also id. at 142-46, 183-84 (discussing the rise of the "virtual" company and networks); William A. Klein & G. Mitu Gulati, A Case Study of Collaborative Production Under High Uncertainty: Economic Organization in the Construction Industry, 1 BERKELEY BUS. L.J. 137 (2004) (describing roles of firms, markets, and contracts in the construction industry).

\textsuperscript{115} See Langlois, supra note 113.

\textsuperscript{116} See Lamoreaux et al., supra note 113.

\textsuperscript{117} See Langlois, supra note 113, at 372.

\textsuperscript{118} See Coase, supra note 3.

\textsuperscript{119} See MICKLETHWAIT & WOOLDRIDGE, supra note 113, at 182 (discussing the balance between transaction and hierarchy costs).
that are "flatter" than the vertical hierarchies of the Chandlerian firm, involve
greater reliance on incentive compensation throughout the organization, and
make less distinction between owners and managers. 120

The evolution of the firm has important implications for governance. The
Chandlerian firm brought significant assets together under central management
whose job was to engage in planning that would mitigate market uncertainties.
Managers accordingly had to have broad powers to decide what to do with the
assets and when and whether to sell them or distribute them to the shareholders.
Thus, Chandler sees as a critical event James Duke's refusal to distribute
dividends despite the insistence of the large shareholders sitting on his board. 121
But in more developed markets, firms' value no longer necessarily depends on
strict enforcement of director primacy. Instead, the development of market-
based buffering mechanisms means that efficient governance choices can be
expected to vary more from firm to firm.

Despite these fundamental changes in firms' structure, there has been little
apparent move from the corporate form. Part IV considers an explanation for
this persistence of incorporation—that the law locks publicly held firms into
the corporate form in order to further rent-seeking by politicians and corporate
managers.

D. The Concession Theory and Regulation

Corporations originated as state-created monopolies that business people
purchased from lawmakers, endowed with particular powers. 122 Thus, Chief
Justice Marshall in Dartmouth College characterized a corporation as "an
artificial being, invisible, intangible, and existing only in contemplation of law.
Being the mere creature of law, it possesses only those properties which the
charter of its creation confers upon it, either expressly, or as incidental to its
very existence." 123 This state-creation characterization effectively sets a
presumption in favor of regulating corporations that does not apply to other
business associations or contracts. 124

The idea of the corporation as a legal creation lends itself not only to
regulation, but also to reduced constitutional constraints on regulation. As

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120. See Raghuram G. Rajan & Julie A. Wulf, The Flattening Firm: Evidence from Panel Data on
(last visited Nov. 14, 2004).

121. See CHANDLER, supra note 14, at 387. Similarly, Henry Ford's retention of earnings gave rise

122. See generally Henry N. Butler, Nineteenth-Century Jurisdictional Competition in the Granting
of Corporate Privileges, 14 J. LEGAL STUD. 129 (1985).


124. See Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary Duties: A Response to the
Anti-Contractarians, 65 WASH. L. REV. 1, 8-10, 64 (1990) (discussing the concession theory and
presumption in favor of regulation).
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"mere" creatures of law, corporations need not be given the same constitutional rights accorded individuals. Thus, while Justice Marshall in *Dartmouth College* applied the Contracts Clause of the Constitution to corporations, this application was soon qualified by the states’ ability to reserve the power to amend statutes retroactively. This effectively lets states transfer wealth from politically weak shareholders to politically strong managers. For example, state anti-takeover statutes resulted from direct lobbying of corporate managers, and reduced the value of corporate shares by limiting shareholders’ key right to transfer control in hostile takeovers.

The entity theory of the corporation also provides a basis for constraining corporate political activity. Individuals’ political speech, including speech in the form of political campaign contributions, receives high-level First Amendment protection. But when this political activity is characterized as that of the corporate “entity,” it loses this strong protection unless the corporation is in a narrow category of firms that are deemed to express shareholders’ views. Moreover, constitutional protection of corporate speech may be further reduced to the extent that courts characterize the speech of corporate entities as commercial, and therefore entitled only to a lower level of protection.

To be sure, the state-creation theory has had payoffs for corporations. Most notably, it smoothes the way toward the internal affairs rule in choice of law, which ensures that a corporation’s internal governance is controlled by the incorporating, or creating, state regardless of where the corporation does business. The internal affairs rule, in turn, has enabled jurisdictional competition, a powerful force in adapting corporate law to the needs of publicly held firms. Thus, the concession theory of the corporation might be viewed as a tradeoff for corporate advantages. But this begs the question of whether there was ever any normative justification for encumbering corporate advantages

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with increased regulatory burden. Part IV provides a political explanation of the regulatory burden on corporate features.

III. THE PARTNERSHIP ALTERNATIVE

As discussed above, the corporate form has both costs and benefits for publicly held firms. Accordingly, it is not obvious whether such firms would be better off organizing as partnerships than as corporations. In order to address this question, Part III.A discusses some advantages of a default partnership structure for publicly held firms, while Parts III.B and III.C discuss benefits attributable to the flexibility of the partnership form.

A. Partnership Structure

As discussed above, the corporate form is suited to publicly held firms in providing for limited liability, free transferability, continuity, and centralized management. In some respects, however, the structure of partnership-type business forms is actually better adapted to modern firms than the rigid corporate structure. Most importantly, partnership-type firms offer an agreement-centered approach to centralized management that provides flexibility and adaptability. These features suit the trend toward markets, flatter hierarchies and networks of contracts and away from the strong central management of the integrated Chandlerian firm.132

Partnership-type statutes provide for two alternative default approaches to centralized management. Firms that want clear separation of ownership and control can choose the limited partnership in which all management power is allocated to general partners, while limited partners are basically glorified creditors with only such voting rights as are provided in the limited partnership agreement.133 The limited partnership form until recently had terms that inhibited its use by many firms, particularly including the personal liability of the general partners and of any limited partners who participated in control.134 Limited partnerships long have been able to minimize the effect of this rule by having corporate general partners. Limited partnership statutes also mitigate control liability with myriad safe harbors and by precluding liability unless limited partners represent themselves as general partners.135 This flexibility has been clarified recently by permitting limited partnerships to organize as limited liability limited partnerships (LLLPs) with full limited liability, and by statutes

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131. See supra Part I.B.
132. See supra Part II.C.
133. See RULPA § 302.
134. See id. § 303.
135. Id.
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that eliminate limited partners' liability for participating in control.\textsuperscript{136}

Firms that want a more flexible form of centralized management than limited partnership offers can organize as limited liability companies and choose to be managed by managers. Under this structure, firms can concentrate the power to bind in a few individuals designated as managers while adopting any internal structure it prefers. Alternatively, firms can be member-managed but place internal management power in some members—perhaps even calling these members "managers."\textsuperscript{137}

These partnership structures provide important alternatives to the rigid, corporate-type centralized management structure. In particular, partnership-type statutes neither require nor even provide for an all-powerful and independent monitoring board, although partnerships can contract for such a mechanism. Managers of partnership-type firms accordingly derive their power from the specific agreement rather than from the fundamental architecture of the firm, as in the corporate context. In interpreting the extent of the managers' power, courts therefore have to refer to this agreement.

Moreover, partnerships are conducive to owner control of distributions. These provisions have been influenced by partnership taxation, which is imposed on partners based on earnings at the partnership level irrespective of whether these earnings are distributed. Compelling distribution of earnings effectively constrains agency costs while reflecting the reduced need for centralized control over corporate assets discussed above.\textsuperscript{138}

Partnership structure is particularly well-adapted to modern firms that rely more on skilled human capital than on fixed assets.\textsuperscript{139} In order to retain their key workers, such firms may have to give them more than the limited participation in profits that is involved in typical corporate stock options. Firms may have to promise workers real participation in management, analogous to the promotion to partner in law firms after workers have served an apprenticeship in which they have proved their loyalty and worth.\textsuperscript{140} Rather than relying on self-interested Blair-Stout-type "mediating hierarchs" to choose to take the interests of multiple constituencies into account,\textsuperscript{141} partnership-type firms give workers real control by making them partners or managing members.

Firms with passive owners who contribute only capital and not services

\textsuperscript{136} All of these changes are embodied in the 2001 revision of the Uniform Limited Partnership Act. See generally, ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON LLPs, RUPA AND ULPA (2003 ed.), ch. 9 (discussing this revision).

\textsuperscript{137} See generally RIBSTEIN & KEATING, supra note 44, ch. 8.

\textsuperscript{138} See supra Part II.C.

\textsuperscript{139} See Rajan & Wulf, supra note 120, at 33-35 (noting evidence of the relationship between flatter management hierarchies and declining value of fixed assets per employee).

\textsuperscript{140} Id. at 33.

\textsuperscript{141} See supra text accompanying note 68.
would want to empower managers to make significant decisions, such as the
sale of the company. But even these firms would not necessarily want to adopt
the corporate model in which some veto power is necessarily reserved to
owners. Rather, such firms might want to choose the limited partnership form
and rely on specific contractual controls on managerial discretion, such as those
included in the *Gotham* agreement discussed below. In this setting, the key
partnership attribute is not necessarily a superior default structure, but greater
flexibility to take account of firm-specific needs in governance arrangements.

**B. The Contractibility of Partnership**

In contrast to corporations, which historically have been treated as creatures
of law and therefore have been particularly vulnerable to regulation, partnerships do not bear the legacy of the concession theory. Indeed, partnerships historically were viewed as “aggregates” of the partners rather than as legal entities, and this theory survived to some extent in the Uniform Partnership Act (UPA). For example, partnership property was formally characterized as belonging to the partners individually, though the partners as a group held all the important rights in the property. To be sure, partnerships, like other legal business forms, have what Hansmann and Kraakman have termed the “essential” entity feature of partitioning the business and its assets from partners’ personal affairs and creditors. Indeed, partnership statutes now clearly characterize partnerships and partnership-type firms as legal entities. However, except to the extent that the continuity of the firm’s operations requires entity treatment, the fundamental legal rights connected with partnerships are viewed as residing in the individual members.

The contractual nature of the partnership is clearly evident in partnership governance. Partners’ rights and duties among themselves are explicitly subject to contrary consent or agreement in the 1914 Act, and at least presumptively so in the 1997 Act, which provides that the agreement controls except as to specific categories of provisions. The partnership agreement can allocate

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142. *See infra* text accompanying notes 159-68.
143. *See supra* Part II.D.
144. *See generally* BROMBERG & RIBSTEIN, *supra* note 20, at § 1.03(b).
147. *See* RUPA § 201; ULLCA § 201. There is, however, some residual confusion on this score. *See* BROMBERG & RIBSTEIN, *supra* note 20, § 1.03. This is reflected in the Supreme Court’s holding that a limited partnership is a citizen of all states where members reside for purposes of diversity jurisdiction, in contrast to corporate citizenship in a single state irrespective of where shareholders reside. *See* Carden v. Arkoma Assocs., 494 U.S. 185 (1990); RIBSTEIN & KEATINGE, *supra* note 44, at § 10.06 (discussing application of *Carden to LLCs*).
149. *See* RUPA § 103.
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power between managers and owners\textsuperscript{150} by providing, among other things, for procedures for conflicting interest and other transactions,\textsuperscript{151} management and governance arrangements,\textsuperscript{152} and variations in transferability of shares.\textsuperscript{153} Accordingly, partnerships permit nuanced and firm-specific variations in governance rather than the general structural rules and ex post judicial pronouncements that characterize corporate law.

Most importantly, there is substantial authority enforcing contractual limits on fiduciary duties in partnerships and limited liability companies.\textsuperscript{154} In general, fiduciary duties potentially permit open-ended ex post judicial manipulation of agreements, often to fit a particular pre-conceived notion of how the firm is governed. But flexibility has become especially important as corporate-style mandatory fiduciary duties no longer suit modern business structures.\textsuperscript{155} For example, the corporate opportunities doctrine assumes that firms are collections of hard assets with rigid boundaries, so that opportunities readily can be assigned to particular firms, and that opportunities are best exploited by firms rather than their employees. But these assumptions do not hold for flexible, market-based firms that rely more on human capital than on hard assets.\textsuperscript{156} This puts a premium on firms' ability to allocate business opportunities by contract rather than being locked into mandatory fiduciary duties.

Delaware is even more explicit than the general law in enforcing partnership agreements. Its non-corporate business association statutes provide that "[i]t is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of . . . agreements."\textsuperscript{157} Consistent with this provision, Vice Chancellor Strine has opined that Delaware courts "will not be tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The [Act] puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be

\textsuperscript{150}. See supra Part II.B.

\textsuperscript{151}. See infra text accompanying notes 159-166; RUPA § 103(b)(3) (providing for certain types of agreements restricting the duty of loyalty).

\textsuperscript{152}. See BROMBERG & RIBSTEIN, supra note 20, at § 6.03.

\textsuperscript{153}. See id. § 3.05(c); In re Asian Yard Partners, No. 95-333-PJW, 1995 WL 1781675 (Bankr. D. Del. Sept. 1995) (interpreting complex provisions on assignment of limited partnership interests).


\textsuperscript{155}. See supra Part II.C.

\textsuperscript{156}. See Savitt, supra note 113.

\textsuperscript{157}. See DEL. CODE ANN. tit. 6, §§ 1413 (Workers Cooperative Act), 15-103 (General Partnership Act), 17-1101 (Limited Partnership Act), 18-1101 (LLC Act); DEL. CODE ANN. tit. 12, § 3823 (statutory trusts).
careful to read partnership agreements before buying units. In large measure, the [act] reflects the doctrine of *caveat emptor*. . . ."\(^\text{158}\)

The Delaware approach to partnerships is evident in the Delaware supreme court’s *Gotham* limited partnership case.\(^\text{159}\) The general partner’s parent corporation had acquired limited partnership units in an odd lot tender offer. The transaction effectively entrenched the general partner because it increased the parent’s stake to almost the one third vote needed to remove the general partner. The agreement authorized the general partner to *issue* new partnership units at a price set by a formula in the provision (the five-day market average). Directors unaffiliated with the general partner approved the odd lot offer at a price determined by the formula. The agreement provided for *non-issuance* transactions (including resales) with the general partner or its affiliate on terms substantially equivalent to those obtainable from an unaffiliated third party upon approval by an independent audit committee. The court held that the transaction was a resale subject to this fairness standard because the parties had treated it as such, and that it did not comply with the agreement’s provisions applying to such a transaction because it was not approved by an audit committee or purchased on terms obtainable from an independent third party.

Thus, relying on the freedom-of-contract provision in the limited partnership statute, the court worked through the standard in the agreement applicable to the transaction at issue. The agreement in effect traded off governance procedures and judicial review. An issuance of new securities involved valuation problems, but these were dealt with by applying a formula. Despite the pricing provision, there was a potential concern with voting dilution that was dealt with by a limited partner vote.\(^\text{160}\) Resale of existing market-traded interests presented less of a pricing issue except to the extent the transaction was with insiders. The agreement addressed the conflicting interest problem directly through independent review under an arms’ length standard. In short, the duties of the general partner’s affiliate were not determined according to some mandatory aspect of partnership structure, but rather by the contractual provisions applicable to the specific transaction at issue (i.e., the resale).

The *Gotham* court opined in dictum that the freedom-of-contract provision did not let the parties *eliminate* fiduciary duties, as the chancery court had suggested. This indicates that there may be a case in which the court deems that

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the agreement provides inadequate protection and mandatory fiduciary duties come into play. But the important point for present purposes is that the court's analysis started with the agreement, and the narrow qualifying dictum suggests that the analysis will end there, too, in all but the exceptional case in which the parties seek to eliminate fiduciary duties. Thus, for example, the opinion suggests that, under the circumstances of the case, the general partner could have entrenched itself had it followed the procedures for a non-issuance transaction and obtained audit committee approval of an arms' length third-party price, even without a limited partner vote.

Similarly, in Marriott Hotel Properties II Ltd. Partnership, the Delaware chancery court held that a general partner had no affirmative Unocal duty to protect the limited partners in connection with a tender offer by the general partner's parent in light of the partnership's specific structure and purpose as simply a Marriott hotel financing arm. The court observed that "the limited partners neither expected nor had any right to expect, that the General Partner or its directors would seek to act independently of [the parent corporation] Host in relation to the Offer."

Also, in In re Nantucket Island Associates Ltd. Partnership Unitholders Litigation, Vice Chancellor Strine held, again after a careful review of interrelated provisions in the partnership agreement, that a general partner breached a limited partnership agreement by amending the agreement to allow it to issue new senior partnership units without the limited partners' consent. The court noted that, although the agreement could have authorized this sort of "blank check" issuance, it did not do so:

This case therefore stands as yet another example of how important it is to draft limited partnership agreements carefully. Although our law permits a limited partnership agreement to invest far-ranging authority in a general partner, it also requires a clear and unambiguous articulation of that authority so that investors are given fair warning of the deal they are making by buying units. When a general partner drafts an agreement that is susceptible to more than one reasonable interpretation, the one most favorable to the public investors will be given effect.

The agreement let the general partner sell additional units without limited partner consent "on such terms and conditions, and additional Limited Partners shall have such rights and obligations, as the Managing General Partner shall determine." The agreement provided for amendment with limited partner

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161. See Ribstein, supra note 154. The Delaware legislature responded to Gotham by clarifying that the agreement can provide for elimination of fiduciary duties and liabilities, other than "the implied contractual covenant of good faith and fair dealing." RULPA - General Amendments, ch. 265, § 15, tit. 6, § 17-1101, Del. Laws 265 (effective August 1, 2004).


163. Id. at 17, n.69.

164. 810 A.2d 351 (Del. Ch. 2002).

165. Id. at 361.

166. Id. at 361-62 (quoting Section 4.3 of the agreement).
consent in certain situations, including when the amendment adversely affects limited partner rights other than as permitted by the foregoing provision. The court held that this exception did not permit unilateral amendment with sufficient clarity to meet the interpretation standard quoted above, particularly in light of commercial practice requiring blank check authority to be made explicit. 167

Compare these cases with the corporate cases discussed above. 168 Managers' power to run partnerships is determined solely by "reasonable interpretation" of the agreement rather than by a general principle that the board should have extensive power to run the firm. If the agreement does empower the managers, this power is not subject to the "sacred space" of owner exit and voice rights. 169 At least in the leading state of Delaware, the agreement may modify both loyalty and care duties, not merely the duty of care as in Delaware corporate law. 170 Delaware's prohibition on eliminating fiduciary duties only preserves only a small space for judicial power when the court determines that the agreement has failed to serve the parties' objectives.

C. Flexibility and Regulation

The flexibility of the partnership form discussed above in this Part not only affects internal governance arrangements, but also might make it harder for government to regulate partnerships. In other words, partnership forms facilitate regulatory "arbitrage," thereby reducing government's ability to exercise monopoly power over these features. Indeed, the limited partnership was born in arbitrage, as a way to avoid usury laws. 171 Moreover, even apart from arbitrage opportunities created by multiple forms, government cannot easily regulate partnership governance when important issues such as the existence of a separate board of directors, limited partner voting rights, and transferability of management rights are inherently subject to firm-specific agreements. 172

Regulation of governance across different business forms presents at least two problems for regulators. First, such regulation is more difficult to draft, as

167. This contrasts with the Delaware Supreme Court's landmark holding on poison pills, which upheld the then-novel issuance of flip-over poison pill rights. Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985). The court settled the board power issue quickly through an extremely broad reading of the board's power to issue rights and preferred stock in connection with those rights under 8 Del. Code title 8, sections 157 and 151(g), respectively. Consistent with the general approach in corporate cases, the court focused on the general allocation of power between directors and shareholders in responding to takeovers.

168. See supra Part II.B.3.

169. See Thompson & Smith, supra note 86.

170. See supra note 84 and accompanying text.

171. See Bromberg & Ribstein, supra note 20, at § 1.02(a).

172. See supra Part III.B.
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legislators and regulators must find a way to apply the regulation to many different governance devices. An example of the difficulty of adapting regulation designed for corporations to flexible partnership structures is a case involving the application of the derivative suit device to a hedge fund organized as a limited partnership in which partners incurred injuries directly through their capital accounts. Chancellor Chandler observed:

[W]hereas corporations are largely creatures of statute with some limited contractual flexibility, limited partnerships offer greater contractual flexibility with only a few statutory constraints. Consequently, the structure and function of a limited partnership is sometimes analogous to the corporate model with the limited partners having similar rights and responsibilities as corporate shareholders and the general partner acting in much the same capacity as a corporate board of directors—but not necessarily so. Application of corporate law rules to disputes related to a limited partnership necessitates a bit of flexibility. This is true because the facts unique to a limited partnership dispute include the contents of the limited partnership agreement—how it specifies or modifies the entity’s function and structure and the rights and responsibilities of the general and limited partners... In some instances, the relationships among the parties and the function and structure of the partnership itself may diverge from the corporate model so dramatically that some claims, which in a corporate context might be classified as derivative, must be brought as direct claims in order to enable the injured parties to recover while preventing a windfall to individuals or entities whose interests were not injured.

Second, having to shape the regulation to cover additional business forms gives interest groups an opportunity to lobby for different rules in the partnership context than those that apply to corporations. Drafting glitches or political compromises, in turn, can enable firms to exploit differences in treatment in their drafting and planning. The other pressures toward partnership discussed above in this Part suggest that choice of form is increasingly on the margin, and therefore even a small increase in federal regulation may be enough to push some firms toward a potential partnership escape hatch.

The malleable nature of partnerships already has undercut the extension of the corporate tax to partnership-type firms. Congress and the IRS attempted through the tax classification rules to identify features that would subject firms to the corporate tax. These rules at first were slanted against a firm’s being a partnership because partnership-type firms were trying to reduce their taxes by taking advantage of tax breaks that were intended for corporations. The case that prompted the initial classification rules was United States v. Kintner, where the I.R.S. unsuccessfully sought to characterize a professional corporation as a partnership. 216 F.2d 418 (9th Cir. 1954).

174. This was evident in early corporate history, as antitrust laws first caused firms to avoid cartels in favor of New Jersey holding companies, and then to avoid holding companies in favor of unitary operating companies. See CHANDLER, supra note 14, at 333-34.
175. These rules at first were slanted against a firm’s being a partnership because partnership-type firms were trying to reduce their taxes by taking advantage of tax breaks that were intended for corporations. The case that prompted the initial classification rules was United States v. Kintner, where the I.R.S. unsuccessfully sought to characterize a professional corporation as a partnership. 216 F.2d 418 (9th Cir. 1954).
types of entities. This effectively forced the IRS to adopt the "check the box" rule, thereby permitting partnerships to decide for themselves how they want to be taxed. 176

Something similar could happen with regard to federal securities regulation. The federal securities laws do not explicitly apply to particular business forms. Instead, they regulate all firms whose interests fit within the broad definition of a "security." 177 This limits firms' ability to avoid federal regulation of corporate governance simply by choosing their standard form or state of incorporation. Thus, the federal securities laws clearly apply to at least some partnerships and limited liability companies, particularly if they have centralized management and are publicly traded. 178 Nevertheless, partnership forms have given at least closely-held member-managed firms a limited opportunity to opt out of the securities laws altogether by choosing governance rules that do not fit the definition of a "security." 179

Avoidance could increase as federal securities regulation expands beyond its traditional disclosure roots and regulates substantive corporate governance, which was previously the province of state law. 180 Such substantive regulation includes regulation of takeovers through the Williams Act, 181 bookkeeping through the Foreign Corrupt Practices Act, 182 insider trading and other insider misconduct through Section 10(b) and Rule 10b-5, 183 and the omnibus regulation in Sarbanes-Oxley. 184 This body of federal law is making state law and state jurisdictional competition increasingly irrelevant. 185

Regulation of corporate governance also may expand in effect through

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177. See, e.g., SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (holding that sale of portions of an orange grove was covered by securities laws).

178. See BROMBERG & RIBSTEIN, supra note 20, §§ 2.13(e), 12.14 (discussing application of securities laws to partnerships); RIBSTEIN & KEATINGE, supra note 44, § 14.02 (discussing application of federal securities laws to LLCs).


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stock exchange rules. The stock exchanges long have regulated the governance of listed firms, beginning even before enactment of the federal securities laws.186 This regulation extends to listed non-corporate firms.187 This regulation might technically be viewed as quasi-contractual in the sense that firms are free to choose where to list. Thus, firms that oppose control of governance need not take the drastic step of changing their form—they can, at least theoretically, choose to list on a less restrictive exchange. Accordingly, given the threat of loss of listings, exchanges might be expected to refrain from broad cross-form regulation. Firms' ability to avoid exchange regulation of governance by delisting seemingly was brought home when, in response to a more liberal NASDAQ rule, the New York Stock Exchange was forced to drop its prohibition on dual-class stock. When the SEC moved to prohibit such competition by adopting Rule 19c-4,188 it was shot down for exceeding its authority under the securities laws.189 Yet the SEC seemingly ultimately had its way when it persuaded the exchanges to agree to prohibit dual-class stock.190

Since the Rule 19c-4 flap, the SEC has sought to use its power over the exchanges as a lever to persuade the exchanges to act together to adopt other regulation of substantive corporate governance.191 The SEC recently approved NYSE and NASDAQ rules regarding shareholder voting on compensation plans,192 noting that the rules would provide "clear and uniform standards for shareholder approval of equity compensation plans."193 Also, following prodding by then-SEC chair Harvey Pitt in February, 2002,194 the NYSE and NASDAQ adopted governance rules that would, among other things, require boards to have a majority of independent directors and would define independence.195

The expansion of federal regulation directly and through exchanges may give firms an additional impetus to avoid the federal securities laws by choice

187. An example is the American Stock Exchange voting rule applied in Gotham. See supra note 161 and accompanying text.
191. See Thompson, supra note 186, at 977-78 (characterizing the interaction between the SEC and the exchanges as a "forum approach").
193. Id. at *88.
of form. Foreign firms have already indicated decreased willingness to cross-list in the U.S. in the wake of Sarbanes-Oxley.\textsuperscript{196} The SEC may have avoided even more extensive defections by deciding not to extend the full force of the Sarbanes-Oxley audit committee rules to foreign firms.\textsuperscript{197} Also, some U.S. public firms are taking advantage of the ability to avoid federal regulation by falling below the securities’ laws minimum size or “float” for mandatory registration.\textsuperscript{198}

Will increased federal regulation lead to a move away from incorporation? As federal law reaches beyond disclosure into the details of governance, it becomes increasingly sensitive to variations among forms in governance rules. This may not be a problem for regulating \textit{corporate} governance because the inflexibility and standardization of the corporate form lets regulators reach most firms simply by identifying the formal device being regulated, such as the board of directors. However, as discussed above,\textsuperscript{199} regulating across business forms presents special problems.

There are recent examples indicating these problems of expanding federal securities regulation into control of internal governance. First, what if a firm does not have a board of directors? The SEC ultimately exempted such firms from the audit committee requirement if their activities are “limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities.”\textsuperscript{200}

Second, how do strict rules regarding director independence apply to partnerships where the relevant board is that of the corporate general partner or manager that is a closely held corporation? In this situation the directors are inherently not independent of the shareholders who control the corporate partner and appoint its directors. The SEC ultimately recognized this when it dropped the rule that a director would be an “affiliated person” if it is the “designee” of an affiliate.\textsuperscript{201}

Third, the New York Stock Exchange has gone further in acknowledging the problem of regulating non-corporate entities in amending its proposed corporate governance rule to provide that “[d]ue to their unique attributes”

\begin{footnotes}


197. See Ribstein, supra note 180 (discussing and analyzing the SEC rules).


199. See supra text accompanying note 175.


201. See id. § 240.10A-3(b)(1)(iv)(E)(1).

\end{footnotes}
limited partnerships need not comply with rules requiring listed companies to have a majority of independent directors and certain committees to have entirely independent directors. 202 The Exchange observed that "partnerships are managed by a general partner rather than by a board of directors," and therefore that only the corporate general partner can be subject to these standards. 203

Extending regulation into corporate governance faces another test with the SEC's proposed rule to require firms to implement direct nomination of directors by shareholders. 204 The rule is explicitly subject to applicable state law not prohibiting such direct nomination. 205 This would present complications for corporations in determining the precise state law that would satisfy the condition. More importantly for present purposes, it is not clear how the rule would be applied to publicly held partnerships.

To be sure, courts and regulators may resist evasion of federal regulation through publicly traded partnerships. 206 Thus, when manager entrenchment topped the regulatory agenda, the SEC and ultimately the exchanges refused to permit firms to entrench managers by moving to the non-standard governance form of dual-class stock. 207 Analogously, the Supreme Court recently crafted a rule that attempts to apply the employment discrimination laws irrespective of the form of the firm. 208 These moves suggest that, when the regulatory stakes are high enough, regulators will try to foreclose arbitrage moves.

There are, however, inherent limits on the extent to which the governance of firms can be regulated where business forms eliminate convenient regulatory handles. Management and control can be allocated in nearly infinite ways, as illustrated by the broad range of business forms that states have developed. Firms might have several management layers, as with the corporate general partner control of limited partnerships. Firms such as limited partnerships could have a "board of directors" with merely advisory power while another body (or bodies) within the firm holds shares of real power. For example, in Simpson v. Ernst & Young, 209 the firm claimed that plaintiff was a partner and therefore not subject to the employment discrimination laws. This determination turned in part on the plaintiff's control. Plaintiff could vote for members of an "Advisory Council," but the court held that the real power was in the "Management

205. Id. at 60787-88.
207. See 17 C.F.R. § 240, supra note 188.
Committee," whose members were selected by the Chairman, who in turn was
selected by the Management Committee.

Moreover, the problems of determining voting rights, or even who can be
considered an "owner," are potentially more complicated than what the SEC
and the exchanges faced regarding dual-class voting. For example, whose
voting rights should be regulated in a firm that has general partners, a limited
partner and holders of fractions of a limited partnership interest? Courts,
legislators and regulators could define the kinds of transactions or entities
regulated by structure rather than name. But it will be difficult for them to
avoid drawing lines that invite regulatory arbitrage. Thus, although the Court’s
employment discrimination test focuses on control, choice of form may prove
to be relevant to the level of control, as well as to other features cited in the test
the Court applied, including "[w]hether the parties intended that the individual
be an employee, as expressed in written agreements or contracts." Courts
may develop rules of thumb differentiating among business forms, and
Congress may have to clarify the law.

Finally, some indication of how Congress will have to approach regulating
partnerships can be inferred from the most comprehensive federal regulation of
partnerships so far, the Limited Partnership Rollup Reform Act of 1993211 and
the SEC’s rollup disclosure rules in Regulation S-K.212 The Act and rules are
intended to address the specific problem of limited partnership rollups which,
after Congress’ decision to tax publicly traded limited partnerships as
corporations,213 turned into financial disasters because investors bought the
interests based on tax benefits and distributions that did not materialize.214 The
rollups promised the liquidity of a public market for interests in the firm in
exchange for heavily discounted prices, large fees, and removing the investors’
right to cash out of the firm. Although the statute regulates both disclosure and
the terms of the transactions, including fees and dissenters’ rights,215 it reaches
only a narrowly defined set of transactions. Most importantly, the rule applies
only to “finite-life” entities—i.e., those that have a policy of distributing rather

210. See Clackamas, 538 U.S. at 450.
211. 15 U.S.C. §§ 78n, 78o-3, 78f (2004) (providing for disclosure in connection with rollups,
regulation of fairness opinions and compensation of brokers, restrictions on changes in the financial or
governance structure of the firm, and requiring exchanges to condition listing on providing for
dissenters’ rights).
214. For an analysis of the problems and ensuing regulation, see John Geschke, Note, Regulating
Rollups: General Partners’ Fiduciary Obligations in Light of the Limited Partnership Rollup Reform
accomplished the latter regulation by requiring exchanges to condition listing of rollup securities on the
existence of these rights.

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than reinvesting assets. As the SEC said in proposing its initial rollup rule, "the definition of roll-up transaction has been more precisely tailored to target those transactions that raise the concerns addressed by the rules." Thus, the most comprehensive federal regulation of partnership governance was carefully designed to apply only to a limited category of vehicles involving a precisely delineated problem.

IV. A POLITICAL THEORY OF THE CORPORATE FORM

This Article so far indicates that publicly held firms could get appropriate default rules with less regulatory burden and more flexibility if they selected partnership standard forms such as limited partnership or centrally managed limited liability companies. Yet while this has been the case for some time, there is no discernable move to partnership by mainstream publicly held firms outside of specific industries such as real estate. If incorporation is inefficient for many firms, why does it continue to dominate? This Part discusses a rent-seeking explanation for the corporation. Publicly held firms select the corporate form not entirely because of its inherent advantages, but rather at least in part because they are channeled into it by regulation and tax laws. The corporate form assists government regulation of firms because, as discussed above, the corporation always has been considered a creature of state law and because its inflexibility makes it easier for regulators to craft restrictions.

Part IV.A discusses how this regulation serves politicians' and managers' interests. Part IV.B discusses how the corporate form has been protected by direct regulation. Part IV.C discusses the roles of tax considerations in explaining the persistence of incorporation.

A. The Relevant Interest Groups

This Section discusses the incentives of the main political actors in preserving regulation of corporate features. Politicians seek not only to assist interest groups that favor regulation, but also to preserve their own power to transfer rents. Corporate managers and shareholders might be expected to resist profit-reducing regulation. But regulation of the corporate form serves the best organized group—corporate managers—by helping them to a bigger slice of

216. See 15 U.S.C. § 78n(h)(5)(A) (2004) (excluding from regulation, inter alia, "a transaction that involves only a limited partnership or partnerships having an operating policy or practice of retaining cash available for distribution and reinvesting proceeds from the sale, financing, or refinancing of assets in accordance with such criteria as the Commission determines appropriate"); 17 C.F.R. § 229.901(b)(2)(i) (2004) (defining "finite-life" entity).


219. See supra Part II.D.
the smaller, regulated, pie.

Politicians could gain directly from controlling corporate governance. First, state legislators could earn political favors by making or blocking changes in general incorporation statutes just as they did by selling special charters. This is particularly true for changes that affect existing contracts, and thus do not give affected parties an opportunity to mitigate wealth transfers. A prominent example is the anti-takeover statutes of the late 1980's. Another is the Bubble Act, which was favored by, among others, the South Sea Company's backers who were concerned about competition for capital by the non-chartered joint stock, or "bubble," companies that imitated the South Sea Company's financial structure.

Second, regulation of corporate governance helps prevent publicly held firms from becoming a powerful rival to government, and therefore lawmakers. For example, some states have enacted statutes permitting or requiring directors to take account of non-shareholder constituencies in corporate control transactions. Also, federal law, particularly the shareholder proposal rule, encourages non-shareholder constituencies to participate directly in corporate governance. Firms are induced to regulate themselves, or at least not lobby actively against business regulation, thereby lowering the lobbying costs of advocates of regulation.

Third, regulation of business forms inhibits the regulatory arbitrage opportunities discussed above. The freer firms are to choose among alternative business forms, the harder it is to regulate the governance of firms.

The main group that could be expected to oppose increased regulation of firms' governance is managers. Corporate managers have common objectives regarding corporate governance and can coordinate through organizations such as the Business Roundtable. They also have a strong incentive to oppose fetters on the business that would reduce profit-making opportunities and, indirectly, managers' share of corporate wealth.

220. See Butler & Ribstein, supra note 125.
221. See Butler, supra note 126.
222. See Henry N. Butler, General Incorporation in Nineteenth Century England: Interaction of Common Law and Legislative Processes, 6 INT'L. REV. L. & ECON. 169, 172-73 (1986) (arguing that the key group was Parliament, which was concerned about the value of its chartering business); RON HARRIS, INDUSTRIALIZING ENGLISH LAW: ENTREPRENEURSHIP AND BUSINESS ORGANIZATION, 1720-1844, at 64-79 (Cambridge University Press, 2000) (stating that the key proponent of the Act was the South Sea Company itself, particularly regarding the exemption for subscriptions of the South Sea Company).
223. See, e.g., 805 ILL. COMP. ANN. STAT. 5/8-85 (West 2004); IND. CODE ANN. § 23-1-35-1(d) (West 2004); MO. ANN. STAT. § 351.347 (West 2004); N.Y. BUS. CORP. LAW § 717(b) (McKinney 2004); OHIO REV. CODE. ANN. § 1701.59(e) (West 2004).
225. Corporate lobbying is also influenced by direct regulation of corporate campaign contributions and corporate speech. See supra text accompanying note 128-31.
226. See supra Part III.C.
Managers' incentive to oppose regulation of corporate governance is, however, tempered by the regulation's effect on increasing managers' power within firms, and therefore their share of corporate wealth. For example, non-shareholder-constituency statutes and other corporate social responsibility rules arguably dilute managers' duties and state anti-takeover legislation helps entrench managers. More generally, managers could be expected to favor the dominant governance model, which gives directors the primary role in governance, abetted by broad judicial interpretation of the board's powers under statutes and governance documents, and constrained only by vague fiduciary duties. Thus, managers could stand to lose more than they would gain from deregulating corporate governance. Even if this were not the case, managers are risk averse because they cannot easily buffer or diversify investments in human capital, and therefore would probably prefer the status quo to a new equilibrium that would threaten their tenure or returns to their human capital.

Lawyers may, however, be the agents of change. Lawyers not only will write new agreements, but also have incentives to refine business association statutes to accommodate publicly held partnership-type firms and special purpose entities, just as they have developed and promoted these statutes for closely held firms. Lawyers lack managers' stake in, and therefore incentive to maintain, the corporate status quo. Indeed, lawyers stand to increase their business by advising on changes in the law.

B. Direct Regulation of Corporate Features

Firms that preferred to adopt non-corporate business forms historically have been constrained by rules that limit the use of corporate features by non-corporate firms. Thus, the English Bubble Act of 1720 outlawed "all...publick undertakings...presuming to act as a corporate body...raising...transferable stock...transferring...shares in such stock...without legal authority,...and all acting...under any charter...for raising a capital stock...not intended...by such charter...and all acting...under any obsolete charter...for ever be deemed to be illegal and void..." Similar rules survive in state corporation statutes that effectively bar incorporation by estoppel, imposing personal liability on those who

227. See supra text accompanying note 72.
228. See supra Part II.B.3.
231. However, other considerations suggest that lawyers may resist change. See infra Part V.
232. 6 Geo. 1, ch. 18 (1720) (Eng.).
presume to act as a corporation without incorporating. But this does not
prevent parties from contracting for corporate features in partnership or other
types of firms.

The main problem with trying to get corporate features without
incorporating is not that firms have been expressly prohibited from doing so, but
the risk that courts may not enforce novel contracts without statutory
authorization. Courts and legislators historically have been hostile to non-
corporate limited liability. Although it was permitted in limited partnerships,
the parties to these firms had to accept the significant limitations of general
partner liability and the limited partner control rule. Thus, although limited
liability is now widely available in partnership-type firms, the historical
constraints on the spread of limited liability may help explain why non-
corporate limited liability forms have not been developed or widely used for
publicly held firms. Parties who attempt to create new forms of limited liability
risk judicial non-enforcement of the liability shield.

Even if a state recognizes a novel form of limited liability, another state
might not enforce the shield. Although the internal affairs rule enforcing
formation-state law generally applies to established business associations, in
other contexts interstate enforcement would be subject to the general rules on
contractual choice of law. Applying those rules, a court might not enforce
contractual choice of a state limited liability rule, particularly if no party resides
in the forum state and limited liability in novel contexts is considered contrary
to local public policy.

C. The Corporate Tax

The double tax on earnings at the corporate level and then again on
dividends may partially explain the persistence of incorporation. The entity-
level tax on firms can be viewed as an end in itself, with incorporation as the
means. An entity-level tax arguably is politically attractive because it removes
the tax one step from voters, who see it as a tax on "corporations" rather than,
more realistically, on them. But while this would explain a single-level tax at
the corporate level, it does not necessarily explain a second-level tax on
dividends at the shareholder level.

233. See, e.g., MODEL BUS. CORP. ACT § 2.04.
234. See supra text accompanying note 134; Larry E. Ribstein, An Applied Theory of Limited
235. One way around this is statutory recognition of limited liability apart from established
This is related to the network effects discussed infra Part IV.D.
236. See generally Larry E. Ribstein, From Efficiency to Politics in Contractual Choice of Law, 37
237. See Arlen & Weiss, supra note 176, at 332-33.
Why Corporations?

Alternatively, the entity theory of the corporation can be seen as providing a theoretical basis for the double tax. But neither the entity theory nor the corporate form is essential to maintaining the double tax. State competition to develop partnership standard forms ultimately broke down the clear boundaries between corporations and partnerships. Closely held firms generally now can elect whether to be taxed as partnerships or corporations, while publicly held firms are now taxed as corporations regardless of form.

A better political explanation of the double-level tax on corporate earnings and on distributions to shareholders is that it encourages retention of earnings in the firm and therefore assists managers' control of those earnings. In other words, the corporate tax helps bolster the distinctively corporate approach to governance of strong central managers and non-interference by owners. Specifically, by imposing a tax cost on distributions, the corporate tax reduces the benefits of giving owners control over distributions. Conversely, if dividends were tax free, as they are in partnerships, owners would have more incentive to contract to compel distributions, including through standard forms that emphasize owner control rather than director primacy.

Without a tax on dividends, firms would have more incentive to find contractual mechanisms to compel distributions. Firms once did this through

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239. Larry E. Ribstein, The Evolving Partnership, 26 J. CORP. L. 819, 829-30 (2001). Note that government may have loosened tax classification rules in order to reduce the political pressure for integration. See 26 C.F.R. pt. 1, 301, supra note 176. This suggests that there is a tension between regulation and competition: broad regulation invites political opposition, while narrow regulation invites competition and arbitrage.

240. See supra note 176 and accompanying text.


243. Although managers support retaining earnings, retention arguably runs counter to politicians' interests in bolstering corporations' economic power, and therefore their ability to compete with government. But this effect is mitigated by the constraints on corporations' ability to convert their money into political power. See supra text accompanying note 129.

244. It has been argued that two-level corporate taxation reduces agency costs by reducing conflicts between managers and shareholders as to asset dispositions by the firm. See Hideki Kanda & Saul Levmore, Taxes, Agency Costs, and the Price of Incorporation, 77 VA. L. REV. 211 (1991). However, even if this is true, it is not clear why firms need this sort of mandatory tax rule to minimize agency costs when contractual approaches are available. See Ribstein, supra note 10, at 469-71.

245. To be sure, eliminating the dividend tax might simply reduce firms' reliance on debt without increasing distributions, thereby reducing overall constraints on agency costs. See Dino Falaschetti & Michael J. Orlando, Cutting the Dividends Tax... and Corporate Governance Too? (November 16, 2003), available at http://papers.ssrn.com/paper.taf?abstract_id=471021 (last visited Nov. 14, 2004). That is particularly likely to be true if firms are limited to the corporate structure, which impedes contracting for distributions. For the reasons discussed below in this Part, the partnership form would then become especially important in providing contractual alternatives to debt as a constraint on agency
leveraged buyouts, which effectively committed managers to distributing cash flow by converting stock into debt. But a lower tax on dividends increases their attractiveness compared to debt, other things being equal. Corporate managers might commit to a policy of increased dividends. But the threat of hostile takeovers that might once have enforced such a policy has now been diminished, and the business judgment rule virtually eliminates any fiduciary duty to make distributions in publicly held firms, at least without aggravating circumstances.

Perhaps the most effective way for corporate managers to commit to distributions is through a charter provision compelling distributions under certain circumstances. The enforceability in the corporate context of such a restriction on broad managerial discretion, however, is subject to doubt. By analogy, Quickturn invalidated a delayed redemption provision in a poison pill that bound a new board because the provision “restricts the board’s power in an area of fundamental importance to the shareholders—negotiating a possible sale of the corporation.” The court did indicate that a limitation on the board’s power might be included in the charter under Section 141(a). However, it is not clear how far such a restriction could go. As discussed above, the courts have proscribed board “sterilization.” Accordingly, a broad charter restriction on a board’s general power to decide how much earnings to retain might be unenforceable. This doubt is reinforced by Omnicare, which refused to enforce a deal-protection provision that was explicitly authorized by the Delaware statute.

Partnership provides an important alternative to incorporation for firms that want to force managers to distribute earnings. Provisions concerning distributions are routine in partnerships. This is not surprising, since partners taxed on partnership-level earnings are exposed to a high risk of squeeze-out where earnings are not distributed. Thus, for example, the partnership agreement may compel distributions of cash receipts subject to a reserve

247. Debt, however, retains the advantage of deductibility at the corporate level. The implications of this point are explored infra text accompanying note 259.
249. See supra text accompanying notes 61-63.
251. Id. at 1291.
252. See supra text accompanying note 61.
253. See supra text accompanying note 105.
254. Indeed, this was an aspect of defining partnerships for purposes of rollup regulation. See supra text accompanying note 215.
Why Corporations?

Recent tax changes may decrease the attractiveness of incorporation. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduces the tax on most dividends to 15%, and 5% for low-income taxpayers. On the one hand, this increases the attractiveness of incorporation for shareholders by reducing the double-tax penalty. On the other hand, it reduces incorporation's attractiveness for managers by increasing the pressure on managers to distribute earnings. After-tax benefits of distributions are now more likely to exceed the benefits of retaining earnings, other things remaining equal. Indeed, many firms have increased their dividends in the wake of the new tax rates. The increasing attention to distributions may encourage some firms to make initial public offerings in partnership, rather than corporate, form, or at least with charter provisions that commit to distributions. More importantly, the increased recognition of the advantages of corporate distributions may provide an atmosphere conducive to more radical changes in the law.

The reduced tax on dividends may be seen partly as an effort to head off political pressure to move toward integration, or a single investor-level tax. It also reduces managers' incentives to use debt, which is fully taxable at the shareholder level. Debt, in turn, may further reduce managers' control over cash flow. In effect, high debt can be seen as a kind of "home-made" integration, since it produces something like the tax effect of a single level tax at the claimant level. By contrast, low taxation of dividends produces something like a single-level tax at the corporate level. This preserves the political advantage of keeping the tax one step removed from individual taxpayers. Accordingly, the dividend proposal may be a way of saving both the corporate form and the corporate-level tax, at least in the short run. Nevertheless, this Section shows that such tax changes may contribute to the demise of the corporation in the long run.

256. Henkels & McCoy, Inc. v. Adochio, 138 F.3d 491 (3d Cir. 1997) (applying such a reserve provision to protect creditors from excessive partner distributions). Although the case suggests caution in drafting distribution provisions in light of the creditors' rights provisions of limited partnership and similar statutes, it does not suggest a problem in restricting the general partner's discretion regarding distributions.


258. This is analogous to the effect of the Tax Reform Act of 1986, which, among other things, caused top corporate tax rates to exceed top individual rates and eliminated the lower tax on capital gains, thereby making incorporation disadvantaged enough for some firms that they had an incentive to push the envelope on tax classification.

259. See Peter A. McKay & Bob Davis, Dividend Tax Cut Pleases Companies More than Investors, WALL ST. J., Aug. 5, 2003, at C1 (noting that share prices of dividend-increasing companies have risen less than the market, but that this may reflect the fact that recent significant market gains have been in non-dividend-paying technology stocks and other non-dividend-paying sectors).

260. See supra note 176.

261. See supra text accompanying note 246.

262. See supra text accompanying note 237.
V. NON-POLITICAL EXPLANATIONS FOR CORPORATE DOMINANCE

In addition to the political considerations discussed in Part IV, there are other impediments to ending the dominance of the corporate form. One is “network” effects. Publicly held corporations have generated significant case law, commentary, and forms that aid interpretation and application and thereby reduce transaction costs as compared with other default rules that are not as widely used and therefore have not generated such devices. The cases concerning non-corporate business forms mainly relate to closely held firms. Thus, for example, while incentive compensation could be designed in partnerships to mimic the effects of corporate stock options, risk-averse executives might shun this alternative because of its novelty and uncertainty about tax and other effects.  

Investors also may distrust new forms until they can be confident that governance and fiduciary duty rules in these forms will protect them. Just as network effects may explain the continued dominance of Delaware corporation law, they also may explain the survival and rigidity of the corporate form.

The move to publicly held partnerships therefore presents a kind of chicken-egg problem. Like starting a new telephone network or computer operating system, the new system may not take hold until the network is established, which cannot happen until the system is accepted. To be sure, the network barrier is permeable. For example, the limited liability company became widely used despite the existence of the limited liability partnership, which was comparable in every way except that it allowed firms to access partnership interpretive materials. The corporation itself arguably faced a network barrier in its early history.

To the extent that network effects constrain a beneficial move to partnership-type publicly held firms, these effects may interrelate with the tax and regulatory constraints discussed above in this Part. As discussed above, courts may be unwilling to enforce limited liability contracts or novel business forms created in other states. This increases the risks associated with these novel forms and, accordingly, the benefits of the network of interpretive cases.

It is important to emphasize that interpretive networks are not always

263. See Joseph Bankman, The Structure of Silicon Valley Start-Ups, 41 UCLA L. REV. 1737 (1994) (explaining the use of Subchapter C corporations despite tax disadvantages of this form).


265. This survival and rigidity also may be an artifact of federal regulation of corporations. See Roe, supra note 185. If so, erosion of federal regulation by the availability of alternative partnership forms discussed in Part III.C. may have the side effect of increasing jurisdictional competition.


267. See supra note 47.

268. See supra text accompanying notes 238-239.
Why Corporations?

beneficial. As this Article has shown, the corporate form may be more costly than the partnership form for many firms, particularly if courts apply the existing body of inflexible corporate cases to partnerships. This suggests that the benefits of a new set of rules for publicly held partnerships may exceed the learning and other costs such new rules entail.

There may be other reasons for continued dominance of the corporate form that relate neither to its efficiency nor to politics. For example, the switch into partnership depends both on suitable partnership forms being developed and firms getting adequate legal advice about the availability of these alternatives. Lawyers may have reputational incentives to participate in making "wholesale" changes.269 However, in order to make these changes on the retail level of individual clients, lawyers have to be willing to learn about the new forms and advise on their use. They may be concerned that their investments in the new learning will not pay off in higher fees or that the increased risk of malpractice in giving such advice exceeds any additional fees.

VI. CONCLUSIONS AND IMPLICATIONS

This Article should be viewed mainly as raising the question posed in its title rather than providing definitive answers. In other words, the Article shows that it is not clear why the corporate form so long has been so synonymous with big business in the United States that the choice of form issue rarely arises in the context of the publicly held firm. Although the corporate structure is well adapted to publicly held firms, the corporate form began to be used before the era of the publicly traded firm. In any case, whatever the corporation's advantages, it also has defects that make it unclear why the corporation ever should have dominated to the exclusion of partnership-based forms. In particular, the corporate form is characterized by an inflexible governance structure and increased susceptibility to government regulation.

Recent developments are making the corporate form even less attractive and therefore are deepening the puzzle posed by the continuing dominance of the corporate form. Business increasingly is moving away from the model of the large, integrated firm with strong central management and toward markets and networks. Reduction of the second-level tax on dividends decreases the benefits and increases the cost of strong managerial control over retained earnings. And expanding federal regulation of substantive corporate governance increases the benefits of avoiding such regulation through arbitrage of business forms. Conversely, the partnership form offers modern firms the flexible alternative to incorporation they need. The partnership form not only provides flexibility, but ensures greater independence than corporate law from

269. See supra text accompanying note 230.
the constraining effects of government regulation. In short, solving the
problems of corporate governance arguably seems to include making corporate
governance irrelevant.

It is not clear, however, how or whether such a shift will come about. The
very fact that partnership offers an escape from regulation also gives regulators
an incentive to resist change in the status quo. They may directly regulate
alternatives to incorporation, or less directly preserve double corporate taxation
which provides an incentive to maintain managers’ hold on distributions. Even
without direct regulation, firms’ concern about enforcement of alternatives to
incorporation combines with network effects to inhibit the development of
alternative business forms. Managers are unlikely to lead any moves to change
the law because of their benefits under the existing corporate structure.

On the other hand, whatever regulators do, changing characteristics of firms
may increase the costs of corporate inflexibility so that developing and
adopting new business forms becomes worthwhile. Moreover, lawyers have
some incentive to promote the wholesale legal changes that are necessary to
smooth the way toward publicly traded partnerships, even if many lawyers may
be reluctant to retool for the partnership era. Thus, political resistance to change
ultimately may determine only when, rather than if, the curtain drops on the
corporation.

Finally, this Article suggests that the institutions that matter to business
development may include selection of the appropriate business form. It follows
that it is important to understand the precise functions of choice of business
form. These functions include the applicable default rules, including the choice
between corporate-type lock-in and partnership-type distribution of assets. But
as discussed in this Article, the overriding importance of the partnership form
may be in its contractibility and relative immunity from government interference.²⁷⁰

²⁷⁰. This has potential implications for emerging economies. For a review of some other
institutional considerations that matter in this context, see Bernard Black et al., Russian Privatization
The Globalization (Americanization?) of Executive Pay

Brian R. Cheffins† and Randall S. Thomas‡

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The Globalization (Americanization?) of Executive Pay

Brian R. Cheffins and Randall S. Thomas

In the United States, the remuneration packages of top executives are characterized by a strong emphasis on pay-for-performance and by a highly lucrative "upside." There is much discussion of the possibility that executive pay practices will globalize in accordance with this pattern. This Article assesses whether such convergence is likely to occur.

After surveying briefly the key components of managerial remuneration and after examining the essential elements of the "U.S. pay paradigm," the Article considers market-oriented dynamics that could constitute a "global compensation imperative." These include wider dispersion of share ownership, more cross-border hiring of executives, growing international merger and acquisition activity, and expansion of business activity by multinational enterprises. The Article will also take into account possible obstacles to the Americanization of executive pay. These could arise from various legal sources (such as corporate law, tax rules, and labor law) as well as "soft law" and "culture." It must be recognized, however, that law could foster as well as hinder a move toward U.S.-style remuneration. For instance, the introduction of tougher disclosure rules seems particularly likely to have this effect.

This Article does not assess in detail whether the Americanization of executive pay would be a "good thing." It makes a normative contribution, however, by identifying obstacles policymakers should address if they want to promote convergence. It also draws attention to strategies regulators might adopt if they conclude that a move towards U.S.-style compensation arrangements would be a mistake.

I. INTRODUCTION

It has been said that executive pay "is the most intractable conundrum in global corporate governance." To the extent that this is accurate, one factor has served to complicate matters more than any other. This is the growing influence of the "U.S. pay paradigm," characterized by highly "incentivized" and lucrative compensation arrangements. Allegedly, a "global compensation

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2. Michael Cave, I'm Worth It, Baby, AUSTL. FIN. REV., Dec. 2, 2000, at 21. To most Europeans, "compensation" means indemnities for injury or damages. They use the word "remuneration" when
"imperative" is at work\(^3\) that can be alternatively dubbed "the Americanization of international pay practices."\(^4\) "As markets become truly global, you'll see the differences in compensation shrink," the managing director of one executive search firm has predicted.\(^5\) Or, as a leading U.S. expert on managerial remuneration has been quoted as saying, "the rest of the world is moving to our pay model."\(^6\)

Not all agree that a "global shakeup in executive comp"\(^7\) is taking place along American lines. Various observers believe that the divergence between the United States and other countries will persist and may even widen.\(^8\) For instance, the author of a well-known book on executive pay has suggested that "[t]he notion of closing the gap is laughable.... When you're 200 laps behind and driving a supercharged Audi, how do you catch up with an American car with 5,000 horsepower?"\(^9\)

Despite the controversy over the potential globalization of executive pay, the issue has attracted relatively little attention in legal circles.\(^10\) This Article addresses the gap in the literature by examining the factors likely to affect convergence on the managerial remuneration front. After surveying the essential elements of managerial compensation in the United States and elsewhere, the Article canvasses market-oriented dynamics that could constitute a "global compensation imperative." Still, while market forces will undoubtedly influence international trends in executive pay to some degree, it is difficult to predict whether they will act as decisive agents of change. This is because, as the Article discusses, legal regulation and business "culture" may hinder...

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\(^1\) Referring to all the elements for rewarding work. See Gary Parker, Establishing Remuneration Practices Across Culturally Diverse Environments, COMPENSATION & BENEFITS MGMT., Apr. 1, 2001, at 23, available at 2001 WL 7675825. These terms will be used interchangeably here.


\(^7\) See Brian R. Cheffins, The Metamorphosis of 'Germany Inc.': The Case of Executive Pay, 49 AM. J. COMP. L. 497 (2001) [hereinafter Cheffins, Metamorphosis], but see Stabile, supra note 8.
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correlation sufficiently to vindicate a claim made by two compensation consultants in 1999: "Global Pay? Maybe Not Yet!"11

The U.S. pay paradigm has sparked controversy at home.12 Not surprisingly, then, a potential shift towards U.S.-style compensation arrangements has proved contentious in other jurisdictions.13 This Article does not assess in detail whether convergence along American lines would be a "good thing." Instead, its primary purpose is to identify and analyze the variables that will determine whether such a shift is likely to take place.14 This does not mean, however, that the Article is purely descriptive. The authors recognize that lucrative U.S. pay packages could either align the interests of shareholders and executives or instead enable self-serving managerial "rent extraction."15 Also, the Article makes a significant normative contribution by identifying obstacles regulators ought to address if they are seeking either to promote or hinder a shift towards the lucrative, incentive-based model of executive pay that prevails in the United States.

The Article is organized as follows: Part II gives an overview of the "U.S. pay paradigm," emphasizing the special position of American chief executives; Part III discusses arrangements in other countries; Part IV offers an analysis of market factors that might promote convergence of executive pay practices along American lines; Parts V and VI consider the impact which legal regulation might have on any sort of globalization trend; and Parts VII and VIII examine the potential effects of "soft law" and "culture." A brief series of normative observations forms the Article’s conclusion.

II. THE U.S. PAY PARADIGM

When assessing the characteristics of executive pay in the United States, it is important to recognize the distinctive position of American chief executives. On the compensation front, American chief executive officers (CEOs) are "a breed apart."16 This pivotal attribute of the U.S. pay paradigm manifests itself chiefly

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15. See infra notes 122-139 and accompanying text. The "rent extraction" terminology is borrowed from Lucian Arye Bebchuk et al., Managerial Power and Rent Extraction in the Design of Executive Compensation, 69 U. CHI. L. REV. 751 (2002).
in three ways. First, American chief executives have highly "incentivized" pay arrangements. Second, relative to rank-and-file workers, their remuneration is very lucrative. Third, even compared to other senior managers within their own companies, American CEOs are remarkably well paid. These aspects of U.S. executive compensation will now be reviewed in turn.

A. Highly "Incentivized" Pay

For a rank-and-file American employee, pay is typically fixed at a prescribed hourly, monthly, or annual level, irrespective of contingencies such as firm performance. By contrast, the compensation packages of American chief executives tend to have a substantial variable component, in that entitlement depends on the satisfaction of prescribed conditions. Admittedly, doubts exist as to whether the targets set are sufficiently robust to ensure that CEOs will suffer meaningful penalties when corporate performance is sub-optimal and whether CEOs will be precluded from reaping a windfall simply because there has been a general rise in stock prices. Nevertheless, data compiled by economists Martin Conyon and Kevin Murphy for a study of executive compensation in the United States and Britain reveal that "incentivized" remuneration is clearly important for American CEOs.

Conyon and Murphy surveyed pay arrangements in over 1600 publicly traded American corporations and found that, as of 1997, the typical U.S. CEO received 29% of overall annual compensation in the form of base salary and 63% by way of variable remuneration. Stock option grants, which give managers the right to buy equity from their company at a prescribed "strike" or "exercise" price, were by far the most important type of incentive pay (42% of total compensation). Next in line, at 17% of total compensation, was the annual bonus, typically a cash payment awarded when a company has met specified yearly targets based on criteria such as share price or accounting earnings. Finally, Conyon and Murphy dealt with the long-term incentive plan.

20. Id. For more recent figures suggesting that stock options may be more important than Conyon and Murphy's study indicates, see Michael Casey, Stock Options Didn't Work; What Will?, WALL ST. J., Aug. 26, 2002, at A2 (indicating that options constituted approximately 69% of the compensation of CEOs in top U.S. companies).
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(LTIP), a bonus scheme that operates over several years rather than annually. According to their data, LTIPs comprised 4% of the compensation of a typical CEO of a publicly traded company.

As data compiled by economists Brian Hall and Jeffery Liebman reveal, the popularity of stock options as a form of CEO compensation is a relatively recent phenomenon. According to their figures, in 1980, the average value of an American chief executive's salary and annual bonus was $655,000 in real 1994 dollars, and the average value of stock option grants was $155,000. As of 1994, the salary and bonus had risen 97% to $1,293,000. In contrast, the average value of stock option grants grew by 683%, to $1,213,000. Over the same period, the fraction of CEOs receiving stock option awards increased from 30% to nearly 70%. Stock options continued to grow in importance throughout the remainder of the 1990s.

The end of the bull market in 2000 and consequent demands for greater managerial accountability resulting in enactment of the Sarbanes-Oxley Act of 2002 led to speculation that U.S. corporations would cut back on the granting of stock options. Massive grants of stock options have indeed become less frequent over the past few years. Still, the vast majority of companies continue to use this form of executive remuneration. Moreover, the total value of long-term incentive compensation awarded to top managers has remained largely constant, as various companies have begun to substitute other forms of performance-oriented remuneration for stock options.

For instance, restricted stock, which cannot be sold until the recipient serves at the company for a specified period of time, is emerging as one popular alternative.

22. Instead of cash, LTIPs often award executives with either "restricted stock" (equity that cannot be sold for a specified number of years) or "units" under a performance scheme that allows them to receive financial benefits akin to owning equity without actually giving them shares (e.g. "phantom stock" or "stock appreciation rights"). See Jeffrey S. Hyman, Long-Term Incentives, in COMPENSATION HANDBOOK, supra note 21, at 357.

23. Conyon & Murphy, supra note 19, at F646-48.


29. Id.


31. Joann S. Lublin, With Options Tainted, Companies Award Restricted Stock, WALL ST. J., Mar. 3,
B. Lucrative Compensation

In addition to providing historical perspective on the use of stock options, the Hall and Liebman data demonstrate that CEO pay in the United States is highly lucrative. More recent figures from other sources drive home the same point. For instance, according to a 2001 study of worldwide executive pay by remuneration consultants Towers Perrin (which used as a benchmark an industrial company with approximately $500 million in annual sales), total annual remuneration for a U.S. chief executive averaged $1,933,000.\textsuperscript{32} Compensation levels are even higher at large companies. According to a survey of 2002 data by \textit{Business Week}, the median total compensation for the 365 most highly paid chief executives in the United States was $3.7 million, and average pay was $7.4 million.\textsuperscript{33}

A highly publicized by-product of the lucrative compensation packages received by American chief executives is a dramatic disparity between their pay and that of rank-and-file workers.\textsuperscript{34} Figures compiled by Hall and Liebman illustrate that the divergence became particularly pronounced during the 1980s and 1990s.\textsuperscript{35} In 1982, the direct compensation of the average CEO (salary and bonus plus the value of stock option grants) was thirty times greater than the pay of the typical employee. Between 1982 and 1994, the average CEO's direct compensation increased 175\%, or approximately 8.8\% annually. During the same time period, the typical employee's pay grew 7.2\%, or 0.6\% annually. As a result, by 1996, CEO direct compensation was 210 times that received by an average employee.\textsuperscript{36} This disparity grew substantially through 2001, when dramatic growth in executive pay shuddered to a halt.\textsuperscript{37}

C. CEOs are Paid More Than Other Senior Managers

Unlike the highly publicized comparisons between CEOs and rank-and-file

\begin{footnotesize}

\begin{itemize}
\item \textsuperscript{32} TOWERS PERRIN, WORLDWIDE TOTAL REMUNERATION 20 (2001).
\item \textsuperscript{33} Louis Lavelle, Special Report: Executive Pay, \textit{Bus. Wk}, April 21, 2003, at 86 (discussing results of Business Week's 53\textsuperscript{rd} Annual Pay Scoreboard).
\item \textsuperscript{36} Randall S. Thomas, \textit{Should Directors Reduce Executive Pay?}, \textit{54 Hastings L.J.} 437, 440 (2003).
\end{itemize}
\end{footnotesize}
employees, relatively little has been said about the compensation disparity between U.S. chief executives and other senior managers.\textsuperscript{38} Nevertheless, the available evidence indicates that the divergence is significant. For instance, according to the same Towers Perrin survey that pegged annual CEO pay at $1,933,000, the total compensation of U.S. CEOs was 4.3 times greater than that of human resources directors in equivalent companies.\textsuperscript{39} Furthermore, a study using 2000 data found that CEOs of large manufacturing companies earned $1.82 in total compensation for every $1 earned by the second-highest paid executive, and $3.44 for every $1 earned by the fifth-highest paid executive.\textsuperscript{40}

In addition to receiving substantially better pay than other top managers, U.S. chief executives tend to have more “incentivized” pay arrangements. According to 2001 data from Towers Perrin, the ratio of long-term incentives (defined to encompass stock options, stock grants, and similar awards) to salary was 1.61 to 1 for a typical American chief executive, but only .66 to 1 for a typical human resource director.\textsuperscript{41} A study using 2000 data showed a similar pattern, with CEOs in large American manufacturing firms receiving, on average, stock option grants worth 636% of salary, while the equivalent figure for the other top four executives was only 390%.\textsuperscript{42} A by-product of this pattern is that, according to figures compiled in the mid-1990s, the average pay-performance sensitivity for a chief executive of an American public company was $41.22 per thousand dollar increase in shareholder wealth and the equivalent figure for executives with divisional responsibilities was only $3.68.\textsuperscript{43}

III. EXECUTIVE PAY IN THE REST OF THE WORLD

American CEOs are not merely a “breed apart” within their own country. Rather, their remuneration arrangements are also distinctive by international standards. As this Part discusses, companies located outside of the United States place less emphasis on performance-oriented pay and award less lucrative managerial compensation packages than do their American counterparts. Still,
there is some evidence of a shift towards U.S. compensation patterns.

A. Less Emphasis on Performance-Oriented Pay than in the United States

In the United States, variable pay is a much more important component of CEO remuneration than is the case elsewhere. The award of annual bonuses contributes partially, though not crucially, to this divergence. For instance, the Towers Perrin survey cited earlier indicates that in an American industrial company with annual sales of $500 million, the CEO's annual bonus is likely to be 56% of salary.\(^4^\) Comparatively speaking, this is a high figure, though not outstandingly so. Indeed, in two jurisdictions (Australia and Venezuela), the annual bonus to salary ratio was actually higher than this, and in many of the other countries, the equivalent figure was at least half.\(^5^\) On the other hand, American companies really stand out when it comes to long-term incentive schemes. As of 2001, according to Towers Perrin, this form of compensation constituted 161% of salary for a typical American chief executive.\(^6^\) Only Canada was close to this figure at 90%, and the top European country, Britain, lagged far behind at 44%.

Regarding executives other than CEOs, incentive-oriented pay is again a key cause of disparities between the United States and elsewhere. As is the case with chief executives, arrangements designed to operate over the long haul are the pivotal consideration. According to Towers Perrin figures from 2001, the annual bonus to salary ratio of an average American human resource director in an industrial company with annual sales of $500 million broadly corresponded to the figures in other countries.\(^7^\) Matters were different, however, with respect to variable pay geared to long-term incentives. According to the Towers Perrin data, this type of compensation amounted to 66% of base salary for the average American human resource director.\(^8^\) In only two out of the twenty-five jurisdictions surveyed (Malaysia and Singapore) was the long-term incentive to base salary ratio even half of what it was in the United States. Thus, the bias in favor of incentive-oriented pay which exists for CEOs of American companies

\(^{44}\) Id. at 26.

\(^{45}\) It should be borne in mind, however, that the Towers Perrin data may conceal some important cross-border differences concerning the use of annual bonuses. Conyon and Murphy's study of executive compensation in the United States and Britain indicates this. Conyon and Murphy discovered that the annual bonus constituted much the same percentage of total compensation in the two countries and that the percentage of CEOs receiving bonuses was roughly the same in the two countries. Nevertheless, they found that when bonuses were awarded, the payments in the United States were on average triple those granted in Britain. See Conyon & Murphy, supra note 19, at nn.647-48.

\(^{46}\) Id. at 26.

\(^{47}\) Id. at 27. The annual bonus of an American human resource director amounted to 29% of salary. Annual bonuses were awarded to human resource directors in all of the twenty-five other jurisdictions Towers Perrin surveyed, and in thirteen of these, the average annual bonus constituted 20% or more of annual basic compensation.

\(^{48}\) Id. at 25.
The Globalization (Americanization?) of Executive Pay is also present with other U.S. senior managers, albeit on a lesser scale.

**B. Executive Pay is Lower Outside the United States**

In addition to receiving remuneration packages with a stronger bias in favor of variable compensation, U.S. CEOs are much better paid overall than their counterparts in other countries. According to the Towers Perrin data cited earlier, total annual pay for a typical U.S. chief executive was $1,933,000.\(^4\)

This amount was more than double the average for CEOs in all of the other twenty-five countries surveyed, and was more than triple the average in all but six (Argentina, Brazil, Canada, China/Hong Kong, Mexico, Singapore, and the United Kingdom).\(^5\)

With lower CEO compensation being the norm outside the United States, foreign companies exhibit a less dramatic pay gulf between chief executives and rank-and-file workers than their American counterparts. Admittedly, in some comparatively poor countries such as Venezuela and Brazil,\(^6\) chief executive compensation is a greater multiple of average employee pay than in the United States. Still, in comparison with leading industrial nations, the United States stands alone. According to data from 1999, while a U.S. CEO earned thirty-four times the average factory wage, the comparable figure was twenty-four in Britain, thirteen in Germany, and eleven in Japan.\(^7\)

Moreover, these numbers may underestimate the disparity in the United States, as some data suggest that the ratio is at least seventy-seven to one in larger companies.\(^8\)

What makes CEO pay in the United States so much higher than elsewhere? Salary differentials play a role, but not a major one. The Towers Perrin survey cited earlier pegged the annual salary of an average U.S. CEO at approximately $540,000.\(^9\)

While this was the highest figure among the twenty-six jurisdictions covered, CEOs in Argentina and Mexico both received base pay that exceeded $400,000 annually and chief executives in eleven other countries had salaries of $250,000 or more.\(^10\)

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\(^4\) See id.

\(^5\) TOWERS PERRIN, supra note 32, at 20.


\(^7\) Robert Taylor, Facts to Confound the Gurus, FIN. TIMES, Sept. 7, 2000, at 16; see also John M. Abowd & David S. Kaplan, Executive Compensation: Six Questions That Need Answering, 13 J. ECON. PERSP. 145, 160-61 (1999); Donkin, supra note 35 (setting out statistics that reveal much the same pattern).

\(^8\) See Hall & Liebman, supra note 24, at 661-67. The primary source of inconsistency is the amount that CEOs earn in the United States. The figure cited in the Taylor study, supra note 52, was $1,351,000, whereas in the Hall and Liebman study, supra note 24, mean CEO compensation was $2,506,000 for 1994.

\(^9\) TOWERS PERRIN, supra note 32, at 20, 24.

\(^10\) Id. The Towers Perrin figures for Argentina likely do not capture the full effect of downward pressure on CEO salaries caused by a bitter recession in that country. For background, see Tony Smith, Shrinking Salaries Hit Home in Argentina, N.Y. TIMES, Apr. 6, 2003, § 3, at 6.
What about fringe benefits ("perks")? Do they contribute significantly to the international gap in CEO pay? While the perks that larger American companies make available to retiring CEOs have recently generated controversy,\textsuperscript{56} the answer is no. According to Towers Perrin's 2001 survey on international executive pay, fringe benefits are not exceptionally generous in the United States.\textsuperscript{57} The Towers Perrin data indicate that benefits such as company contributions to retirement and insurance plans and perquisites such as company cars and club memberships constituted 11\% of the total compensation of an average U.S. CEO. The equivalent percentage was higher in twenty of the twenty-six countries dealt with in the study.\textsuperscript{58}

What, then, separates U.S. CEOs from their counterparts in other countries? The answer is that long-term incentive schemes, such as stock option packages and LTIPs, are primarily responsible for the disparities between the United States and elsewhere. Annual bonuses for American CEOs are quite generous by world standards, but not inordinately so.\textsuperscript{59} On the other hand, the long-term incentive remuneration to base salary ratio is considerably higher in the United States than elsewhere.\textsuperscript{60} Since the salaries of American CEOs are already the highest in the world, the end result is that U.S. companies award total compensation that well exceeds that granted in other countries. According to the Towers Perrin survey on international executive pay, a typical U.S. chief executive officer received approximately $870,000 annually in the form of long-term incentive compensation.\textsuperscript{61} In only two of the other twenty-five jurisdictions studied did aggregate annual CEO compensation match this figure (Argentina at $879,000 and Mexico at $867,000).\textsuperscript{62}

It is helpful to put the raw data in context. The current pattern in CEO remuneration worldwide is consistent with historical trends. Survey evidence from the early 1960s onwards indicates that American chief executives have consistently been paid more than their foreign counterparts.\textsuperscript{63} As the 1990s

\textsuperscript{57} Moreover, amid accounting and fraud scandals, various large U.S. companies have begun to cut back on the perks they do offer to top corporate officials. Lynnley Browning, \textit{The Perks Still Flow (But With Less Fizz)}, N.Y. TIMES, Apr. 6, 2003, § 3, at 6.
\textsuperscript{58} \textit{TOWERS PERRIN}, supra note 32, at 24. On how the terms were defined for the purposes of the study, see \textit{id}. at 3. See Shawn Tully, \textit{American Bosses are Overpaid. . . Or Their Counterparts in Europe are Underpaid}, FORTUNE, Nov. 7, 1988, at 121; Abowd & Kaplan, supra note 52, at 146, Table 1 (according to 1996 data, out of twelve industrialized countries, the total value of fringe benefits offered by U.S. corporations to CEOs only ranked fifth).
\textsuperscript{59} \textit{See TOWERS PERRIN}, supra note 32.
\textsuperscript{60} \textit{id}.
\textsuperscript{61} \textit{id}. at 20, 24, 26.
\textsuperscript{62} \textit{id}. at 20.
\textsuperscript{63} Abowd & Kaplan, supra note 52, at 146, Table 1 (setting out data for 1984 and 1996); Arch Paton, \textit{Executive Compensation Here and Abroad}, HARV. BUS. REV., Sept.-Oct. 1962, at 144, 152 (citing data from McKinsey & Co.); Detlev Vagts, \textit{Challenges to Executive Compensation: For the Markets or
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began, there was some speculation that the gap between the United States and elsewhere was closing. By the middle of the decade, however, any such narrowing had stalled as dramatic increases in long-term incentive compensation caused American executive pay to rise to unprecedented levels.

Also noteworthy is that U.S. CEOs do not seem to sacrifice job security for higher pay. Though some have suggested that chief executives outside the United States do not face the same external scrutiny as their American counterparts, the reality appears to be different. Data from the 1980s indicate that CEOs in Japan and Germany were, if anything, more likely to be dismissed than American chief executives when a company suffered a major share price decline or a drop in earnings. More recently, a 2000 study carried out by management consultants Drake Beam Morin revealed that CEO turnover rates are equally high world-wide. Moreover, according to data from 2002, CEO tenure was shorter in Europe than in North America, and the dismissal rate for sub-standard performance was roughly equivalent.

A final point to keep in mind when thinking about the disparity between CEO pay levels in the United States and elsewhere is that the situation is not nearly as exceptional with lower-ranking executives. As mentioned, a notable, if little remarked upon feature of the U.S. pay paradigm is that CEOs are much better paid than other senior managers.


70. See TOWERS PERRIN, supra note 32.

71. Id.

72. Derived from data set out in TOWERS PERRIN, supra note 32, at 20-21. The contemporary pattern constitutes something of a reversal of historical trends. According to data from the early 1960s, the divergence between CEO compensation and the compensation made available to other top executives
C. Evidence of Convergence

Since performance-related remuneration (especially stock options and other incentivized pay with a long-term orientation) serves to distinguish executive pay in the United States from that in other countries, an internationally oriented shift towards performance-based compensation would constitute a significant convergence trend. There is some evidence to suggest that such a pattern is in fact developing. First of all, annual bonuses appear to be an increasingly important element of overall compensation worldwide. The Towers Perrin survey of worldwide executive remuneration for 2001 indicates that in eighteen of the twenty-six jurisdictions covered, the annual bonus to salary ratio was higher for CEOs than it was in 1996. For human resource directors, the outcome was similar in twenty-one countries.

The same pattern is evident with long-term incentive compensation. According to the Towers Perrin data, in 1996 there were fourteen jurisdictions where chief executives did not participate in a long-term incentive scheme and twenty where the human resource director did not do so. By 2001, these figures had dropped to four for both CEOs and human resource directors. Moreover, in those countries where long-term incentive plans were in place in 1996 and 2001 for both CEOs and human resource directors, the long-term incentive scheme to base salary ratio increased in every country but one (Switzerland).

Additional research from a Towers Perrin 2001 report on stock options confirms that incentivized pay based on long-term targets is becoming increasingly common outside the United States. According to the study, which examined the practices of large, local companies headquartered in twenty-two different countries, such compensation prevailed in only a handful of jurisdictions in 1997. The study predicts, however, that soon it will be the norm for executives to participate in long-term incentive schemes. Moreover, consistent with the U.S. pattern, stock option plans are emerging as the most popular type of performance-oriented compensation.

Anecdotal evidence confirms the trends identified by the Towers Perrin report. Traditionally, the American practice of granting stock options has not been followed elsewhere. In Britain, for instance, share option plans were...
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largely unknown until the mid-1980s, when large numbers of companies began to change their approach.82 Stock options began to gain ground in some other European countries during this same period,83 but they remained of negligible importance in Germany and Italy.84 Likewise, long-term incentive compensation of any sort was virtually unknown in countries such as Belgium, the Netherlands, Sweden, and Spain.85

Matters have been changing in Europe during the past few years, however. By the late 1990s, growing numbers of European executives were reportedly receiving part of their pay in stock options or LTIPs.86 The trend towards performance-oriented compensation attracted attention in the business press, eliciting headlines such as “Euroland Bonanza”87 and “A Yawning Gap Begins to Close.”88 Indeed, by 2001, most of Europe’s large publicly traded companies had adopted share option programs.89

The experience has been similar in several countries in other regions. Until recently, stock option plans were virtually unknown in Japan.90 Now, a growing number of Japanese companies are creating such schemes for senior employees.91 Similarly, in Australia, stock option plans were not widely adopted

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82. Helen Kay, Have We Killed the Share Option?, DIRECTOR, Oct. 1995, at 64, 66; Laura Mazur, Europay, ACROSS THE BOARD, Jan. 1995, at 40; Executive Pay; Perky, ECONOMIST (UK ed.), Oct. 8, 1988, at 48 (referring to share options as “the newest executive game”).

83. Alain Alcouffe & Christiane Alcouffe, Control and Executive Compensation in Large French Companies, 24 J.L. & SOC’Y 85, 96 (1997); Lublin, supra note 64 (mentioning Austria, Denmark and Norway). The evidence concerning France is, however, conflicting. See, e.g., Charles Peck et. al., Top Executive Compensation: Canada, France, the United Kingdom, and the United States, in THE CONFERENCE BOARD, RESEARCH REPORT 1250-99-RR, 1999, at 19-21; Mazur, supra note 82.


85. Abowd & Kaplan, supra note 52, at 146. For more detail on Spain see Charlotte Villiers et al., Controlling Directors’ Pay in English Law and Spanish Law, 2 MAASTRICHT J. EUR. & COMP. L. 377, 391-92 (1995).

86. Damn Yankees, supra note 13; Johnston, supra note 6.

87. Blackledge, supra note 8.

88. Tony Barber, FT Director Survey, FIN. TIMES, June 2, 2000, at 5.


91. Nicholas Benes, Japan’s Coming Shareholder Revolution, ASIAN WALL ST. J., Feb. 14, 2001, at 6; Yasmin Ghahremani, In the Company of Millionaires, ASIA WK., Mar. 17, 2000, available at 2000 WL 8936312. For further background, see Paul Abrahams, Japan’s Ray of Hope, FIN. TIMES, May 6, 247
prior to 1990,92 but have since become popular.93 Canada has experienced the same trend, though most larger public companies did grant some stock options prior to the 1990s.94

While long-term incentive compensation is becoming more common as a form of executive pay, it should not be assumed that American-style compensation is now the international norm. It must be remembered that stock options and similar incentive schemes remain much more lucrative in the United States than elsewhere, particularly for CEOs. The Towers Perrin survey cited earlier draws attention to this divergence by indicating that the ratio of long-term incentive compensation to salary remains considerably higher in the United States than in other countries.95 This study, however, might not do full justice to the disparity. While stock option grants did become firmly established in Britain in the 1980s,96 as of 1997, among CEOs receiving such compensation, the median option grant in the United States was nearly twenty times that of Britain.97

Also significant is that stock options made available to executives in other countries often differ in type and form than those granted domestically. In the United States, most companies award "plain vanilla" share options to executives, meaning that options can be exercised without regard for performance conditions.98 Therefore, management can be rewarded for any rise in their company's share price, even if the increase was well below that realized by competitors or by the market as a whole.99 On the other hand, in countries such as Australia, Germany, Italy, the Netherlands, South Africa, and Britain, it is the norm for stock options to be awarded subject to performance conditions.100 With this sort of arrangement, executives are only able to exercise

95. See supra notes 17-31 and accompanying text.
96. See supra note 82 and accompanying text.
97. Conyon & Murphy, supra note 19, at 848.
99. Bebchuk et al., supra note 15, at 796-97; Abowd & Kaplan, supra note 52, at 162; Rappaport, supra note 98, at 93.
100. TOWERS PERRIN, supra note 78, at 7.
options if the company has met specified “benchmarks” such as exceeding a designated earnings per share target.

With respect to possible convergence on the executive pay front, increased use of performance-related pay implies a shift towards potentially more generous managerial compensation. Why is this the case? The key point to keep in mind is that, for good reason, executives will have reservations about having their pay tied directly to shareholder return.\textsuperscript{101} For instance, on diversification grounds, they will dislike having their remuneration linked to the performance of a company in which they have already tied up substantial human capital.\textsuperscript{102} Also, since an individual company’s stock price often fluctuates markedly, they will fear significant swings in income. Moreover, they will worry about having their remuneration tied to share prices since factors unrelated to the skill and effort of a company’s top people can influence its market standing.\textsuperscript{103}

Despite these various difficulties, companies seeking to recruit and retain good people do have an ability to link managerial remuneration more closely with shareholder return if that is a key priority. The strategy to adopt is straightforward: offer a highly lucrative “upside.” If the potential rewards are large enough, a talented executive will accept the risks of linking remuneration to shareholder return.\textsuperscript{104} The upshot is that if foreign companies move towards the U.S. pay paradigm by using more performance-related compensation, there will be pressure to shift towards the sort of lucrative pay that serves to make America’s CEOs a “breed apart.”

The analysis of executive pay convergence offered thus far has focused on other countries moving towards the U.S. model, but a different convergence scenario also merits consideration. Conceivably, recent economic conditions might temper America’s exceptional managerial compensation arrangements and bring matters more in line with other nations. Indeed, declining stock market prices and corporate scandals have undercut faith in “superstar” CEOs, individuals who had formerly been lauded for their significant roles in realizing the American economic expansion of the 1990s.\textsuperscript{105} A predicted consequence of this shift in attitude is the reining in of executive pay.\textsuperscript{106} Indeed, one U.S.

\begin{footnotesize}
\begin{enumerate}
    \item Cheffins, supra note 17, at 686.
    \item John E. Core et al., Executive Equity Compensation and Incentives: A Survey, FED. REV. BANK N.Y. ECON. POL’Y REV., Apr. 2003, at 27, 36-37 (saying that an executive will discount the value of a grant of stock options because of poor diversification).
    \item In companies with concentrated share ownership, there are additional reasons why managers will not value highly compensation that is linked to share price performance. See infra notes 117 to 143 and accompanying text.
    \item Cheffins, supra note 17, at 686-87.
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It is possible that certain interrelated factors could operate simultaneously to downgrade performance-oriented executive pay and to cut remuneration levels for U.S. CEOs. The high-powered incentive plans that delivered spectacular rewards when times were good may yield few benefits for executives when companies are suffering from faltering shareholder returns. Investors disillusioned by mediocre stock prices and corporate scandals may try to exert pressure on companies to curb perceived management excesses. Top executives seeking to boost corporate morale and secure public relations benefits might "share the pain" with employees and shareholders by voluntarily surrendering pay to which they might otherwise be entitled. Finally, "star" managers, nervous that a prolonged economic slump will make it difficult to cash in on incentive-oriented compensation, might begin to use their negotiating leverage to secure deals in which variable pay is featured less prominently.

Indeed, some evidence indicates that the configuration of executive pay in the United States is being overhauled. According to a Business Week survey, though the average total compensation of America's 365 most highly paid executives was $7.4 million in 2002, this represented a 33% decline from 2001, and the second year in a row in which there had been a decline. Still, it is important to keep matters in perspective: the 2001-2002 drop in average CEO compensation recorded by Business Week occurred not on account of wholesale rearrangement of compensation schemes, but rather because massive payments at the very top of the scale largely disappeared. Correspondingly, while average pay for the 365 CEOs decreased by one third between 2001 and 2002, median pay actually increased by 5.9%. Other surveys of executive remuneration carried out by the business press confirm that, while some downward revisions are occurring, these do not "threaten the underlying nature of the CEO entitlement system." Hence, despite current economic conditions, the dismantling of the American model of compensation advisor proclaimed "the end of a golden era."

112. Lavelle, supra note 33.
113. Id.; see also Jerry Useem, Have They No Shame?, FORTUNE, Apr. 28, 2003, at 56.
114. Samuelson, supra note 106; on the surveys in question, see also Useem, supra note 113; Joann S. Lublin, Why the Get-Rich-Quick Days may be Over, WALL ST. J., Apr. 14, 2003, at R1; Patrick McGeehan, Again, Money Follows the Pinstripes, N.Y. TIMES, Apr. 6, 2003, sec. 3, at 1.
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Executive pay does not appear to be happening. It follows that, to the extent that global convergence is imminent, it remains more likely that corporations in other countries will move towards the American approach rather than the reverse.

IV. MARKET-ORIENTED DRIVERS OF EXECUTIVE PAY

The foregoing discussion illustrates that companies outside the United States pay their executives (and particularly their CEOs) in a manner that is considerably different from their American counterparts. At the same time, though, the disparity may be diminishing as companies around the world shift, in varying degrees, towards the U.S. pay model. What might be providing the impetus for this convergence trend? Market forces of various types are potentially playing a role. This Part of the Article identifies examples and concludes with some observations on how influential these market dynamics are likely to be in the future.

A. Evolving Share Ownership Patterns

Share ownership in large U.S. business enterprises is typically widely dispersed. Such diffusion results from the fact that most big companies are publicly traded, and only in a minority of these does a single investor own a substantial block of shares. Britain's corporate economy is configured in a similar fashion. In other major industrial countries, however, concentrated share ownership is the norm. In these jurisdictions, many large companies do not trade on the stock market, and those which do frequently have a dominant shareholder. Anecdotal evidence suggests that throughout continental Europe and East Asia, the internationalization of both product and financial markets is beginning to destabilize traditional ownership structures and cause some form of convergence in the Anglo-American direction. Tangible manifestations of this trend include a significant increase in the number of publicly traded

118. Id. at 1703-04, 1750-54.
119. Id. at 1704.
companies and growth in the aggregate market capitalization of national stock markets. If the momentum in favor of dispersed share ownership proves to be robust, the reconfiguration could act as a catalyst for the Americanization of executive pay.

To understand why a shift in ownership patterns potentially matters, it is necessary to consider why managerial remuneration arrangements tend to vary in accordance with a company's ownership structure. Take incentivized compensation, for instance. In a publicly traded corporation with highly dispersed share ownership, a managerial "agency cost" problem may exist that can be addressed at least partially by establishing a strong correlation between executive pay and corporate performance. By contrast, in a firm where control is highly consolidated, the "core" shareholder(s) should have both the means and motivation to discipline disloyal or ineffective managers. Monitoring, then, can at least partially displace the need for performance-related compensation. At the same time, a dominant investor fearing dilution of control will be averse to share-based incentive schemes whereby managers who hit performance targets could be transformed into major shareholders.

Concentrated share ownership is also relevant to the use of incentivized compensation because executives of companies lacking a dispersed investor pattern will have legitimate grounds for being skeptical of rewards based on share price performance. For any business that is not publicly traded, share valuation will be difficult since the stock market will not be functioning as an ongoing barometer of firm value. Even with companies listed on the stock market, those with concentrated ownership structures will typically have a small "free float," which means that share prices could be strongly influenced by


125. Thomas Bates et al., Promotion Incentives and Executive Compensation in Family Firms 17 (2000) (unpublished working paper, on file with the author); Thomas, supra note 14, at 124.

126. Thomas, supra note 14, at 120.
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"noise" unrelated to prospective future earnings. Under such circumstances, price fluctuations may not reflect in any meaningful way the quality of managerial performance.127

There is a body of empirical evidence which confirms that the adoption of highly incentivized executive pay arrangements occurs less readily in companies with a major blockholder.128 Admittedly, there are some conflicting data.129 Still, if countries in which concentrated ownership is the norm for large business enterprises are in fact shifting towards a more dispersed pattern, a consequence may be greater momentum in favor of performance-oriented managerial compensation.

The potential reconfiguration of share ownership, in addition to influencing the use of incentive-based executive remuneration, might also affect aggregate pay. On this count, work done by Lucian Bebchuk, Jesse Fried, and David Walker is instructive.130 They argue that the setting of executive pay in the typical American widely-held company is biased in favor of management, in large part because board committees delegated the task of determining compensation are often more beholden to management than to shareholders. Correspondingly, top executives have considerable scope to extract "rent" in the form of remuneration in excess of the level that would be optimal for shareholders.131

Arguably, where core shareholders dominate, "rent extraction" is less likely to occur via managerial compensation.132 Take the example of a company that has a concentrated ownership structure in which the CEO is not part of the dominant faction. Those with a controlling interest should be motivated to prevent excessive compensation because any "unspent" money reverts to the

127. Abowd & Kaplan, supra note 52, at 155-57; Melis, supra note 84, at 353; Mazur, supra note 82; Parker-Pope, supra note 65. For illustrations of the point, see Maurizio Dallocchio, Why Do Italian Stocks Read Like Opinion Polls?, WALL ST. J. EUR., June 11, 2001, at 7; Throw Out the Rule-Book, ECONOMIST, May 26, 2001, at 112.

128. Brunello et al., supra note 124, at 141, 155; Park et al., supra note 124, at 251-52; Paul Durman, How Different Factors Affect the Level of Pay at the Top, SUNDAY TIMES, Dec. 9, 2001, at 8 (discussing a report by SCA Consulting); Yun M. Park et al., Executive Pay Practices of Firms with Dominant Shareholder CEOs: Self-Dealing or Efficient Contracting, 15 (2002) (unpublished manuscript, available at http://business.fullerton.edu/finance/yunpark/files/papers/DSCEO.doc) (last visited Dec. 3, 2004) (finding that executive pay is less stock-based when a CEO is a dominant shareholder than it is when a company lacks a blockholder).


130. Bebchuk et al., supra note 15. For additional explanations why concentrated share ownership might be associated with lower levels of executive pay, see Bates et al., supra note 103, at 5-6, 10 (finding, however, that the situation would be different with executives below the CEO level); Cordeiro & Veliyath, supra note 129.

131. Bebchuk et al., supra note 15, at 754, 784-86.

132. Id. at 843-45; Ferrarini et al., supra note 89, at 11.
shareholders, including those who qualify as "core" investors.\textsuperscript{133}

Scrupulous blockholder monitoring of managerial remuneration is much less likely to occur if the chief executive of a company with a concentrated ownership structure is a member of the controlling group or family. Nonetheless, even in such a situation, rent extraction via executive compensation is likely to be muted. To the extent that the dominant faction in a company attempts to exploit the private benefits of control, they will probably take advantage of more clandestine and efficient methods such as diverting promising business opportunities and arranging "sweetheart" deals with related corporations.\textsuperscript{134} Certainly, the available empirical evidence suggests that CEOs who are also dominant shareholders are not "overpaid" as compared with other chief executives.\textsuperscript{135}

The foregoing suggests that, to the extent that corporate ownership becomes more dispersed in countries where blockholding currently prevails, there likely will be a rise in executive pay levels as well as a shift towards U.S.-style performance-oriented compensation. The attitudes of those likely to buy equity as part of a shift towards increasingly diffuse share ownership would probably reinforce this trend. One hallmark of the alleged transition away from traditional blockholder arrangements is growing foreign portfolio investment by financial intermediaries based in the United States and Britain (pension funds and mutual funds, for example).\textsuperscript{136} If companies from continental Europe, Asia, and Latin America want to raise funds on international capital markets, they will be obliged to respond to the preferences of these institutional investors.\textsuperscript{137}

American and British shareholders have generally sought to promote incentive-oriented managerial remuneration and have been prepared to accept lucrative


\textsuperscript{134} Bebchuk et al., \textit{supra} note 15, at 844-45. For more benign explanations regarding why CEO pay will not be excessive in this instance, see Derek Matthews, \textit{Fat is a Relative Issue}, MGMT. TODAY, June 1996, at 50; Ramaswamy et al., \textit{supra} note 133, at 182-83; Bates et al., \textit{supra} note 125, at 5.

\textsuperscript{135} Park et al., \textit{Executive Pay, supra} note 128, at 13-14; Ramaswamy et al., \textit{supra} note 133, at 171, 182-83; Clifford G. Holderness, \textit{A Survey of Blockholders and Corporate Control}, FED. RES. BANK N.Y. ECON. POL. REV., Apr. 2003, at 51, 56-57.


compensation for managerial "high-flyers." Correspondingly, growing Anglo-American cross-border portfolio investment might serve to provide a congenial environment for lucrative performance-based managerial remuneration in countries where share ownership has traditionally been highly concentrated.

While a shift towards dispersed ownership could imply the spread of an increasingly American approach to executive pay, some cautionary notes are in order. Although a growing number of companies outside the United States and Britain are becoming versed in the Anglo-American way of doing business, doubts still exist about whether any shift in attitude is more than superficial. Thus, it cannot be taken for granted that the preferences which U.S. and U.K. investors have concerning executive pay arrangements will have more than a marginal influence for the foreseeable future.

Evidence from continental Europe also suggests that an immediate and radical shift towards substantial ownership dispersion may in fact not be imminent. For instance, while statistical evidence does establish clearly that it is becoming more common for European companies to go public, the general trend among these newly-listed companies is to retain a concentrated ownership structure. Assuming this practice persists, controlling shareholders presumably will continue to predominate even if the current trend toward increased stock market participation remains on track.


141. Supra note 121 and related discussion.


blockholders will serve to diminish the likelihood of convergence towards the U.S. executive pay model.

B. Cross-Border Hiring

While it cannot be taken for granted that share ownership patterns will soon evolve along Anglo-American lines, there are other economic dynamics that might nevertheless foster a partial executive pay transition. One is the growing internationalization of the labor market for executives. It has been said that “[t]he dawn of the millennium is ushering in a true global marketplace for CEOs, with a record number of foreign CEOs running major companies in the United States, Britain, and several other countries around the world.”144 If this prognosis is correct, increased cross-border hiring of top management might promote the Americanization of executive pay.

There are various ways in which the growth of the nascent market for global executive talent could prompt a shift to American-style managerial compensation. One dynamic which could be relevant is that companies based outside the United States will fear losing top people. In a global marketplace for executive talent, gifted managers might be tempted to migrate to America to take up generous remuneration packages stateside. Market forces will in turn pressure foreign firms to restructure managerial compensation so as to conform more closely to typical arrangements in the United States.145

Increased cross-border hiring of Americans for top posts outside the United States also might help to foster a reconfiguration of executive pay. A foreign company may look stateside to recruit senior managers in order to take advantage of the United States’ comparatively deep executive talent pool.146 Also, a company may want to signal that maximizing shareholder value is a high priority by hiring a CEO from the country that embraces this notion most firmly.147 Those aspiring to a top managerial position in the United States are unlikely to leave the country unless a prospective foreign employer offers a compensation package comparable to those which American companies provide.148 Thus, large-scale recruitment of American executives by non-U.S.

145. See, e.g., Tully, supra note 58; Martin Dickson, Package Envy: Or the Curse of Keeping Up with the Yanks, FIN. TIMES, Apr. 28, 2001, at 13; Dan Bilefsky, Mad About Money, WALL ST. J., Apr. 14, 2003, at R3; see also Gates, supra note 8 (discussing a survey of large European companies indicating that 78% of total responses cited attracting and retaining executives as among the forces driving change in European executive compensation).
147. See Plender, supra note 146.
148. Delroy Alexander, Over-Hyped, Overpaid and Over Here, INVESTORS CHRON., Nov. 24, 1995, at 20; Chwialkowska, supra note 146; Matthews, supra note 134.
companies could trigger global changes in approaches to executive pay.149

While in theory the emergence of a global market for executive talent may foster convergence in managerial compensation, how important are the relevant dynamics likely to be in practice? According to some evidence, quite a bit. On the "demand side" of the labor market, growing competition for managerial talent apparently is forcing more companies to recruit internationally.150 Moreover, many large corporations seeking leaders capable of operating effectively in a global marketplace are increasingly willing to select the best managerial talent irrespective of country of origin.151 Turning to the "supply" side of the equation, there are growing numbers of "true global nomads" who speak English fluently, have honed their business skills in countries outside their own, and are perfectly content to move to further their careers.152 This international cadre of executives offers companies a wide choice of potential recruits.

Still, it cannot be taken for granted that internationalization of the managerial labor market will be a robust cause of convergence in executive pay.153 First of all, foreign firms are unlikely to recruit an American to serve as CEO unless he or she speaks the native tongue fluently. Even where language is not a barrier, however, the recruitment of a U.S. chief executive may still tend to be an exceptional event.154 To illustrate, in Canada, many firms shy away from hiring American CEOs because the large compensation package required to recruit the new person will be too costly and may well create discord among modestly paid incumbent executives.155 Even in Britain, the most popular destination for Americans taking up a CEO post,156 hiring directly from the United States is still considered risky.157 British companies in search of a "U.S.

149. Parker-Pope, supra note 65; Alexander, supra note 148; Tony Boyd, World Class, AUSTL. FIN. REV., Nov. 8, 2002, at 34; John Kipphoff & Tony Tassell, UK Pays a Big Price to Keep Up With the US, FIN. TIMES, May 19, 2003, at 19; Cf. Cave, supra note 2 (arguing that the effect of recruiting a U.S. CEO will be transitory unless the company has to go back to the international marketplace to find a replacement).

151. Lyons & Spencer, supra note 144, at 52.
155. Chwialkowska, supra note 146; Gay, supra note 66.
156. Lyons & Spencer, supra note 144, at 52; see also Keep on Purring, ECONOMIST, July 24, 1999, at 25 (finding that fourteen of the thirty-one best-paid executives in Britain were from the United States).
157. Plender, supra note 146 (noting that it is more conventional to hire Americans who have risen through the ranks).
superman" typically do so in order to address pre-existing credibility problems and deflect pressure from impatient investors.158

Likewise, it cannot be taken for granted that American companies will hire foreign-born managers on a wide scale.159 Tough immigration regulations constitute a potential deterrent.160 Also, evidence from Britain and Canada suggests that the number of top executives actually in a position to move remains quite small. In both countries, the argument that senior management might depart to the United States has been invoked to defend significant increases in executive pay.161 Nevertheless, in Britain, skeptics say that no more than a handful of individuals could really move to the United States and secure a highly lucrative pay deal.162 In Canada, the prevailing view is that only executives in companies now competing successfully for business in a North American or global marketplace might be able to leave.163 Thus, most Canadian CEOs have not actively sought opportunities in the United States because many are "landlocked": they work for small companies that only service the domestic market.164 The upshot is that, while cross-border hiring is a potential catalyst for Americanized executive pay, the global market for managerial talent is characterized by "continuing stickiness."165

C. Transnational Mergers and Acquisitions

As with the market for managerial talent, growing internationalization of the market for corporate control could foster a shift in executive compensation.166

158. Id. For a mildly dissenting view, see Alexander, supra note 148.
159. Overell, supra note 152.
162. Look Out, There's a Monster Coming to Your Annual Meeting, TELEGRAPH, July 25, 2000, at 27; Sally Patten & Jon Ashworth, UK 'Fat Cats' Look on in Envy at Their American Cousins, SUNDAY TIMES (LONDON), July 15, 2000, at 29; Simon Targett, Heat May be Turned Up, FIN. TIMES, Nov. 17, 2000, at FT Director 7; Jane Simms, Has the Milk Gone Sour for Fat Cats?, ACCOUNTANCY (U.K.), Sept. 30, 2002, at 40, 41.
165. ICGN SUB-COMMITTEE ON EXECUTIVE REMUNERATION, supra note 153, ¶ 19; see also Martin Dickson, Pay: It's Not Such a Small World After All, FIN. TIMES, June 25, 2002, at 22.
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Though the combined effects of economic uncertainty and political turmoil have recently taken their toll, cross-border merger and acquisition (M & A) activity has generally been robust over the past decade. Reasons include heightened competitive pressures, improvements in technology and communications, and the growth of global markets for goods and services.

International M & A activity has potentially profound implications for executive compensation packages because when companies with different managerial remuneration arrangements merge, pressure arises to move to a single pay system. Specifically, so long as a strong U.S. element is party to a cross-border merger or acquisition, there will be a shift toward an American-style compensation scheme.

First consider foreign firms making acquisitions in the United States. If the American target previously offered lucrative remuneration packages to its executives, a merger could create huge internal pay inequities. The parent company might then be forced to resolve the problem by increasing home-country executive pay. The alternative—slashing salaries of top management in the United States—would likely be untenable because it would cripple efforts to recruit new people and retain key incumbent talent. For instance, prior to the 1998 merger between Daimler-Benz AG, a German automobile manufacturer, and Chrysler Corporation, an American rival, Chrysler’s second-ranking executive made more from salary, bonuses, and share options than the top ten Daimler-Benz executives combined. This type of disparity led the new merged entity—Daimler Chrysler—to try to develop an internal pay system that was equitable on cross-border terms and yet would allow the company to retain and recruit managers to run the American operations. The key initiative taken in this regard was to implement a major stock option plan for which 6,000 executives, including those based in Germany, were eligible.

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170. Fung, supra note 81, at 38.
173. Fung, supra note 81, at 37.
174. Kemba J. Dunham, *Home Disadvantage: WALL ST. J.*, April 11, 2002, at B12 (noting that because German law does not require corporations to report individual executive salaries, it is unknown whether any DaimlerChrysler executive currently working in the U.S. is paid better than the CEO).
Now consider an American company acquiring a foreign business enterprise. Given the exceptional nature of managerial remuneration in the United States, the executives of the acquired company are unlikely to be nearly as well paid as their American counterparts. If matters remain the same after the merger, dissatisfaction could arise among top people in the acquired company, perhaps leading to harmful defections. As a result, pressure will again exist to move pay in the U.S. direction. Since the presence of a strong American element in a cross-border merger has this sort of effect and because the United States is a major player in such transactions, a prompt return to recent levels of cross-border deal-making should create renewed momentum in favor of U.S.-style executive remuneration.

**D. The Growth of Multinational Enterprise**

Cross-border mergers are a manifestation of an even broader trend, the dramatic increase in the number and size of companies that operate multinationally. The growth of multinational enterprises has significant implications for the globalization of executive pay. Business enterprises with cross-border operations often find it useful to coordinate managerial pay arrangements around a universal standard because this makes it easier to organize company-wide systems of promotion and incentivized compensation. For multinational corporations that in fact make "executive pay decisions on a worldwide level . . . more uniform executive pay structures are the result." Correspondingly, when multinationals headquartered in the United States set managerial pay in accordance with a universal corporate policy, Americanization of executive pay will likely ensue.

Thus, when an American multinational adopts a uniform executive compensation structure, host-country nationals directly employed by the company will end up having their pay aligned more closely with standards prevailing in the United States. Also noteworthy, however, will be the effect on the market for managerial talent in the country in question. Higher pay for

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180. HELEN DERECKY, *INTERNATIONAL MANAGEMENT: MANAGING ACROSS BORDERS AND CULTURES* 366-67 (Prentice Hall, 3d. ed., 2000); Mazur, *supra* note 82 (making the same point by referring to a UK parent company). Still, when U.S. multinationals use Americans for top management positions in foreign subsidiaries, the top executives can often be segregated in terms of their pay. See Fung, *supra* note 81, at 41.
locals hired for top posts by American companies will skew the expectation scale and pressure domestic companies to introduce equally remunerative compensation packages so as to attract and retain effective managers. For instance, when American multinationals began awarding growing numbers of stock options to managers working outside the United States in the 1990s, local firms were provoked into adopting this type of compensation.

While some multinationals seek to establish an internationally uniform executive remuneration structure ("globalizer" companies), others prefer to take into account domestic compensation norms, national tax considerations, and other local conditions ("adapter" or "localizer" organizations). The latter type of policy will obviously do little to foster the globalization of executive pay. Organizing managerial pay purely on a country-by-country basis, however, may not be tenable for multinationals headquartered outside the United States that have substantial American operations. Specifically, if such a company sets managerial pay strictly in accordance with local conditions, it would need to offer remuneration that is competitive stateside in order to recruit or retain talented managers to run the U.S. division. This, in turn, could cause disquiet among the parent company's top executives because they might not be earning as much as their highly paid managerial subordinates in the United States. Also, the firm's managerial "high-flyers" might lobby noisily for assignments stateside so as to become entitled to lucrative American-style pay packages and then insist on retaining their compensation upon returning to the head office. Faced with such pressures, foreign multinationals operating in the United States might feel compelled to restructure executive pay at the parent company in ways that would foster the globalization of executive pay.

E. Conclusion

How potent are the various market forces which could foster executive pay convergence? This is a difficult question to answer. More dispersed share ownership in countries where "core" investors now dominate would likely yield increasingly lucrative and performance-based managerial pay packages.

181. Murphy, supra note 12, at 2497; Atul Mitra et al., Crossing a Raging River, WORLDATWORK J., 2d Quarter 2002, at 6.
182. TOWERS PERRIN, supra note 32, at 3.
185. Berman, supra note 163, at 17; Johnston, supra note 6; Lublin, supra note 154 (focusing on the jealousy that high U.S. pay can generate).
186. Dunham, supra note 174.
However, it is uncertain whether such ownership patterns will evolve substantially in the near future. Similarly, cross-border mergers and acquisitions will likely promote the Americanization of managerial remuneration, though current economic uncertainties mean that it may be some time before transnational deal activity returns to levels seen in recent years.

Finally, it must be remembered that, in a general sense, market forces may not wield a decisive influence on the globalization of executive compensation. Instead, various types of legal regulation could deter companies from making American-style pay arrangements. Indeed, as we have already seen, immigration laws are one potential barrier. Rules and guidelines promulgated by private organizations rather than lawmakers ("soft law") could also impede the globalization of managerial compensation to some degree, as could the business culture in the countries in which companies operate. The next four parts of the Article consider these various possibilities in turn, beginning with an analysis of corporate law.

V. CORPORATE LAW AND THE GLOBALIZATION OF EXECUTIVE PAY

A. Direct Regulation

Corporate law encompasses various types of legal rules that might influence the setting of executive pay. Statutory measures that stipulate specifically how executive pay arrangements should be structured—"direct regulation"—have the potential to address the issue in the most forthright manner. Past experiences in India offer a striking illustration of how far the law might go. The Companies Act of 1956 introduced various provisions that dictated how management was to be paid. For instance, total managerial compensation could not exceed 11% of a company's net annual profits. Also, the remuneration of directors acting in a managerial capacity could not be increased without government approval. The government issued guidelines for permissible increases, including a ceiling on annual pay apparently based upon the prevailing salary of the President of India.

The law on executive pay was liberalized somewhat in India in the early

187. See supra notes 140-142 and accompanying text.
188. Mitra et al., supra note 181.
189. See Fried, supra note 160 and accompanying text.
192. Companies Act, No. 1 § 310. For background on this provision, see RAMAIYA, 6th ed., supra note 191, at l, 22, 508-10.
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1990s.194 This relaxation brought the country more into line with the global norm, as direct regulation of managerial compensation is the exception rather than the rule in industrialized countries. Indeed, corporate law typically does not dictate in any way the nature or scope of executive remuneration.195 Nevertheless, in some countries, corporate law does directly regulate executive pay.196 One approach has been to prohibit a company from paying more than a designated percentage of annual earnings to its directors; Argentina and the Philippines have laws of this sort.197 Also, certain jurisdictions, such as Australia198 and Germany,199 stipulate that executive pay must be “reasonable.” A similar restriction exists in Brazil, where the remuneration of a corporation’s administrators (essentially its directors and executive officers) must be set with due regard for the professional experience of the administrators, their reputation, their duties, and the market value of their services.200

194. Ramaswamy et al., supra note 133, at 182. Essentially, unless a company is unprofitable, it is free to work out a suitable remuneration package for its managerial personnel within the limit of a designated percentage of net profits. A. RAMAIYA, GUIDE TO THE COMPANIES ACT, 1738-44, 2435-50, 2732-61 (Wadhwa & Co., 15th ed., 2001) [hereinafter RAMAIYA, 15th ed.].


196. With respect to the United States, at first glance, sanctions that can be imposed under § 304 of the Sarbanes-Oxley Act of 2002 serve to regulate executive pay. Upon closer examination, however, this does not appear the case. By virtue of statutory amendments made by this Act, a public company’s CEO and CFO must certify the corporation’s periodic financial statements. If a company’s financial statements have to be restated, §304 of the Act provides that the CEO and CFO must pay back bonuses, incentive-based compensation, and equity compensation received during the twelve-month period following the initial filing of the impugned financials. See 15 U.S.C. § 7243 (2004). Since this provision can operate regardless of how managerial services contracts might be structured, it appears to function more as a sanction for the filing of inaccurate financial statements than as a method for regulating executive remuneration.

197. In Argentina the amount is 25% of earnings (5% if no dividend is distributed) and in the Philippines it is 10% of net income before tax. See INTERNATIONAL HANDBOOK OF CORPORATE GOVERNANCE 1, 4, 168 (Thomas Learning, 1996) [hereinafter INTERNATIONAL HANDBOOK]; Paul van Nieuwenhove, Argentina, in INTERNATIONAL ENCYCLOPEDIA; supra note 167, at 86.

198. A public company is prohibited from providing remuneration to managers that is not “reasonable” unless the arrangement has been approved by the shareholders. See Corporations Act 2001, No. 50 (2001) § 211 (Austl.). See also Corporations Amendment (Repayment of Directors’ Bonuses) Act 2003, No. 25 (2003) (Austl.) (amending various sections of the Corporations Act 2001 to permit the recovery in bankruptcy proceedings of unreasonable director-related payments).

199. In Germany, most firms that distribute shares to the public do business as a stock corporation or “AG,” and an AG’s management board will be staffed by senior full-time executives. The legislation governing such companies stipulates that the aggregate remuneration of each member of the management board of an AG must bear a reasonable relationship to duties of the particular member and to the financial condition of the company. See German Stock Corporation Act (Aktiengesetz or AktG), of Sept. 6, 1965 (Legal Gazette I 1089) § 87, ¶ 1.

Detailed regulations such as those that existed in India would likely constrain a move towards Americanized executive pay. However, the restrictions of the sort just outlined are unlikely to pose a serious obstacle. For instance, Argentina's chief executives have traditionally been among the most highly paid in the world, demonstrating that laws limiting director pay to a percentage of profits apparently do not prevent lucrative compensation arrangements. Similarly, in Australia, following the introduction of its "reasonable" remuneration rule in 1992, the country experienced an "enormous and well-publicized escalation in the rewards for CEOs."

Consistent with the general pattern, in Germany, the requirement that compensation reasonably correspond to the services provided has caused few logistical difficulties. On the other hand, the German provision did provide a legal foundation for "breach of trust" charges brought in 2003 as a result of controversial payments made to senior executives of Mannesmann AG after the company opted to abandon stubborn opposition to a hostile takeover. There was speculation that, if the prosecution succeeded, "Germany [would have] become a scorched earth for international executives" who might be candidates for jobs in the country. Dismissal of the charges, however, seems imminent.

B. Breach of Duty and Related Causes of Action

Even if legislation does not stipulate the structure of executive pay arrangements, judicial regulation remains a possibility. Usually, a company's board of directors is assigned the lead role in determining executive pay, with

202. See TOWERS PERRIN, supra note 32, at 20, 24 and accompanying text.
203. Since directors in Argentina are not allowed to have service contracts, it may be that Argentina's well-paid executives choose not to serve on the board. INTERNATIONAL HANDBOOK, supra note 197, at 8.
204. Henry Bosch, Looking in the CEO's Pay Packet Has a Cost, SHARES MAG., Oct. 1998, at 61. For statistics, see Mitchell, supra note 13. The statutory provision was first introduced by the Corporate Law Reform Act, No. 210 (1992) § 2 (Austl.).
205. Walter Oppenhoff & Thomas O. Verhoeven, The Stock Corporation, in Dennis Campbell ed., BUSINESS TRANSACTIONS IN GERMANY §24.03[1][c][ii][B] (Matthew Bender, 1999). For background on why the relevant provision does not have a major practical impact, see Cheffins, supra note 10, at 526-27.
206. Germany's Fat Cats on Trial, ECONOMIST, Sept. 27, 2003, at 86.
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a "supervisory" board in charge when a two-tier board structure is in place (as in Germany, for example).²¹¹ Decisions directors make in this context can potentially be impugned on the basis of breach of duties of care, loyalty, or good faith.²¹² In the United States, for example, derivative litigation has been used in numerous instances to challenge managerial remuneration arrangements.²¹³ These suits are more frequently successful in closely held corporations, but even in publicly traded firms they provide something of a check on managerial remuneration.²¹⁴

Still, while the judiciary can theoretically regulate executive pay in certain instances, it is highly unlikely that suits for breach of duty will significantly affect any trend toward the globalization of executive pay. Certainly, in the United States itself, litigation has done little to stop dramatic overall increases in managerial remuneration.²¹⁵ Part of the reason is that American judges have typically been reluctant to meddle in corporate policymaking²¹⁶. Their colleagues in other countries likely will share this deferential attitude.²¹⁷

Moreover, even if judges in a particular jurisdiction were prepared to rule that awarding overly generous remuneration constitutes a breach of duties owed to a company, significant procedural constraints would probably deter litigation. In various civil law countries, shareholders do not have any right to bring derivative actions.²¹⁸ In others, those interested in bringing proceedings must own a minimum designated percentage of shares (5% or 10%, for example) to obtain standing.²¹⁹ In a common law country, on the other hand, case law can offer exceptions to the principle that breaches of duty by directors must be litigated by the company.²²⁰ These exceptions, however, are narrowly focused

²¹¹. On Germany, see AktG, §§ 87(1), 112. Even if there is a one-tier board, in some countries a remuneration committee composed primarily of outside directors will typically take the lead role in setting executive pay: Cheffins & Thomas, supra note 122, at 285, 298 (discussing the United States and Britain).

²¹². On the law on these duties in various countries, see S.J. Berwin & Co. eds., DIRECTORS’ RESPONSIBILITIES IN EUROPE 8, 16, 25-27, 34-35, 41-42, 49-51, 57, 67, 74 (1997); BETTY M. HO, PUBLIC COMPANIES AND THEIR EQUITY SECURITIES ch. 10 (Kluwer Law International, 1998) (Hong Kong); INTERNATIONAL HANDBOOK, supra note 197, at 69-70 (Japan); WOON, supra note 195, ch. 8 (Singapore and Malaysia); Neto & Levy, supra note 200, at 65-67 (Brazil).

²¹³. For empirical evidence on such litigation, see Thomas & Martin, supra note 209, at 573-93.

²¹⁴. Id. at 586-87. On publicly traded companies, see, e.g., In re Walt Disney Co. Derivative Litigation, 825 A.2d 275 (Del. Ch. 2003).

²¹⁵. Thomas & Martin, supra note 209, at 601-02, 605.

²¹⁶. Id. at 601-02.

²¹⁷. CHEFFINS, supra note 17, at 674 (UK); Cheffins, supra note 10, at 527-28 (Germany); Zoher Adenwala, Directors’ Generous Remuneration: To Be or Not to Be Paid, 3 BOND L. REV. 25, 30 (1991); Benjamin Alarie, Executive Compensation and Tax Policy: Lessons from Canada with the Experience of the United States in the 1990s, 61 U. TORONTO FAC. L. REV. 39, 62-63 (2003).


²¹⁹. Id. The position is the same in Brazil: Neto & Levy, supra note 200, at 65.

and are usually of little assistance to a disgruntled minority shareholder. In some common law jurisdictions such as Canada, South Africa, and Australia, the standing rules have been liberalized somewhat by statute. Still, the fact that recovery is the right of the company rather than the shareholder conducting the litigation will likely cause investors to conclude that suing is more trouble than it is worth.

In a number of common law jurisdictions, the logistical difficulties just discussed can be overcome by statutory measures that authorize the judiciary to grant a remedy to a shareholder unfairly prejudiced by a company’s actions. With such a provision, a minority shareholder can sue without having to finesse the procedural constraints associated with derivative litigation. Also, since recovery is the right of the shareholder seeking relief rather than the company, the remedy granted can be tailored to the applicant’s personal considerations. Still, while there is case law to indicate that excessive remuneration can qualify as “unfairly prejudicial” conduct, the judiciary has proved reluctant to grant relief under the relevant statutory provisions where a company is traded on the stock market. As a result, proceedings brought under the unfair prejudice remedy are unlikely to significantly affect those businesses in which globalization of executive pay is most likely to occur, namely publicly traded companies.

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221. CHEFFINS, supra note 17, at 315-16, 665-66.
223. Cheffins, supra note 222, at 256-58. Cf. Mark D. West, Why Shareholders Sue: The Evidence from Japan, 30 J. LEGAL STUD. 351 (2001) (noting that Japanese shareholders have weak incentives to bring derivative litigation but explaining the launching of proceedings of this type by reference to attorney motives).
224. See, e.g., Companies Act 1985, c. 6, s. 459 (Eng.); DENIS H. PETERSON, SHAREHOLDER REMEDIES IN CANADA § 18.15 (Butterworths, 1989) (outlining Canadian statutory provisions); Corporations Act 2001, s. 232 (Austl.); Ho, supra note 212, at 657-58 (outlining the position in Hong Kong); WOON, supra note 195, at 158-60 (discussing Singapore and Malaysia).
225. CHEFFINS, supra note 17, at 345.
227. PETERSON, supra note 190, § 18.96; Andrew Defina et al., What is Reasonable Remuneration for Corporate Officers? An Empirical Investigation Into the Relationship Between Pay and Performance in the Largest Australian Companies, 12 COMPANY & SEC. L.J. 341, 342-44 (1994).
C. Shareholder Voting

Legally mandated shareholder voting constitutes another constraint that corporate law can impose on executive pay arrangements. Again, a company’s board of directors most often will have responsibility for setting executive pay. At the same time, though, corporate legislation may stipulate that the shareholders have some say. For instance, in certain jurisdictions, laws governing the issuance of equity and corporate “buy-backs” of shares mandate that shareholders pass a resolution endorsing the creation of stock options for top management before such compensation can be granted. Also, in 2002, Britain enacted measures requiring shareholders in publicly traded companies to vote annually on executive pay arrangements. Still, the vote is advisory only, in the sense that a “no” verdict has no effect on entitlements under validly negotiated managerial services contracts.

Another approach some countries use to involve shareholders in determining executive pay is to give those owning equity the right to fix yearly the total remuneration to be awarded to the directors. This apparently sweeping power can be greatly qualified, however, since the packages upon which shareholders vote may not encompass managerial services contracts. Under such circumstances, any veto the shareholders have will only relate to compensation awarded to individuals acting qua director (fees for attending meetings, for example).

The intention underlying the various statutory provisions giving owners of corporate equity a vote presumably is to impose a check on excessive

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229. Supra note 131 and related discussion.
230. See supra notes 84 and 90 and accompanying text (discussing Germany and Japan). The position is the same, for example, in France: Francois Marty & Jean-Francois Dumas, France Opens up the Options, 8 Int’l Tax Rev., July 1997, at 52.
232. ROBERT BAXT ET AL., AUSTRALIAN CORPORATIONS & SECURITIES REPORTER ¶ 41, 620 (North Ryde, NSW: CCH Australia, 1990) (discussing Australia); JEAN-PIERRE LE GALL AND PAUL MOREL, FRENCH COMPANY LAW 104 (Longman, 2d ed., 1992) (discussing France); M.T. Kreek & S.E. Eisma, Netherlands, in INTERNATIONAL HANDBOOK, supra note 197, at 60 (discussing the Netherlands); Rolf Skog, The Swedish Corporate Governance System and International Corporate Governance Debate - A Letter to Katherine, in Mette Neville & Karsten E. Sorensen eds., THE INTERNATIONALISATION OF COMPANIES AND COMPANY LAWS 123, 128 (DJOF Publishing, 2001) (discussing Sweden); Kawamoto et al., supra note 195, at 176 (discussing Japan); Neto & Levy, supra note 200, at 63 (discussing Brazil); van Nieuwenhove, supra note 197, at 86 (discussing Argentina).
233. In Brazil, this is the case with administrators who are hired as employees rather than being elected by the shareholders: E-mail from Rachel Sztajn, Univ. of Sao Paolo, to Brian Cheffins (on file with authors). In the Netherlands, the corporate constitution can displace the rule that shareholders must vote and the board in fact does normally settle the terms of the service contracts of managing directors: P. SANDERS, DUTCH COMPANY LAW 72 (Oyez, 1977). In France, the directors settle all executive service contracts. See LE GALL & MOREL, supra note 233, at 114.
managerial remuneration.\textsuperscript{235} Yet, regardless of how the particular rules are formulated, it is doubtful that they can ever act as the safeguard that regulators seemingly expect them to be. First consider companies with a controlling shareholder. Statutory measures requiring remuneration issues to be put to a vote may effectively give the dominant investor a veto over changes falling within the scope of the relevant rules. On the other hand, a “core” shareholder will be well-situated to influence executive pay regardless of whether a shareholder resolution is specifically required or not.\textsuperscript{236}

What will the situation be in companies with dispersed share ownership? The experience in the United States and Britain, where a diffuse share ownership pattern is typical for publicly traded companies, provides a possible guide. In these two countries, the available empirical evidence suggests that shareholder voting only functions as a potential check on executive pay when arrangements deviate far from the norm.\textsuperscript{237} Again, certain countries in which concentrated share ownership is the norm for large business enterprises may be shifting towards the more diffuse Anglo-American pattern.\textsuperscript{238} The experience in the United States and Britain implies that this sort of shift would not cause shareholder voting to emerge as a significant determinant of executive pay.

\textbf{D. Restrictions on the Distribution of Shares to Executives}

When a company has established a stock option plan for its executives, it must be able to satisfy its obligations when the options are exercised. The most straightforward way to do this is either to issue new shares to the option holders or to repurchase outstanding equity to sell to the executives.\textsuperscript{239} In many jurisdictions, however, the issuance of new equity is heavily regulated, and share buy-backs may be prohibited except under special circumstances.\textsuperscript{240} Such regulations, therefore, may make it impractical for companies to grant stock options.

The German experience is illustrative. The country’s stock corporations are

\begin{itemize}
  \item \textsuperscript{235} See, e.g., Kawamoto et al., \textit{supra} note 195, at 175-76 (discussing Japan).
  \item \textsuperscript{236} \textit{Supra} note 132 and accompanying text.
  \item \textsuperscript{237} Cheffins & Thomas, \textit{supra} note 122, at 43; Randall S. Thomas and Kenneth J. Martin, \textit{When is Enough, Enough? Market Reaction to Highly Dilutive Stock Option Plans and the Subsequent Impact on CEO Compensation}, \textit{J. Corp. Fin.} (forthcoming 2004). The introduction of a mandatory advisory vote in Britain in 2002 does not appear to have changed the situation since only in very rare instances have shareholders voted down what has been proposed. See Clay Harris, \textit{Aegis Shareholders Reject Chief’s Deal}, \textit{Fin. Times}, May 27, 2004, at 1 (describing Aegis Group, a marketing services company, as joining “a select club of UK companies” that had suffered a “no” vote).
  \item \textsuperscript{238} See \textit{supra} notes 120-121 and accompanying text.
  \item \textsuperscript{239} Cheffins, \textit{Metamorphosis}, \textit{supra} note 10, at 14.
  \item \textsuperscript{240} See, e.g., Shaun W. Thorpe ed., \textit{Company Law in Europe} B62, D60-61, EC 88, F50, H48, P42, Q66 (1995) (discussing pre-emptive rights in various European countries and European Union company law measures governing share repurchases); WOON, \textit{supra} note 195, at 592-95 (discussing share repurchases in Singapore and Malaysia); van Nieuwenhove, \textit{supra} note 197, at 66, 70 (discussing pre-emptive rights and share repurchase rules in Argentina).
\end{itemize}
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only permitted to issue and repurchase shares under tightly prescribed circumstances, and satisfying option rights exercised by top executives traditionally did not qualify as a legally valid exception. As a result, firms could only make stock options available to executives by granting bonds that could be converted into shares of the company (convertible bonds) or that had a warrant attached granting the right to acquire shares upon exercise (warrant bonds). The situation was similar in Japan, Finland, and South Korea.243

Since stock options are a pivotal aspect of the U.S. pay paradigm, rules effectively precluding companies from using this form of remuneration inevitably will at least partially hamper the Americanization of managerial compensation. Still, due to deregulation, such restrictions are of diminishing importance. During the late 1990s, Germany, Japan, South Korea, and Finland all liberalized their statutory rules to make it easier for corporations to grant stock options to executives. In these countries, deregulation was not fully implemented: shareholder approval still must be obtained before a company can issue or buy back shares and thereby transfer equity to executives who have exercised stock options. Still, the law now constitutes less of a deterrent to the Americanization of executive pay than previously. Indeed, large numbers of German and Korean companies have taken advantage of reform to begin granting stock option plans. This has also been the case in Japan, though concerns persist that the law remains too restrictive.247


243. See generally The Best... and the Rest, supra note 4, at 13. On Japan, see Akira Kawamura, Introduction of Stock Option, 12 J. INT'L BANKING L. N-226 (1997); Curtis J. Milhaupt, The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Governance Debate, 91 NW. U. L. REV. 865, 890 (1999). As both authors note, in 1995 the legal regime was partially liberalized for new businesses approved by the Ministry of International Trade and Industry but only a small number of companies sought such approval.

244. The Best... and the Rest, supra note 4, at 13. For example, in South Korea, regulations dealing with the issuance of shares were amended so as to permit companies to satisfy their obligations under stock option plans (Kon-Sik Kim & Chong-Kee Lee, South Korea in INTERNATIONAL ENCYCLOPEDIA, supra note 167, at 85). The same was done in Germany and Japan and changes were also made to the rules governing share buy-backs. See Maximilian Grub, The Concept of Corporate Governance and Recent Developments in Germany, CORP. GOVERNANCE INT'L, issue #4, at 20, 24-25; Florian Haase, Stock Option Schemes in Germany, 23 COMPANY LAW. 223, 223 (2002); Kawamura, supra note 243, at N-226-27 (Japan).

245. See supra note 244 and accompanying text.

246. Woodruff, supra note 139; 105 Listed Firms Introduce Stock Options This Year, KOREA HERALD, Oct. 20, 2000, available at 2000 WL 27394960.

E. Disclosure

"Direct regulation," shareholder litigation, shareholder voting requirements, and rules governing the distribution of corporate equity thus seem unlikely to be important determinants of the Americanization of executive pay. On the other hand, another set of corporate law rules could constitute a significant variable. These are measures requiring periodic public disclosure of corporate executives' compensation packages.248

The extent to which disclosure of executive pay is mandated varies widely around the world. In the United States, under Securities and Exchange Commission (SEC) rules, when a corporation's management team contacts investors to solicit proxy votes for the stockholders' annual meeting, the corporation must send a highly detailed report on executive pay prepared by the board of directors or a compensation committee acting on behalf of the board. The report, in addition to describing the corporation's general approach to executive pay, must offer a detailed breakdown of compensation arrangements for the CEO and the next four highest-paid executive officers.249 Britain, Canada, and Australia have disclosure rules that match the SEC standards or come fairly close.250 France, Italy, the Netherlands, and Sweden also regulate the topic quite closely; in each jurisdiction, companies must provide individualized pay details for top executives.251

In contrast, disclosure regulation elsewhere tends to be lax. Indeed, some

248. Prospectus regulation is also potentially relevant on the disclosure front when a company is planning to make stock option grants or create incentive schemes where equity will be distributed to executives. See Mary Carter & Mary Bryson, International Employee Stock Plans: Part 1, GLOBAL COUNS., June 2001, at 21; Jocelyn Mitchell, Share Schemes and the International Company, IN-HOUSE LAW., May 1997, at 43. Prospectus regulation is not dealt with in detail here because the experience in America suggests that its presence or absence is unlikely to affect significantly the spread of U.S.-style executive pay. In the United States, the relevant rules are potentially rigorous (Carter & Bryson, supra, at 24) but stock option plans are nevertheless used more widely than they are in any other country.

249. Items 402(a)(2), (a)(3), (b), (k) of Regulation S-K, 17 C.F.R. § 229.402(a)(2), (a)(3), (b), (k) (2000). To be more precise, the board is obliged to describe the corporation's general approach to executive pay and, in a table organized according to SEC specifications, specify how much was paid to each of the five most highly paid executives in the form of salary, bonuses, share options, and other designated categories. The directors must also prepare a performance graph allowing investors to evaluate the corporation's shareholder return over a five year period in comparison with a "peer group" index and with a well-known stock market index such as the Standard and Poor's 500: Item 402(l) of Regulation S-K, 17 C.F.R. 229.402(l) (2000).

250. On the fact that disclosure standards in Britain and Canada are fairly close to those which exist in the United States, see Conyon & Murphy, supra note 19, at F643; Xianming Zhou, CEO Pay, Firm Size, and Corporate Performance: Evidence from Canada, 33 CAN. J. ECON. 213, 216 (2000). On the law in Australia, see Michael Quinn, The Unchangeables - Director and Executive Remuneration Disclosure in Australia, 10 AUSTL. J. OF CORP. L. 1, 92 (1999).

In Britain, until 2002, disclosure of executive pay was regulated by the listing rules that apply to publicly traded companies. There has now been a shift to a statutory format. See Companies Act, 1985, s. 234B, schedule 7A, introduced by Directors' Remuneration Report Regulations (2002), Statutory Instrument 2002/1986, §§ 3, 9.

jurisdictions do not have any reporting requirements at all. More commonly, corporations eligible for stock market listing must identify aggregate director remuneration. These companies are not required, however, to publish specific details on each director’s remuneration, to break down the types of compensation, or to otherwise offer details on performance-related pay.

The approach which a country takes towards disclosure of executive pay will likely exert some influence on any possible shift toward American-style executive pay. Anglo-American institutional investors are keen on remuneration schemes that give management incentives to maximize shareholder value, and might be expected to promote this agenda globally. Disclosure regulation could affect their ability to do so since the availability of data on executive pay will determine to some degree the costs of shareholder monitoring. The comments offered by a former securities regulator when the Canadian province of Ontario bolstered disclosure regulation in 1993 make the point well: “Good corporate governance relies on an informed and active investor community. In some respects, this legislation recognizes their legitimate need for information that enables them to relate management’s performance to the performance of the company.” Indeed, the available Canadian empirical and anecdotal evidence suggests that enhanced disclosure regulation had the effect predicted and helped to cause a shift towards incentivized managerial pay in publicly traded companies.

In additional to fostering incentive-oriented compensation, greater disclosure may facilitate a shift towards the U.S. pay model by accelerating increases in executive remuneration. As Charles Elson, an American

253. See, e.g., Ferrarini et al., supra note 89, 24-29 (describing arrangements in Germany, Austria, Spain, Belgium, Luxembourg, Denmark, Finland, Greece and Portugal); INTERNATIONAL HANDBOOK, supra note 197, at 4, 77, 94, 106, 201 (discussing Argentina, Japan, Malaysia, Singapore and South Korea).
254. This point has been made in relation to Germany by Jeffrey N. Gordon, *Corporate Governance: Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany*, 5 COLUM. J. EUR. L. 219, 236 (1999), (making this point in relation to Germany though it apparently applies generally).
255. See supra note 138 and accompanying text.
257. Quoted in Iacobucci, supra note 256, at 497.
academic specializing in corporate governance, has observed: "The normal trend is the more that’s out there about how much people get, the more they get." To elaborate, when detailed disclosure is mandated, both managers and board members who set executive pay will be able to find out readily the "market rate" offered by competitors in the same industrial sector and by firms of a similar size. Therefore, the executives of a company paying below the norm will be fully aware of their inferior position in the compensation hierarchy and they may seek adjustments accordingly. A perceived loss of social status could fuel their demands on this count. Those who set executive remuneration might well be sympathetic to such claims, particularly if a company’s frugal compensation packages are perceived as a tacit admission that the management team is "below average." Fears that valued executives will defect to rivals offering more generous terms will also likely stoke higher pay.

If all companies ultimately seek to match or exceed the "market rate," the inevitable result will be an upward “ratchet” in pay. Consistent with this reasoning, some speculate that British, Canadian, and Australian lawmakers’ introduction of more rigorous executive pay disclosure requirements in the 1990s resulted in accelerated increases in managerial remuneration. Empirical work using Canadian data indicates that such suspicions are well-founded.

It is ironic that increased disclosure might contribute to an American-style executive pay spiral because those who fret that top managers are paid “too much” are often keen supporters of reform. For instance, when Ontario bolstered executive pay disclosure in 1993, the left-wing administration then in office was concerned about the excesses of free-market economics. One columnist in a leading Canadian newspaper suggested that the “real motivation” for reform “was to plunge the population into an egalitarian snit over the money paid to the capitalist scoundrels who run private-sector corporations.” Matters
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did not quite work out as planned. In 2001, the same columnist observed: "So far, the only impact of the disclosure has been to drive compensation higher as companies now compete more aggressively for talent."269

If extensive disclosure regulation does indeed provide a hospitable platform for American-style executive pay arrangements, recent legislative trends are potentially very significant. For instance, rules requiring French, Italian, and Dutch companies to disclose the pay of top corporate officials on an individualized basis have all been introduced in the past few years.270 Moreover, additional changes are in the making. The Towers Perrin stock options study discussed earlier anticipates moderate or significant changes to the disclosure laws in sixteen of the twenty-two jurisdictions covered.271 Perhaps, then, "secrecy is on the way out for executive pay."272 If so, reform may, perhaps somewhat counter-intuitively, foster a shift towards the lucrative performance-oriented compensation packages prevalent in the United States.

VI. OTHER LEGISLATION

A. Tax

Regulations outside the realm of corporate law rules could also affect the globalization of executive pay. Tax rules constitute one example. To illustrate, income tax rates to which executives are subject likely will influence whether the lucrative managerial compensation associated with the United States becomes increasingly commonplace elsewhere. All else being equal, corporate executives should be more highly paid in a country where the top marginal tax rate (the rate applicable to any further taxable income) is low. Executives will value generous remuneration more highly in a liberal tax environment because they will be able to keep more of what they earn. Since a typical company will tailor compensation arrangements to match managerial preferences, a lower income tax rate should therefore be correlated with higher executive pay.273 The available historical and empirical evidence indicates that the two are indeed linked.274 Tax rules may also influence the use of stock options. Towers

271. TOWERS PERRIN, supra note 78, at 15.
272. Woodruff, supra note 139 (quoting the proprietor of a U.S.-based corporate governance consultancy).
273. CHEFFINS, supra note 17, at 704.
274. Id. at 704 (discussing the history in the United States and Britain); John M. Abowd & Michael L. Bognanno, International Differences in Executive and Managerial Compensation, in Richard B. Freeman & Lawrence F. Katz eds., DIFFERENCES AND CHANGES IN WAGE STRUCTURES 67, 85-87, 91-92, 95 (University of Chicago Press, 1995). For additional supporting anecdotal evidence, see Margaret
Berkeley Business Law Journal

Perrin’s 2001 study of stock options cited taxation as a key determinant of stock option implementation in a majority of the countries covered. This finding is consistent with speculation that unfavorable treatment under personal income tax laws accounts for the relatively unimportant role of stock options outside the United States. The experience in a number of countries confirms that tax rules can matter. In Britain, for example, tax changes carried out in the 1980s are often cited as being a catalyst for the current popularity of executive share options. Over the past decade, Japan, India, and a number of continental European jurisdictions have restructured their tax rules so as to reduce the tax burden for an employee whose employer grants stock options. These reforms have reputedly encouraged the awarding of this type of compensation.

Work done by economists John Abowd and David Boganno suggests, however, that the importance of tax rules cannot be taken for granted. Using data from the period 1984-1992, they examined how stock options were taxed in twelve countries with the aim of discovering whether differences in tax rules correlated with the popularity of stock-based incentive pay. The study concluded that tax treatment of stock options did not explain in any meaningful way the proportion of stock options relative to other types of remuneration.

Abowd and Boganno’s findings need to be qualified, however, in that the position of corporations granting stock options was not taken into account. The experience in the United States shows why this is a significant consideration. Under American tax law, executives’ gains from exercising share options are typically deductible from corporate profits as an ordinary business expense.

Lyons, Australia’s Top Executives: Are They Paid Too Much, BUS. REV. WKLY., Nov. 16, 1990, at 52; Lublin, supra note 64; David Woodruff, Across Europe, CEOs Get No Respect, WALL ST. J., June 17, 2002, at A9 (discussing the impact of high rates of income tax on executive pay in Denmark).

275. Towers Perrin, supra note 78, at 10.


277. Don Egginton et al., Executive and Employee Share Options: Taxation, Dilution and Disclosure, 23 ACCT. & BUS. RES. 363 (1993); Kay, supra note 82; Tully, supra note 58.

278. Stock Options (S.J. Berwin & Co., 1999); Monteiro & Shah, supra note 276; Bob Zukis, Japan and USA Compared, BENEFITS & COMPENSATION INT’L, Sept. 1, 1997, at 9; European Private Equity and Venture Capital Association Special Paper, at 17, 19, 23, 25, 27, 31 (on file with authors) (describing changes enacted in a variety of European countries).

279. Belgium Revamps, supra note 276; Jill Eswick, Relative Values, EMP. BENEFIT NEWS, June 15, 2001, available at 2001 WL 7984504; Woodruff, supra note 139; Zukis, supra note 278, at 6. Spain is an exception to the typical pattern since there has been tax reform recently but this did not liberalize the relevant rules. Delaney & Wessel, supra note 276.

280. Abowd & Bognanno, supra note 274, at 92-95. Smith and Watts reached a similar conclusion in their analysis of the tax effects of executive compensation in the United States. Smith & Watts, supra note 81, at 361.

281. I.R.C. § 83(h); Conyon & Murphy, supra note 19, at 665; Brian J. Hall & Jeffry B. Liebman, The Taxation of Executive Compensation. 14 TAX POL’Y ECON. 1, 7-9 (2001). By virtue of section 422(a)(2) of the Internal Revenue Code, a tax deduction is not available to a corporation that awards...
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Thus, when a senior manager exercises stock options, the corporation receives a deduction equal to the difference between the market price of the shares and the exercise price. The American position is very much the exception rather than the rule. In other countries, a company generally cannot treat gains from exercising share options as deductible, since no out-of-pocket expense is incurred.282 Conyon and Murphy’s study of CEO pay in America and Britain suggests that this difference in tax treatment accounts in part for the greater popularity of executive share options in the United States.283

Though the tax status of corporations might affect the use of stock options, it cannot be taken for granted that this will be a pivotal variable. Instead, there is empirical evidence suggesting that U.S. corporations that do not benefit from stock options’ tax deductibility nevertheless grant them as frequently as other firms.284 This pattern suggests in turn that tax treatment is in fact not determinative with respect to the use of stock options as a form of managerial remuneration.

Other aspects of U.S. tax policy illustrate that tax rules may not have the sort of impact on executive compensation that might be anticipated. In 1993, President Clinton, fulfilling a campaign pledge to halt “excessive executive pay,” initiated changes to tax law that disallowed tax deductibility of executive pay exceeding $1 million annually, unless the additional compensation was “performance related.”285 Data collected in subsequent years indicates that this change did very little to slow increases in executive pay and only fostered a minor substitution of performance-related pay for salary.286 This pattern, together with the evidence on the deductibility of stock options, suggests that corporate tax policies may in fact not have a significant impact on globalization trends in executive compensation.

B. Labor Law

Compensation experts warn that U.S.-style incentive-oriented managerial compensation could conflict with national labor legislation. Several countries in


Europe and Latin America have laws regarding "acquired rights" that might, over time, transform compensation conditioned on performance into entitlements. Since companies will understandably be reluctant to risk this transformation, acquired rights laws could deter a move towards American-style executive compensation packages. Indeed, according to a Towers Perrin study of stock options, these rules have had a "very important" effect on the awarding of such compensation in France and Mexico.

The impact of "acquired rights" legislation should not, however, be overestimated. While share option plans might constitute an "entitlement" under acquired rights legislation in some countries, they may not in others. Also, companies' experience in Brazil suggests that, even if acquired rights regulations do apply to incentive-oriented pay arrangements, the practical impact will not necessarily be significant. During the 1990s, performance-based pay became substantially more popular as Brazilian subsidiaries of major multinationals offered lucrative bonus schemes to lure managerial talent away from domestic companies. In response to this trend, and in direct contradiction of existing legislation, Brazil's Labor Ministry expressly authorized domestic companies to use variable pay based on corporate performance.

VII. "SOFT LAW"

"Soft law" is an increasingly important determinant of international corporate behavior. For present purposes, we define the term as corporate rules and guidelines promulgated by private organizations rather than by legislatures, government regulators, or judges. Under this definition, the fact that those formulating the relevant standards act pursuant to a statutory mandate does not affect the regulations' "soft law" status. Hence, in an American context, accounting standards developed by the privately organized Financial Accounting Standards Board (FASB) qualify as "soft law," even though the Board exercises powers delegated to it by the SEC. Similarly, listing rules governing the privately owned New York Stock Exchange (NYSE) and


288. TOWERS PERRIN, supra note 32, at 10.


291. In the Towers Perrin study of stock options, "acquired rights" legislation was found to be "somewhat important" in Brazil. TOWERS PERRIN, supra note 32, at 10. There were six other countries where the situation was found to be the same. Id.


293. Id. (providing other definitions).

294. For more background on the FASB and its relationship with the SEC, see CHEFFINS, supra note 17, at 376-77, 410-11.
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NASDAQ are "soft law." Even though the SEC has the power to veto proposed regulations and amend or delete existing rules, the NYSE and NASDAQ formulate and enforce the relevant standards.295

"Soft law" touches on various executive pay issues. One is shareholder voting. To use an American example, the listing rules of the NYSE and NASDAQ stipulate that, subject to a few exceptions, listed companies must obtain shareholder approval before introducing a stock option plan.296 On the foreign side, the Australian Stock Exchange's listing rules provide that, under an employee incentive scheme, shareholders must vote on the issuance of securities to directors.297 The stock market rules in New Zealand, Hong Kong, and Singapore provide for similar regulations.298

"Soft law" can also address disclosure issues. Britain was a "first mover" in this regard, as disclosure of executive pay was dealt with in considerable detail in London Stock Exchange listing rules beginning in the mid-1990s299 until the relevant rules were shifted to legislation in 2002.300 Similarly, Germany now stands out as a country in which "soft law" has strongly influenced disclosure regulation.301 Under German corporate legislation, companies are not obliged to divulge remuneration arrangements for individual corporate officials.302 In 2002, however, the federal legislature amended the German Stock Corporation Act to compel publicly traded companies to disclose whether their corporate governance practices complied with a code drafted by a business-led committee.303 Changes made to the code in 2003 require listed companies to publish a detailed breakdown of the pay arrangements of each director serving

299. For an overview, see RICHARD SMERDON, A PRACTICAL GUIDE TO CORPORATE GOVERNANCE 66-69 (Sweet & Maxwell, 1998); Brian R. Cheffins, Corporate Governance in the United Kingdom: Lessons for Canada, 28 CAN. BUS. L.J. 69, 83 (1997) [hereinafter Cheffins, Corporate].
300. The self-regulatory orientation of disclosure regulation was in fact displaced to a significant extent in 2000 when the Financial Services Authority, a government regulator, replaced the Stock Exchange as the administrator of the listing rules. For further details, see infra notes 318-320 and accompanying text.
301. It also appears that listing rules are being used to bolster executive pay disclosure in India. RAMAIYA, 15th ed., supra note 194, at 2747.
302. See supra notes 253-254 and related discussion.
on the management board or explain why such disclosure has not been made. Observers anticipate that large companies will not want to justify opacity, and will instead disclose executive pay in accordance with the precepts of the code.

"Soft law" accounting standards can also govern disclosure of information on managerial compensation and thereby affect how companies deal with remuneration. For instance, some attribute the popularity of stock options in the United States to their treatment under FASB guidelines covering the income statement. According to FASB standards, a corporation awarding stock options with no attached performance conditions does not have to set the "cost" against profits, though the information does have to be disclosed in footnotes to the accounts. Since granting stock options to executives does not affect the "bottom line," U.S. accounting rules allegedly create a bias in favor of this form of compensation, at least where the options are of the "plain vanilla" variety. Amid scandal-induced criticism of alleged abuses of incentive-oriented executive compensation, the FASB launched a debate in 2002 over accounting for stock-based remuneration. At present, it is unclear whether America's publicly traded companies will ultimately be compelled to "expense" options in their financial statements.

While FASB guidelines might affect to some degree the form of America's


305. Id.

306. For examples, see Bebchuk et al., supra note 15, at 45. In Britain, the equivalent document is known as the profit-and-loss account. See The Party's Over, ECONOMIST, Jan. 27, 2001, at Survey of Corporate Finance 16.


executive remuneration, they do not entirely explain why stock options are more popular in the United States than they are in other countries. The promulgation of accounting standards is not universal—Germany only established an independent standard setter in 1998—and, where standards are well-established, they commonly do not include guidance on the treatment of share-based remuneration. The result is that, just as with FASB rules, the granting of stock options does not affect the corporate "bottom line." As is the case with the United States, reform is on the policy agenda. Still, for now, the key point is that, since the accounting bias in favor of stock options currently exists outside the United States, other factors must account for the unique popularity of this form of compensation among America's publicly traded corporations.

Soft law, in addition to addressing shareholder voting and disclosure, can directly set down guidelines for the determination of executive pay. Over the past few years, various "blue ribbon" committees around the world (often staffed by business leaders and stock market officials) have drafted codes so as to provide publicly traded corporations with guidance on a range of corporate governance issues. These committees often address the setting of executive pay. A path-breaking forerunner on this count was a corporate governance code set out in the London Stock Exchange's listing rules. Beginning in 1995,
the code instructed listed companies to take into consideration the "wider scene" (such as pay and employment conditions elsewhere in the business), to avoid paying more than necessary when hiring talented executives, and to follow detailed guidelines in designing performance-related compensation.318 In 2000, a government regulator (the Financial Services Authority, or "FSA") was vested with authority to administer the listing rules for companies quoted on the London Stock Exchange.319 Though no longer constituting "soft law," the current listing rules continue to contain a modified version of code principles on executive pay first introduced in 1995.320

Listed companies in Britain have never been obliged to comply with corporate governance codes offering guidance on how to set executive pay. Instead, they have only been required to disclose whether they have conformed with the relevant standards.321 Nevertheless, compliance with the standards has been substantial.322 Hence, it is sensible to infer that Britain's best practice guidelines on executive pay have influenced the configuration of managerial remuneration,323 even if they were originally developed as "soft law."

The British example notwithstanding, it is unclear whether corporate governance codes offering guidance on the setting of managerial remuneration will have a significant impact elsewhere. In some jurisdictions, the relevant document receives little or no backing from securities regulations or stock market listing rules, thus rendering compliance purely voluntary.324 In addition, the guidelines offered are typically less detailed than those which were introduced in Britain, with a standard format being a few sentences stressing the importance of linking pay to performance.325 "Soft law" guidelines framed in

318. SMERDON, supra note 299, at 72-75.
319. On the Financial Services Authority's status as the administrator of the Listing Rules, see OFFICIAL LISTING OF SECURITIES (CHANGE OF COMPETENT AUTHORITY) REGULATIONS 2000, S.I. 2000/968.
321. SMERDON, supra note 299, at 67; Fin. Servs. Auth., Listing Rules, ¶ 12.43A(b); Cheffins, Corporate, supra note 299, at 82-83. Those failing to divulge departures from the relevant guidelines have been subject to various possible sanctions, including delisting. Cheffins, Corporate, supra note 299, at 83; Fin. Servs. Auth., Listing Rules, ¶ 1.9.
322. See, e.g., HAMPEL REPORT, supra note 265, ¶ 1.10; COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: DEVELOPING THE FRAMEWORK ¶ 3.129 (2000).
323. HAMPEL REPORT, supra note 265, ¶ 1.9 (discussing disclosure); PENSIONS & INVESTMENT RESEARCH CONSULTANTS LTD., CORPORATE GOVERNANCE 2000 25 (2000) (discussing the length of directors' service contracts, dealt with in the Combined Code, ¶ B.1.7).
324. For a breakdown of countries where the corporate governance code is merely voluntary as compared with those where there is regulatory backing, see Cheffins, Reform, supra note 316, at 14; Holly J. Gregory, Overview of Corporate Governance Guidelines & Codes of Best Practice in Developing & Emerging Markets 3 (1999) (unpublished working paper on file with authors).
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dthis sort of general way may well lack the sort of clout required to significantly affect trends in executive pay.

VIII. CULTURE

"Culture" is difficult to define with precision, and it may constitute nothing more than a country's particular legal and financial arrangements. Still, experts on managerial compensation frequently draw upon the concept to explain why remuneration arrangements differ considerably across countries. Thus, culture—which we will define as a society's shared values, understandings, and assumptions—merits examination as a variable potentially affecting the globalization of executive pay.

It has been said that foreign cultural sensitivities toward lavish managerial remuneration might help to "prevent the wretched excess of... American-size pay packages." Underlying this view is the assumption that the United States is highly "tolerant of income inequality, especially if the inequality is driven by differences in effort, talent or entrepreneurial risk taking." On the other hand, Americans do worry about the fairness of their market-based system; according to one observer, criticizing executive compensation is "something of a national pastime." Ultimately, though, "Americans suffer neither envy nor egalitarian yearnings when gazing at the fortunes of their business leaders." This, in turn,
allegedly provides a hospitable platform for lucrative performance-oriented executive pay.\textsuperscript{334}

Matters supposedly are much different in other countries. A strong egalitarian impulse, it is said, may create distaste for hierarchy and enforce a presumption that "enrichment of an individual on the backs of the workers is . . . exploitation."\textsuperscript{335} To illustrate, people in continental European countries are said to be acutely sensitive to pay differentials based on rank,\textsuperscript{336} and are reputedly uneasy about conspicuous displays of wealth.\textsuperscript{337} Similarly, the Japanese allegedly subscribe to the adage that "when in public, wear cotton. If you must wear silk, wear it at home."\textsuperscript{338}

Strikingly, even in English-speaking countries reputed to share a common business culture with the United States, this account of cultural aversion to high executive pay is invoked.\textsuperscript{339} For instance, one commentator has noted that "[t]he British have always been suspicious of wealth, particularly of the rich who made their money in the marketplace."\textsuperscript{340} This bias purportedly explains why executive pay arrangements in Britain are not as lucrative or performance-oriented as in the United States.\textsuperscript{341} The discrepancy in managerial remuneration between the United States and Canada has also been ascribed to "fundamental cultural differences,"\textsuperscript{342} namely Canada's "gentler society"\textsuperscript{343} and "stubborn egalitarian streak."\textsuperscript{344} Experts on Australian executive compensation have spoken similarly about the country's comparatively modest managerial pay, saying that Australians are uncomfortable with "tall poppies" who stand out

\textsuperscript{334} Cox, supra note 4; Michael Crawford, Peanuts for Elephants, CAN. BUS., July 1994, at 16; Morais, et al., supra note 66, Maria Slade, NZ Executives Pay Third World Salaries, INDEP. BUS.WEEKLY, Sept. 26, 1997, at 23. See also David Leonhardt, Executive Pay Drops Off The Political Radar, N.Y. TIMES, Apr. 16, 2000, at Week in Review 5; Murphy, Explaining, supra note 283, 855-56 (drawing attention to a general lack of hostility towards generous executive pay in the United States).

\textsuperscript{335} Fung, supra note 81, at 39; see also Gross & Wingerup, supra note 11, at 27; Woodruff, Across Europe, CEOs Get No Respect, supra note 274, Birgit Gugath & Neal E. Boudette, Angry German Public Lashes Out at CEO Pay, WALL ST. J. EUR., Aug. 6, 2002, at A6.


\textsuperscript{337} See, e.g., Tully, supra note 58.

\textsuperscript{338} Berger, supra note 90.

\textsuperscript{339} On business culture typologies, see DERESKY, supra note 180, at 117-18.


\textsuperscript{341} Conyon & Murphy, supra note 19, at nn.667-68; Martin Vander Weyer, Too Much Cream, INDEP., Aug. 16, 1998, at 16; but cf. Martin Dickson, Alice in Wonderland World of Executive Pay, FIN. TIMES, June 22/23, 2002, at 15 (arguing that disclosure of executive compensation in Britain is highly complex because "the knee-jerk UK antipathy to high pay" leaves companies wary about revealing how much top managers stand to earn).

\textsuperscript{342} Crawford, supra note 334.

\textsuperscript{343} Gay, supra note 66.

\textsuperscript{344} Deirdre McMurdy, Taking Stock of Options, MACLEAN'S, Apr. 28, 1997, at 49; see also Paul Waldie, Canadian CEOs in Middle of Pay Pack, GLOBE & MAIL, Apr. 26, 1999, at B6.
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economically.  

If culture is as important as the received wisdom suggests, it could potentially deter convergence of executive pay along U.S. lines. Remuneration consultants report that in continental Europe and Japan, executives find distasteful the massive pay-outs American companies deliver to high-flying managers. Allegedly, "the greed factor is lower than in the US," manifested in a belief that those who run companies should not seek inordinately large managerial compensation. To the extent that executive self-restraint is firmly entrenched, it will act as a brake on a shift towards U.S.-style executive pay.

A sense that companies serve a range of "social" objectives rather than simply existing to maximize shareholder return could also impede a transition towards the U.S. approach to executive pay. In continental Europe and the market-oriented economies of Asia, managers are often characterized as trustees acting on behalf of a corporate community that encompasses constituencies other than profit-oriented investors. An American-style "incentivized" managerial services contract will give management a financial inducement to promote shareholder interests potentially at the expense of other "stakeholders." Correspondingly, heavy use of variable pay could create considerable anxiety outside the shareholder class. So long as the "public service" notion of the company continues to be taken seriously, this apprehension could inhibit the adoption of the U.S. pay paradigm.

Culture could also serve to check the Americanization of executive pay by engendering societal resistance stemming from what Bebchuk, Fried, and Walker refer to as the "outrage" constraint. If executive pay packages become highly lucrative, the violation of equity norms within society might yield a "backlash." This sort of societal "backlash" could, in turn, affect executive pay by activating corporate self-discipline. More precisely, since directors...
and executives could suffer social and reputational losses for violating the outrage constraint, they might shy away from being associated with highly lucrative service contracts. As Bebchuk et al. say, "[d]irectors [w]ill be loath to approve a compensation plan that would embarrass them" and "the same fear of embarrassment . . . might also affect managers directly and thereby discourage them from seeking such a package." In extreme cases, directors may even feel compelled by shareholder criticism or public outrage to orchestrate the departure of an executive caught in the middle of a controversy over executive pay.

Breach of the "outrage" constraint might also prompt government-instigated reform. President Clinton's introduction of a deductibility exclusion for managerial remuneration exceeding $1 million demonstrated that public unease over managerial remuneration can spark regulation. Likewise, in the mid-1990s, a British trade organization representing the interests of the U.K. business community felt compelled by growing disquiet over executive pay to set up a committee (chaired by Sir Richard Greenbury) to study the issue. The ensuing report prompted the London Stock Exchange to deal with executive pay issues by amending the corporate governance code contained in its listing rules. Neither tax reform in the United States nor the work of Britain's Greenbury Committee in fact fully satisfied the critics of executive pay in either country. Still, both incidents point to how violation of the "outrage constraint" can lead to reform designed to correct controversial remuneration practices.

While cultural values conceivably might hinder the Americanization of executive pay, these values can also evolve in ways that will actually increase receptivity to U.S.-style change. The experience in Britain is illustrative. During the 1970s, British executives were paid less than their counterparts in all other major industrial countries. Moreover, at the time, British managerial culture

356. Bebchuk et al., supra note 15, at 787-88; see also Alex Brummer, Failing Brakes on Boardroom Pay, GUARDIAN, June 1, 1996, at 38.
357. Bebchuk et al., supra note 15, at 787. For an example of this process, see Parker-Pope, supra note 65.
358. This appears to be what happened to Dick Grasso, who resigned as chief executive of the New York Stock Exchange after a controversy surrounding his compensation package. See Adrian Michaels, The Grasso Resignation: Largest Groups Rein in Excessive Deals, FIN. TIMES, Sept. 19, 2003, at 32. In a similar vein, terminated CEOs may find that public disclosure of a lucrative severance package can cause adverse publicity which leads directors to cut back on these payments. See Vauhini Vara, Hard Landing for Europe's Ex-CEOs, WALL ST. J., Sept. 5, 2003, at A7.
359. See Murphy, supra note 285.
360. CHEFFINS, supra note 17, at 655-56.
361. Id. at 656.
was suffused with highly muted reward preferences similar to those prevailing in egalitarian West Germany.364

Matters changed substantially within a fairly brief period of time, however. Throughout the 1980s, a Conservative administration imbued with a free-market ideology governed Britain. The effect on executive pay was profound.365 In 1988, Fortune magazine declared that "[a] pay revolution is shaking Britain. Prime Minister Margaret Thatcher’s bracing brand of capitalism brought not just tax cuts and high profits but also a profound change in public attitudes. Big pay packages are no longer frowned upon." Coincident with this shift in attitude was a dramatic change in managerial compensation. Between 1979 (when the Conservatives took office) and 1994, the gross pay of chief executives in larger U.K. public companies rose nearly 600%.367 By the mid-1990s, British CEOs were no longer remuneration also-rans, but instead counted among the best paid executives in the industrialized world.368

Outside Britain, there are signs that the cultural environment is becoming more hospitable for U.S.-style executive pay. An expert on Canadian managerial compensation observed in 2001 that the market for executive talent was being influenced ever more strongly by American trends, thus "imposing the US social order on good old Canada."369 Australia allegedly is engaged in a "slide towards US-style inequality" and significant increases in pay awarded to the country’s executives have been cited as a "depressing milestone" marking this trend.370 Moreover, speculation has it that Germans, both inside and outside the boardroom, are adopting a more tolerant attitude towards wealth accumulation.371 Thus, while social values may continue to influence the setting of executive pay, shifting cultural norms could actually function to bring other countries closer to U.S.-style executive remuneration.

364. CHRISTEL LANE, MANAGEMENT AND LABOUR IN EUROPE: THE INDUSTRIAL ENTERPRISE IN GERMANY, BRITAIN AND EUROPE 131-32 (Edward Elgar, 1989); Andreas Budde et al., Corporate Goals, Managerial Objectives, and Organizational Structures in British and West German Companies, 3 ORG. STUD. 1 (1982).


366. Tully, supra note 58. On how matters progressed in the decade which followed, see Vander Weyer, supra note 341.


368. Abowd & Kaplan, supra note 52, at 146, Table 1. A possibility is that the 1970s were exceptional and the pay surge in the 1980s and 1990s brought matters back into line with longer-term trends. Matthews, supra note 134.


American chief executives are the most highly paid in the world, and not surprisingly, CEO pay has proved controversial in the United States. Similarily, British managers are well paid by global standards and executive compensation has been an intensely debated topic. Managerial remuneration has also attracted attention in Canada and Australia. Elsewhere, though, debate about the topic has typically only flared up periodically.

Matters, however, may soon change. As this Article has described, there is evidence that a “global shakeup in executive comp” could be occurring. To reiterate, market dynamics that might foster such a shakeup include wider dispersion of share ownership, increased cross-border hiring of executives, growing international M & A activity, and the expansion of business activity by multinationals. Gauging how influential these factors will be in practice is difficult. Still, if their impact is substantial and a strong Americanization trend develops, the changes likely will prompt vigorous debate in the affected countries.

The controversy which would ensue if U.S.-style executive pay becomes more prominent would place policymakers under pressure to confront the situation. Views on the appropriate response would no doubt differ. Those supportive of a shift in an American direction might assert that domestic companies are justified in changing policy since talented nationals would be less likely to emigrate in pursuit of higher pay. They also might cite America’s successful corporate economy as testimony to the effectiveness of performance-oriented compensation. Underlying this contention would likely be the premise that the introduction of a highly “incentivized” approach to remuneration would provide a valuable boost to companies that had previously treated shareholders as “second class citizens.”

On the other hand, after the corporate governance scandals which afflicted

372. See supra note 12 and accompanying text.
373. See infra note 387 and accompanying text.
374. See, e.g., Francis, supra note 282; Deirdre McMurdo, The Polarized Economy, MACLEAN’S, Oct 7, 1996, at 49; Rod McQueen, Executive Payoffs are out of Control, NAT’l POST (Canada), Apr 3, 2000, at C3 (on Canadian executives); S. Karene Witcher, Big CEO Pay as Lure Riles Some Australians, GLOBE & MAIL (Toronto), July 31, 1998, at B6.
375. Ferrarini et al., supra note 89, at 4 (saying that the controversy has been restricted to countries with dispersed share ownership but noting that there was concern about executive pay in France); Thomas J. André, Jr., Cultural Hegemony: The Exportation of Anglo-Saxon Corporate Governance Ideologies to Germany, 73 TUL. L. REV. 69, 159-61 (1998); Gail Edmondson, France: A CEO’s Pay Shouldn’t be a Secret, BUS. WEEK, Aug 9, 1999, at 24 (saying that with respect to executive pay French society had yet “to confront its schizophrenic feelings about wealth”).
376. See supra notes 187-89 and accompanying text.
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the United States at the end of the 1990s stock market boom (such as Enron Corp., WorldCom Inc., and Tyco International Ltd.), policymakers elsewhere might see borrowing from the American model of capitalism as unwise.378 Most pertinent for present purposes, policymakers might conclude that, in the case of executive pay, drawbacks to the American approach would make imitation undesirable. As Bebchuk, Fried, and Walker have argued, managerial compensation in the United States arguably is a manifestation of counterproductive “rent extraction,” not the product of fair-minded efforts to align the interests of shareholders and executives.379 Also, American-style incentivized compensation packages could tempt executives to engage in misleading or dishonest earnings management in order to prop up their share prices until they can unload their equity.380

An additional reason why the U.S. approach to executive pay might be thought of as an inappropriate model for other countries is that unswerving confidence in the notion of the all-powerful “superstar” CEO underpinned the shift towards lucrative performance-oriented pay in American public companies. Even Americans are now acknowledging that a quiet, understated leadership style might be more likely to deliver strong results.381 At the same time, there might be fears that the awarding of U.S.-style compensation would foster resentment among rank-and-file employees, with a consequent drop in morale and productivity.382 Finally, in strongly egalitarian countries, a growing gap between ordinary workers’ wages and corporate leaders’ soaring fortunes would be societally objectionable in itself.383

This Article provides guidelines for regulators called upon to address the potential Americanization of executive pay. If a regulator prefers to curb convergence in an American direction, our analysis suggests the most direct course of action would be to orchestrate an increase in the top marginal rate of


382. On this possibility, see CHEFFINS, supra note 17, at 658; Murphy, supra note 12, at 2554.

383. See, e.g., Bryant, supra note 9; McMurdy, supra note 345.
income tax. This is because under the new conditions, executives would know that they would keep less of what they earned and thus would not press as hard for lucrative remuneration.\textsuperscript{384} On the other hand, the politics of taxation are delicate and it is doubtful whether concern about the level of managerial compensation could ever provide, in isolation, a sufficiently strong political platform for a more progressive tax regime.\textsuperscript{385}

Tax reform is not the only regulatory strategy available to policymakers seeking to impede the Americanization of managerial remuneration, but there is reason to doubt whether the alternatives would achieve the desired objective. For instance, the analysis offered here indicates that amending corporate law to introduce "direct" regulation of executive pay, strengthen directors' duties, or impose new shareholder voting requirements would likely not cause a significant reconfiguration of managerial compensation. Bolstering disclosure requirements would also be unwise and might indeed serve to accelerate the Americanization of executive pay. Moreover, deploying "soft law" would not be a particularly promising alternative. Consider Britain. Detailed "soft law" guidance was put in place during the mid-1990s and those setting executive pay were instructed to take into account the "wider scene."\textsuperscript{386} Nevertheless, managerial remuneration subsequently rose substantially in U.K. companies.\textsuperscript{387}

Assume now that our policymaker has concluded that the preferred course of action is to foster a shift towards the U.S. executive pay model. Under such circumstances, introducing stronger disclosure requirements would be a prudent course to follow. The primary reason would be that shareholders, having additional information at hand, would be well situated to press for compensation packages that linked pay more closely with performance. Also, the likelihood that enhanced disclosure regulation might well foster an upward ratchet in executive pay would presumably be an acceptable by-product of reform.

Another approach that a policymaker who is favorably disposed towards U.S.-style executive pay might adopt would be to promote the unwinding of control blocks in domestic companies. All else being equal, a company with a "core" shareholder will probably have lower executive pay than its widely held counterpart, and performance-oriented compensation will likely play a less important role. A popular thesis at present is that a country that wants to foster outside investment in domestic companies can "jump start" a move in this direction by enacting laws designed to protect minority shareholders.\textsuperscript{388} It is by

\textsuperscript{384} See supra note 276 and accompanying text.
\textsuperscript{385} CHEFFINS, supra note 17, at 706-7.
\textsuperscript{386} Supra note 319 and related discussion.
\textsuperscript{388} On this line of thinking, see Cheffins, Bedrock, supra note 120 at 5-6, 16.
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no means certain whether any such attempt will succeed.\textsuperscript{389} Still, for a country that does make a law-driven transition towards the sort of dispersed pattern of ownership that prevails in the United States and Britain, a likely by-product would be at least a partial shift towards the American model of executive pay.

This Article has not sought to address explicitly whether a move towards the U.S. model of executive pay would be a "good thing." Instead, the purpose here has primarily been descriptive, namely identifying and discussing the variables likely to influence global managerial remuneration trends. The analysis that has been offered here, however, does have significant normative ramifications. Specifically, this Article provides a "check list" of factors that policymakers outside of the United States can take into account once they have formulated a policy on executive pay. Thus, while those wondering whether the Americanization of executive pay would be a "good thing" will need to find their answers elsewhere, this Article offers valuable guidance for those seeking to implement policy decisions.

\textsuperscript{389} Id. at 16-23.
Stealth Compensation via Retirement Benefits

Lucian Ar ye Bebchuk† and Jesse M. Fried‡

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Stealth Compensation via Retirement Benefits

Lucian Arye Bebchuk and Jesse M. Fried

This Article analyzes an important form of "stealth compensation" provided to managers of public companies. We show how boards have been able to camouflage large amounts of executive compensation through the use of retirement benefits and payments. Our study illustrates the significant role that camouflage and stealth compensation play in the design of compensation arrangements. It also highlights the importance of having information about compensation arrangements not only publicly available but also communicated in a way that is transparent and accessible to outsiders.

To improve the transparency of executives' retirement payments and benefits, we propose several changes in current disclosure requirements. Among other things, firms should be required to report to investors each year the dollar value of all the retirement benefits to which their executives become entitled. For example, firms should disclose to investors the annual buildup in the actuarial value of executives' retirement plans, as well as the tax savings reaped by executives at the company's expense through the use of deferred compensation arrangements. Firms should also disclose to investors each year the present value of all the retirement benefits their top executives have accumulated.

I. INTRODUCTION

This Article focuses on an important form of "stealth compensation" provided to managers of public companies. We show how designers of compensation arrangements for these managers have been able to camouflage large amount of executive compensation through the use of retirement benefits and payments. Our study highlights the significant role that camouflage and stealth compensation play in the design of compensation arrangements. Our study also highlights the importance of ensuring that information about compensation arrangements not only be placed in the public domain but also be communicated in a way that is transparent and accessible to outsiders.

We begin by discussing the critical role of outrage costs and camouflage in the setting of executive compensation. Managers have considerable influence over their pay and use their influence to extract pay that is both higher and less performance sensitive than arm's-length bargaining with the board would produce. The difference between what managers' power enables them to receive and what they would receive under arm's-length bargaining constitutes "rents." Managers' ability to extract rents, however, is hardly unlimited. When
a board approves a compensation arrangement that favors managers at the expense of shareholders, executives and directors will bear certain economic and social costs. The magnitude of these costs will depend on how the arrangement is perceived by outsiders whose views matter to the directors and executives. An arrangement that is perceived as outrageous might reduce shareholders' willingness to support incumbents in a proxy contest or takeover bid, might lead to shareholder pressure on managers and directors, and might embarrass directors and managers or harm their reputations. The more outrage a compensation arrangement is expected to generate, the more reluctant directors will be to approve it and the more hesitant managers will be to propose it in the first place.

The critical role of outsiders' perception of executives' compensation, and the significance of outrage costs, explain the importance of "camouflage." The desire to minimize outrage gives designers of compensation arrangements a strong incentive to try to obscure and justify—or, more generally, to camouflage—both the level and performance-insensitivity of executive compensation. Camouflage thus allows executives to reap benefits at the expense of shareholders. More importantly, attempts to camouflage can lead to the adoption of inefficient compensation structures that harm managers' incentives and in turn company performance, imposing even greater costs on shareholders.

We discuss elsewhere how various forms of non-retirement compensation, including bonuses, stock option plans, and executive loans, have been designed with an eye to camouflaging rents and minimizing outrage.¹ In this Article, we examine how retirement arrangements have often been designed in a way that serves this goal. As disclosure requirements for executive salaries, bonuses, and long-term compensation have become stricter, firms have increasingly turned to post-retirement payments and benefits as ways to compensate managers. Post-retirement value has been provided to executives through four main channels: retirement pensions, deferred compensation, post-retirement perks, and guaranteed consulting fees. As we will explain, these methods enable firms to provide a substantial amount of performance-insensitive value in a less transparent form than, say, salary. Firms have used these channels to make less transparent both the total amount of compensation received by managers and the extent to which pay is decoupled from managers' own performance.

Before describing outrage costs and camouflage in more detail and discussing each of the four channels, we should note two attributes they all

share. First, these arrangements differ substantially from those that firms elect to provide to other employees. Although firms often provide pensions and deferred compensation to lower-level employees, they do so only to the extent that these arrangements receive a tax subsidy. This pattern suggests that, absent such a subsidy, pensions and deferred compensation are generally not efficient. Yet most of the arrangements provided to executives do not enjoy similar tax advantages. Furthermore, consistent with economists' belief that in-kind benefits are inefficient, firms do not generally provide retired employees with coverage for specified consumption expenses. Such benefits are, however, given to high-level executives. And although firms occasionally use retired employees as consultants when the need arises, they generally do not guarantee lifetime consulting fees to any employees other than executives.

The second shared attribute of these various retirement payments is that they all make it possible to obscure large amounts of performance-decoupled compensation. As we shall see, firms do not have to disclose the value transferred to executives through these channels in the same way that other forms of compensation—such as salary, bonuses, and stock options—must be disclosed. Retirement payments hence offer what might be called "stealth compensation." Indeed, the dollar figures used by the media in reporting compensation levels, and by financial economists in their studies, usually do not include the large value provided to executives through retirement benefits.

The remainder of this Article proceeds as follows. Part II describes the importance of outrage costs and camouflage in the setting of executive compensation. Part III discusses the widespread use of supplemental executive retirement plans (SERPs). It explains how SERPs differ from the pension benefits provided to regular employees and how they can be used to camouflage a significant amount of performance-insensitive compensation to executives. Part IV discusses the deferred compensation arrangements offered to managers. It describes how these plans differ from the 401(k) plans offered to other employees and how these plans, like SERPs, are used to provide a significant amount of performance-decoupled pay to executives in a way that is largely hidden from view. Part V considers the use of post-retirement perks and consulting contracts. Part VI explains why increased transparency of retirement arrangements would be beneficial to shareholders and proposes several changes to the disclosure requirements for retirement payments and benefits. Part VII concludes.

II. OUTRAGE COSTS AND CAMOUFLAGE

This Part explores the role and significance of outrage costs and camouflage in the setting of executive compensation. Section II.A explains why outsiders' perceptions and the possibility of outrage are of concern to boards when they fashion pay packages for managers. Section II.B describes the key role of camouflage in the design of compensation arrangements. Section II.C provides empirical evidence on the effect of outrage and camouflage on managerial pay.

A. The Importance of Outsiders' Perceptions

As we discuss and document in great detail elsewhere, top executives have considerable influence on their own pay arrangements. Although directors are supposed to negotiate with executives at arm's-length, they have both financial and non-financial incentives to provide managers with pay arrangements that favor managers at the expense of shareholders. A variety of psychological and social factors acting on the directors reinforce these incentives to serve managers' interests. Moreover, neither shareholder pressure nor market forces have been able to effectively constrain managerial influence over pay.

Managers have used their power to extract pay that is both higher and less performance-sensitive than arm's-length bargaining with the board would produce. The difference between what managers' influence enables them to receive, and what they would receive under arm's-length bargaining, is called "rents." The rents captured by managers come in both the form of higher pay and reduced pressure to generate value for shareholders.

However, managers' ability to extract these rents is hardly unlimited. When a board approves a compensation arrangement that favors managers at the expense of shareholders, executives and directors may bear certain economic and social costs. Although market forces, the need for board approval, and social sanctions do not altogether prevent deviations from arm's-length contracting, they do, as we explain below, place some constraints on managers' ability to obtain favorable compensation packages, and the tightness of these constraints depends on outsiders' perceptions of these pay arrangements.

In the face of these constraints, how far firms will go in favoring managers will depend not only on how much contemplated arrangements will actually favor executives, but also on how these arrangements will be perceived by outsiders. Whether directors and managers are deterred from adopting a given compensation arrangement depends on the extent to which it will be viewed by

3. See Bebchuk et al., Managerial Power, supra note 1, at 764-783; Bebchuk & Fried, Executive Compensation, supra note 1, at 73-75; BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, supra note 1, at ch. 2.
relevant outsiders as unjustified or even abusive or egregious. We have broadly referred to negative reactions by outsiders as "outrage," even though some of them may amount to criticism not reaching the level of outrage, and to the costs that such reactions impose on managers and directors as "outrage costs."\textsuperscript{4} The more widespread and strong these negative reactions are—that is, the greater the outrage—the larger the costs to directors and managers. When the potential outrage costs are large enough, they will deter the adoption of arrangements that managers would otherwise favor. Arrangements that are deterred in this way can be regarded as ones that violate the "outrage constraint."

Why should perceptions—and, in particular, outrage—matter? To begin with, the extent to which markets penalize managers and directors for the adoption of particular arrangements depends on how these arrangements are perceived. Consider the market for corporate control. This market may penalize the adoption of arrangements by increasing the vulnerability of managers and directors to a control contest. Such a penalty is likely to be significant only if the firm adopts compensation arrangements that appear sufficiently outrageous. Institutional investors may view such arrangements as a strong signal that the executives or directors are relatively insensitive to shareholder interests. These investors may become less likely to support the incumbents should a hostile takeover or a proxy fight occur. In this manner, through the operation of the market for corporate control, outrage over compensation can impose a penalty on managers and directors.

Consider also the labor market and the reputation of managers and directors in this market. Reputational damage might have an adverse effect on the future career prospects of managers and directors. It might also affect their current business dealings with others outside the firm. Indeed, some outside directors join boards partly for the prestige and connections that the posts provide, and gaining a bad reputation could eliminate these benefits and impose costs instead. Reputational losses to managers and directors will likely be significant, however, only if their firms adopt compensation arrangements that generate sufficiently negative reactions—that is, sufficient outrage. An arrangement that fails to serve shareholders would be unlikely to impose such costs as long as it falls within the range of what is perceived as conventional and legitimate.

Indeed, we believe that arrangements that are perceived as abusive or outrageous impose on executives greater costs than an analysis based solely on the above market incentives suggests. That is, we believe that constraints on rent extraction are somewhat tighter than suggested by an analysis of the (limited) market penalties that outrageous compensation arrangements involve.

\textsuperscript{4} See Bebchuk et al., Managerial Power, supra note 1, at 786-88; Bebchuk & Fried, Executive Compensation, supra note 1, at 75-76; BEBCHUK & FRIED, PAY WITHOUT PERFORMANCE, supra note 1, at ch. 5.
As we have explained elsewhere, directors are affected not only by “narrow” interests of a *homo economicus*, but also by various social and psychological factors (such as collegiality, loyalty, and so forth) that pull them in the direction of favoring executives. Similarly, there are social and psychological factors that increase the costs that managers and directors incur from adopting arrangements that are viewed by outsiders as sufficiently outrageous.

Managers and directors likely care about the extent to which relevant social and professional groups view them with approval and esteem. Directors are also likely to prefer to avoid criticism or ridicule from the social or professional groups whose opinions they value—even if such criticism or ridicule does not involve any economic losses for them. As a result, even if the economic incentives provided by the markets for corporate control and managerial labor would be insufficient to deter managers from seeking certain outrageous compensation, fear of embarrassment or criticism could discourage managers from doing so. When former General Electric CEO Jack Welch made headlines by giving up much of the retirement perks to which he was contractually entitled—including the free use of a corporate jet and a New York apartment—he was undoubtedly seeking to protect the approval and esteem he had earlier enjoyed at the expense of his narrow economic interests.

Clearly, for outrage to impose significant costs, it must be sufficiently widespread among a relevant group of observers. It is not enough for a small group of researchers or arbitrageurs to identify a compensation scheme as egregiously bad for shareholders. For executives or directors to be adversely affected in a material way by market penalties or social costs, the outrage must be shared by those outsiders whose views matter most to them: the institutional investor community, the business media, and social and professional groups to which directors and managers belong.

B. Camouflage

The main costs to directors and managers of adopting compensation arrangements that favor managers, then, depend mainly not on how costly the arrangements actually are to shareholders, but on how costly the arrangements are perceived to be by important outsiders. Perceptions matter. This brings us to another concept that is critical for understanding the compensation landscape: camouflage.

Because perceptions are so important, the designers of compensation plans

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5. See BECHUK & FRIED, PAY WITHOUT PERFORMANCE, *supra* note 1, at ch. 2.
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can limit outside criticism and outrage by dressing, packaging, or hiding—in short, camouflaging—rent extraction. The more reasonable and defensible a package appears, the more rents managers can enjoy without facing significant outrage. Accordingly, under the managerial power approach, managers will prefer compensation practices that obscure the total amount of compensation, that appear to be more performance based than they actually are, and that package pay in ways that make it easier to justify and defend.

The greater the ability of plan designers to engage in camouflage, the more they can be expected do so. Before 1992, the SEC required firms to report executive compensation to the public but allowed them to do so in the format of their choosing. Not surprisingly, firms took full advantage of their discretion to obscure the amount and form of their pay. An SEC official describes the pre-1992 state of affairs as follows:

The information [in the executive compensation section] was wholly unintelligible . . . . [T]he typical compensation disclosure ran ten to fourteen pages. Depending on the company’s attitude toward disclosure, you might get reference to a $3,500,081 pay package spelled out rather than in numbers. That gives you an idea of the nature of the disclosures: it was legalistic, turgid, and opaque; the numbers were buried somewhere in the fourteen pages. Someone once gave a series of institutional investor analysts a proxy statement and asked them to compute the compensation received by the executives covered in the proxy statement. No two analysts came up with the same number. The numbers that were calculated varied widely.8

In 1992, the SEC tightened its disclosure rules by providing standards for how information about executive pay must be presented. The standardized compensation tables that firms now must use have made camouflage more difficult. As we describe elsewhere, however, the 1992 disclosure requirements have hardly brought an end to firms’ ability to camouflage the amount and form of executive pay.9

One might reasonably ask how, if rent extraction is camouflaged, any observer (including this Article’s authors) can determine that executives are enjoying rents. In theory, rent extraction could be camouflaged so well that it becomes absolutely undetectable. In fact, camouflage is successful as long as the rent extraction is not apparent to those outside observers whose outrage would be particularly costly for directors and managers, even if other observers are aware that the executives are enjoying large rents.

Thus, the notion of camouflage is consistent with the possibility that an outsider might identify the hidden rents of a compensation arrangement. Such a conclusion would simply reflect the observer’s judgment, not yet widely shared, that the compensation program is distorted in favor of managers. In

9. See BECHUK & FRIED, PAY WITHOUT PERFORMANCE, supra note 1, at chs. 6-14.
time, of course, such conclusions might become widely accepted, in which case the rent extraction will no longer be camouflaged. But a given form of rent extraction might continue to be camouflaged long after it has been recognized by some observers.

C. Outrage and Camouflage at Work

Some critics of our earlier work argued that the idea of outrage costs, and the related idea of camouflage are not empirically testable.\(^\text{10}\) This, however, is not the case. There is evidence that directors and executives are indeed influenced—in compensation and other types of decisions—by strong outside criticism and outrage. And there is evidence that they engage in camouflage.

To begin with, there is evidence that shareholder precatory resolutions that criticize managers’ high compensation have an impact. Although such resolutions are nonbinding and generally fail to pass anyway, their appearance may shine a critical light on problematic aspects of the firm’s executive compensation policies and make them less opaque. Indeed, a study by Randall Thomas and Kenneth Martin examined the effect of pay-related precatory resolutions during the mid-1990s and found that they had a moderating influence on subsequent compensation decisions.\(^\text{11}\) The study found that during the two-year period following the passage of shareholder resolutions criticizing executive pay in particular firms, total compensation (adjusted for industry) in those firms declined by a statistically significant average of $2.7 million. In a subsequent study, the researchers also found that higher negative votes on management-sponsored proposals to ratify an option plan slowed the increase in CEO compensation in subsequent years.\(^\text{12}\)

Another study, by Alexander Dyck and Luigi Zingales, documents the effects of media scrutiny on corporate decisions in general. The authors found that such attention leads firms to adopt more environmentally friendly policies, for example. As for issues of corporate governance, they also found that media attention reduces the amount of value that controlling shareholders siphon off.\(^\text{13}\)

A well-known example of how outside criticism affects governance decisions involves the campaign of shareholder activist Robert Monks against

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the directors of Sears. During the late 1980s and early 1990s, Monks urged the Sears board to adopt various proposals to improve the firm’s dismal performance. In April 1992, having been repeatedly ignored by the board, Monks took out an advertisement in the *Wall Street Journal* titled “The Non-performing Assets of Sears” and identified the directors by name. The presumably embarrassed directors then adopted many of Monks’s proposals, generating an abnormal stock price return (the change in stock price adjusted for overall stock market movements) of almost 10% when the changes were announced.14

Another example is the California State Pension Fund for Public Employees’ (CalPERS) practice of identifying poorly run companies. For some years, CalPERS put poorly performing firms on what it called its “focus list” and suggested various ways to improve their corporate governance practices, such as making compensation and nominating committees fully independent. In many cases, firms placed on the list implemented some of the requested changes. Then, in 1991, after several CEOs told CalPERS that being less antagonistic would be even more effective, CalPERS decided to adopt a “kinder, gentler” approach that did not involve public shaming.15 Absent the threat of adverse publicity, however, firms approached by CalPERS were actually much less cooperative. The then-CEO of CalPERS, Dale Hanson, said at the time, “It has shown us that a number of companies won’t move unless they have to deal with the problem because it’s in the public eye.” In 1992, CalPERS reinstated its policy of publicly shaming uncooperative firms.16

In fact, CalPERS’ policy of shaming has had a measurable effect on targeted corporations. Yi-Lin Wu found that firms put on CalPERS’ poor governance focus list were subsequently more likely to reduce the number of inside directors on their boards. These firms were also more likely to experience CEO turnover.17 Shaming also appears to have adversely affected the careers of inside directors that left the targeted firms’ boards. They were much less likely than inside directors departing nontargeted firms to land other board positions.18 As this study makes clear, negative publicity—or outrage—does impose costs.

Finally, and perhaps most importantly, there is substantial evidence of camouflage activities. A testable implication of the camouflage idea is that

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16. *Id.*
18. *Id.*
when compensation arrangements deviate from arm's-length bargains, they should do so in a way that makes the amount of pay or the insensitivity of pay to performance less visible. This prediction is borne out by actual compensation practices. As we have shown elsewhere, many common non-retirement compensation practices—such as company loans and the structure of conventional options—provide camouflage benefits. And as we will explain below, the four channels through which executives are paid after retirement also serve to obscure a significant amount of compensation.

III. RETIREMENT PENSIONS

Many employees are covered by pension plans that provide payments to workers after retirement. At first glance, it seems only natural for firms to provide such benefits to their executives. A closer look, however, raises serious questions about whether the extensive use of executive pensions as a form of compensation reflects arm's-length bargaining. Part III.A describes the difference between executive retirement pensions and the retirement benefits offered to ordinary workers. Part III.B explains how the executive pensions are used to camouflage a substantial amount of performance-decoupled executive pay.

A. Differences from Regular Pensions

Most of the pension plans used for employees are designed to be "qualified" for favorable tax treatment. The firm gets a current deduction for contributing funds to a qualified plan for employees—the same deduction it would have received had it paid the amount of the contribution to workers in the form of salary. Workers, however, do not pay income taxes on the pension money until they retire and begin receiving payouts from the plan. In the meantime, the funds invested by the firm grow tax-free. Neither the firm nor the employees must pay any taxes while the plan's investments increase in value. Thus, the plans provide a tax benefit to employees at no cost to the firm.

19. See BECHUK AND FRIED, PAY WITHOUT PERFORMANCE, supra note 1, at chs. 9-14.

20. To illustrate how the tax subsidy provided to a qualified plan operates, consider the following examples involving a hypothetical firm and employee. Assume that both face a 40% tax rate on all of their income, including capital gains. Also assume that both are able to earn, between the pre-retirement period and retirement period, a pretax return of 100% on their investments.

Example 1: The employee invests for retirement outside a qualified plan. Suppose the firm pays the employee $100 in the pre-retirement period. The firm deducts $100 from its taxable income, reducing its tax liability by $40. The employee pays $40 in taxes, takes the after-tax income of $60, and invests it. The $60 grows to $120 by the retirement period—a gain of $60. This $60 gain triggers a tax liability of $24 (40% of $60), leaving the employee with $96 ($60 + $36) when the employee retires.

Example 2: The firm invests for the employee's retirement under a qualified plan. Now suppose the firm contributes the $100 to a qualified pension plan in the pre-retirement period. The firm again deducts...
Given the opportunity, boards might well prefer to offer executives qualified retirement plans. A qualified pension plan, however, can use only about $200,000 of annual compensation as the basis for determining benefits under the plan. For example, a plan that promises to pay all retirees, annually, 50% of the compensation earned during their last year of service cannot pay a retired executive more than $100,000 annually, even if the executive earned $1 million of compensation during that final year. As a result, firms cannot use qualified plans to provide executives with pensions that are similar in size to their annual compensation. For this reason, most firms also provide executives with nonqualified "supplemental" executive retirement plans (SERPs).

SERPs differ from typical qualified pension plans in two critical ways. First, they do not receive the favorable tax treatment enjoyed by qualified plans; no investment income goes untaxed under a SERP. The company pays taxes on the income it must generate in order to pay the executive in retirement. If the money had been distributed as salary, on the other hand, the executive who invested the money for retirement would have had to pay taxes on any income generated. The effect of the SERP, therefore, is to shift some of the executive's tax burden to the firm.

If the employee and the firm are subject to the same tax rate and are able to earn the same pretax rate of return on their investments, a SERP cannot reduce the total amount of taxes paid by the parties. For every dollar the employee's tax burden is reduced, the firm's tax burden is increased by one dollar. Unlike a qualified plan, the SERP would not reduce the parties' total tax burden.

To illustrate the effect of a SERP on the tax burdens of the parties, consider the following example and explanation, which builds on the examples provided in note 20. Assume again that both the firm and the executive face a 40% tax rate on all of their income, including capital gains. And assume that both are able to earn, between the pre-retirement and retirement periods, a pretax return of 100% on their investments.

Example 3: The firm invests for the executive's retirement under a nonqualified plan. Suppose a firm seeks to use a SERP to give an executive the same retirement payment that it gives the employee in
In reality, of course, the situation is more complicated. In many cases, the total tax liability faced by the parties will be affected by whether the executive or the firm saves for the executive’s retirement. Even if the firm and the executive are able to earn the same return on their investments, they may face different tax rates. Suppose, for example, that an executive investing personal funds for retirement in the stock market is paying a low long-term capital-gains tax rate of 15%, while the firm pays taxes on the income generated for the executive’s retirement at a corporate tax rate of 35%. In such a case, using SERPs would be tax-inefficient and would increase the total amount of taxes paid by the two parties. On the other hand, if the firm had no taxable earnings and was not expected to pay taxes for a considerable amount of time, the reverse might be true: shifting retirement savings from the executive to the firm might be tax-efficient.

Similarly, even if the firm and the executive face the same tax rate, the investment returns available to the firm may be higher than those available to the executive. For example, firms having difficulty raising capital may enjoy a higher expected rate of return on new investments than the market generally. (This is unlikely to be the case for companies with easy access to capital, as such companies are unlikely to have unutilized investments with returns much higher than the market.) If the firm has better investment opportunities, having example 2 using a qualified plan. As in the case of the employee, the firm sets aside $100 to fund the executive’s pension, which grows to $200 by the time the executive retires. The $200 is distributed to the executive, who, like the employee, pays a 40% tax on the retirement distribution—a tax of $80. This leaves the executive, like the employee in example 2, with $120, $24 more than the employee in example 1 made.

Now consider the effect of the SERP on the firm. In examples 1 and 2, discussed in note 2, the firm reduces its tax liability by $40 in the pre-retirement period when it pays the worker $100 or contributes $100 to the worker’s qualified pension plan. In example 3, the firm reduces its tax liability by $80 in the retirement period when it pays the executive $200. However, the firm must add to its taxable income in the retirement period the $100 gain on the funds it previously invested for the executive’s retirement, and this increases the firm’s tax liability in the retirement period by $40. The net effect of the $200 payment to the executive and the $100 gain is to reduce the firm’s tax liability by $40 during the retirement period.

Had the firm reduced its tax liability by $40 in the pre-retirement period, rather than during the retirement period, it could have invested the $40 and earned a pretax return of $40 (100%) by the retirement period. That $40 would also have been taxed at 40%, leaving the firm with $64. But by reducing its tax liability in the retirement period, the firm has only an extra $40, $24 less. The firm is thus worse off than in example 2, in which it received the same $40 reduction in its tax liability in the pre-retirement period. The $24 gain to the executive from the use of a nonqualified plan designed to put the executive in the same position as an employee under a qualified retirement plan comes at the expense of the firm.

For an explanation of the tax effects of using arrangements such as SERPs to defer compensation under various scenarios, see MYRON S. SCHOLE ET AL., TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 181-185 (Prentice Hall, 2d ed., 2002).

25. The tax efficiency of a SERP will also be affected by expected changes in the firm’s (or the executive’s) tax rate change over time. For example, if the firm is losing money and thus unable to get a current tax benefit by deducting executive compensation in the current period, but is expected to be subject to a higher tax rate in the future, deferring an executive’s compensation will be tax efficient, all else being equal.
it invest for the executive's retirement will be efficient for both parties, even if their tax rates are identical.

However, there is no reason to believe that, absent a tax subsidy, it is generally efficient to have the firm save for the executive. On the contrary, there are good reasons to think that it is inefficient for many firms to save for their executives' retirement, given individuals' low long-term capital-gains tax rate. It is telling that firms providing SERPs to executives do not offer nonqualified retirement plans to other employees. Consider the case where it is efficient for a firm to provide a SERP to its executives because the firm has better investment opportunities than they do. In such a case, it should also be efficient for the firm to provide nonqualified retirement to its nonexecutive employees who supplement their qualified pensions with personal retirement savings. However, firms rarely, if ever, do so. This fact suggests that, absent the tax subsidy provided to qualified plans, using nonqualified retirement benefits is commonly not an efficient way to compensate employees. Yet in 2002, more than 70% of firms provided nonqualified SERPs to their executives.26

The second important difference between executive SERPs and qualified pension plans for nonexecutive employees concerns the risk borne by the firm and by the participant. Qualified pension plans offered to new lower-level employees are usually based on a defined contribution. The firm commits to contribute a specified amount each year. The value available to an employee upon retirement depends on the performance of the plan's investments. The risk of poor investment performance falls entirely on the employee.

In contrast, SERPs offered to executives are defined-benefit plans, which guarantee fixed payments to the executive for life. All of the CEOs in the S&P ExecuComp database have defined-benefit plans.27 These plans shift the risk of investment performance entirely to the firm and its shareholders. No matter how poorly the firm and its investments perform, the executive is guaranteed a specified lifelong stream of payments.

Given that arm's-length negotiations with most employees lead to defined-contribution arrangements, why should arm's-length bargaining with executives yield such a different result? If anything, there are reasons to believe that defined-benefit plans should be more valuable to regular employees—and thus offer a more efficient form of compensation—than they are to executives. Unlike most executives, ordinary employees are unlikely to accumulate substantial wealth over their lifetimes. They are likely to be more dependent on their pensions to meet their financial needs in retirement and therefore less able

27. STEVEN BALSAM, AN INTRODUCTION TO EXECUTIVE COMPENSATION 175 (Academic Press, 2002).
to bear the investment risks associated with defined-contribution plans. In contrast, executives faced with defined-contribution plans could easily insure themselves against poor investment performance by using some of their already high salaries and option-based compensation to buy fixed annuities that would provide them with guaranteed payments. If only one of the two groups were to receive defined-benefit plans, arm’s-length contracting would predict that group to be nonexecutive employees, not executives.

B. Camouflage Benefits

Although the efficiency benefits of providing executives with defined-benefit SERPs are far from clear, such plans do considerably reduce the visibility of a substantial amount of performance-insensitive compensation.

SERP payments are usually based on years of service and pre-retirement cash compensation. The higher the executive’s salary and the longer the period of employment, the higher the payout. SERP payments—like salary—are therefore largely decoupled from the executive’s own performance. Many firms have also credited executives with years they did not actually serve, ratcheting up the final payout under the plan’s formula.28

In their annual public filings, firms must publish a summary compensation table indicating the dollar value of different forms of compensation received by the current CEO and the four other highest-paid executives of the firm. The numbers in these tables are the most visible indicators of executive compensation in public firms. They are easily accessible to the media and others reading the public filings. Indeed, the standard databases of executive compensation, which are used by both financial economists and compensation consultants, are based on these numbers.

If an executive’s pensions were structured as a defined contribution plan, the firm’s annual contributions to the executive’s account would be reported in the summary compensation table. An important camouflage benefit of SERPs is that the annual increase in the present value of an executive’s defined benefit plan—due to pay raises and the addition of another year of service—is largely hidden from view: firms are not required to include this increase in value in the compensation tables. A person examining the compensation tables would not see the steady buildup in value of an executive’s SERP.

Furthermore, and importantly, disclosure requirements require firms to include in their summary compensation tables only amounts paid to their current executives. Because the executives are no longer employed by the firm when the pension payments begin, the payments need not be included in the published tables. Thus, the value of an executive’s defined-benefit SERP never

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28. See, e.g., Mike Blahnik, A Credit for Work Not Served; Years Added to Pensions as Part of Executives’ Job Perks, STAR TRIB. (Minneapolis), May 18, 2003, at 1A.
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appears in the place where the media and researchers collect most of their information about executive compensation. In addition, because the value of an executive's pension payouts is obscured, the performance insensitivity of such payments also gets little notice.

Consider a situation in which a CEO serves a company for ten years and then receives annually, for life, a payment that equals a large fraction of the salary earned during the last year of service. In such a case, the total value of the pension payments may in the end exceed the total value of the salary received during the CEO's actual tenure. Unlike the salary amounts, however, the value of the pension payments will never appear in the firm's published compensation tables.

For example, when IBM CEO Louis Gerstner retired after about nine years of service, he was entitled to a $1,140,000 annual pension beginning at age sixty.29 The actuarial value of this annuity was of a similar order of magnitude as the approximately $18 million in salary he received during his nine years as CEO. IBM, however, was not required to include the pension in the summary compensation table or even place a dollar value on it.30

Not surprisingly, SERP plans are designed and marketed specifically as ways to increase compensation "off the radar screen of shareholders."31 Indeed, according to media reports, some directors have voted to adopt SERPs only after being reassured that the amounts involved do not have to be reported to the public.32

To be sure, although neither the increase in value of the SERP plan before retirement nor the amount of payments after retirement appears in the compensation tables, the existence of SERPs, and the formulas under which payouts are made, must be disclosed in the firm's SEC filings.33 But it is

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32. The Star Tribune reported that the HealthPartners board adopted a SERP for the CEO "after receiving assurances that the supplemental retirement plan wouldn't have to be reported to the public" and "rejecting a suggestion that awards in the plan be tied to company performance." Glenn Howatt, HealthPartners Ex-CEO Reaped Board's Favors; Secret Deals Contributed to 55.5 Million Package, STAR TRIB. (Minneapolis), Jan. 17, 2003, at 1A.
33. In addition, firms are required to file a letter with the Labor Department indicating the number of executive pension plans and the number of participants. However, not all firms comply with this requirement. Ellen E. Schultz, Big Send-Off: As Firms Pare Pensions for Most, They Boost Those for Executives, WALL ST. J., June 20, 2001, at A1.

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difficult for anyone without actuarial or financial training to estimate with precision the value—and thus the cost to the company—of these future payments. As noted above, firms are not required to supply, and usually do not provide, any estimate of the dollar value of a particular executive’s defined-benefit pension plan. The lack of easy access to the monetary values of these substantial benefits presumably explains their absence from the standard databases used for research on executive compensation.

Indeed, it is often difficult even to figure out the total SERP liability of a firm with respect to its executives as a group. A firm must report only one figure: the sum of the liabilities associated with all of its employee pension plans that are “unfunded” or “underfunded” (that is, plans for which the firm does not have assets set aside to cover the plans’ liabilities fully). The Financial Accounting Standards Board (FASB) does not require that liabilities associated with SERPs be itemized separately. Thus, firms can simply report one number that represents all the liabilities associated with underfunded qualified plans and unfunded SERPs.

Although they are not required to do so, some firms do report the total obligations arising under SERPs. These figures can be staggering. In 2000, for example, GE reported a $1.13 billion pension liability for all of its executives. Unfortunately, GE did not report what portion of this amount was due specifically to its CEO and other top executives. Most companies do not even break down pension liabilities into separate categories for executives and other employees.

It is worth noting at least one way in which executives’ plans may not be as advantageous to their beneficiaries as the plans of lower-level employees. Firms using qualified plans are required, as a condition for favorable tax treatment, to set aside assets to ensure that they can pay their liabilities under the plans. Given that executives’ SERP plans would not qualify for the favorable tax treatment even if they were so funded, firms do not bother funding SERP plans. Executives’ retirement benefits are thus at greater risk of nonpayment than the benefits of ordinary workers—and Congress is considering legislation that would make it difficult for firms to shelter executives from this risk.

37. Schultz, supra note 33.
38. In June 2004, the U.S. House of Representatives passed the American Jobs Creation Act of 2004, which penalizes firms using certain types of trusts to protect deferred compensation from the
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In the past, however, firms facing financial problems have often purchased insurance policies that guaranteed payment of executive retirement benefits, transferred the money to a designated trust, or taken other steps to guarantee the benefits against insolvency.\(^3\) Delta Airlines, for example, set up an executive-protecting arrangement shortly after September 11, 2001, when the solvency of the airline industry appeared to be in danger.\(^4\) Although putting the money beyond the reach of the firm’s creditors triggers a tax liability for the executive, firms often “gross up” the payment to cover part or all of that liability.\(^4\) It was reported in 1991 that approximately fifty major companies had set up fully guaranteed executive pension plans.\(^2\) This practice may have been much more widespread; many firms, fearing criticism that they are insulating managers from the effects of their own failures, have failed to announce the existence of such guarantees.\(^4\)

IV. DEFERRED COMPENSATION

Deferred compensation is a second technique used to transfer large amounts of mostly performance-insensitive value to executives without attracting much shareholder attention. Many firms offer programs that permit executives, or sometimes even require them, to defer receipt of compensation until some future date. In the meantime, the deferred compensation “builds” according to a formula devised by the firm. Executives do not pay taxes on the original compensation or on the accumulated increase until they receive payment, which often occurs after they leave the company. At that time, the firm takes a tax deduction for the amount paid. Most large companies have plans of this kind.\(^4\)

Deferred compensation plans can take different forms. Some firms require that managers receiving salary in excess of $1 million, which would otherwise be nondeductible under Section 162(m) of the Internal Revenue Code, defer the excess. Other firms have purely elective plans. Some arrangements permit

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40. Francis & Schultz, supra note 39.
41. Id.
42. Suskind, supra note 39.
43. Id.
44. Clark Consulting reports that close to 93% of firms responding to a survey said they had such plans in 2002. Clark Consulting, supra note 21.
deferral of salary only, while others also allow deferral of long-term incentive compensation and gains from the exercise of stock options or from the sale of restricted stock. Companies frequently provide matching contributions, with the amounts varying from firm to firm. At some companies, contributions are awarded at the board’s discretion. At others, they are determined by formulas.45

Plans also differ in how the deferred compensation is “invested,” that is, how the amount owed to the executive at the end of the deferral period is determined. Many companies provide a guaranteed rate of return (or a guaranteed minimum rate) on the funds.46 Firms have often granted extra benefits to executives by providing rates of return that are higher than the market rate. For example, in 2001, at a time when one-year Treasury bills offered returns of 3.39% to 4.63%, both GE and Enron guaranteed executives a 12% rate of return. Other firms have offered a market return plus a premium. For example, Lucent has offered the return on the ten-year Treasury bill plus 5%.47 Congress is now considering legislation aimed at preventing firms from providing executives with above-market returns in their deferred-compensation plans. Although the adoption of such legislation would eliminate this particular benefit to managers, deferred compensation plans would still provide executives with significant other financial and camouflage advantages as we discuss below. Part IV.A identifies the differences between executive deferred compensation arrangements and the 401(k) plans offered to other employees. Part IV.B describes the camouflage benefits of executive deferred compensation arrangements.

A. Differences from 401(k) Plans

Deferred-compensation arrangements appear analogous to the familiar 401(k) plans used by many employees. But, just as SERPs differ from the qualified retirement plans offered to lower-level employees, there are some important differences between executives’ deferred compensation and 401(k) plans.

To begin with, the 401(k) plans give workers an opportunity to put money in designated investment instruments; whatever the investments, employees get the same pretax returns they would receive by investing in similar instruments outside the 401(k) plan. In contrast, executives’ deferred-compensation arrangements often provide higher returns than those available in the market.

In addition, 401(k) plans are given a tax subsidy, while executive deferred-

45. For example, when Sears, Roebuck & Co. executives postpone bonuses and long-term incentive pay, they receive an additional contribution equal to 20% of the amount deferred. Ellen E. Schultz & Theo Francis, Buried Treasure: Well-Hidden Perk Means Big Money for Top Executives, WALL ST. J., Oct. 11, 2002, at A1, A9.
46. Weston, supra note 31.
47. Lublin, supra note 34; Weston, supra note 31.
compensation plans are not. Under a 401(k) plan, a fraction of the employee's salary is placed in a tax-deferred account. The firm may also make a separate contribution to the account. As in a qualified retirement arrangement, the funds are invested and grow tax-free. Neither the firm nor the employee pays taxes on the income and capital gain generated in the account. Employees do not pay taxes on the contributions or the increase until they withdraw the funds. The employer, on the other hand, gets a deduction for both its contribution and the employee's contribution to the 401(k) plan. By placing current compensation in a 401(k) account, the employee gains the benefit of tax deferral without the employer's loss of a tax deduction.

Firms could provide deferred compensation to executives through 401(k) plans. However, there are limits on how much money can be contributed annually to a 401(k) account. For the tax year 2004, employees covered by such a plan ordinarily cannot defer more than $13,000 of compensation. In order to provide executives with amounts exceeding this limit, firms implement deferred-compensation arrangements outside the tax-advantaged framework of 401(k) plans. Executives' deferred compensation is therefore not based solely, or even primarily, on 401(k) plans.

Rather than contribute a portion of the executive's compensation to an account where the investment grows tax-free, the firm simply withholds part of the executive's pay and credits the executive each year with a prespecified return on the money, allowing it to "grow" over time. The withheld compensation, along with the appreciation credited to it by the firm, is paid to the executive at a later date.

The company pays taxes on the income it must generate in order to pay the executive the promised buildup of the deferred compensation. If, on the other

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48. To illustrate how the tax subsidy provided to a 401(k) operates, consider the following examples involving a hypothetical firm and employee. As in the SERP examples found in note 20 (examples 1 and 2), assume that both the firm and the employee face a 40% tax rate on all of their income. Assume also that both are able to earn, between the pre-retirement and retirement periods, a pretax return of 100% on their investments.

Example 4: The employee saves outside the 401(k) plan. Suppose the firm pays the employee $100 in the pre-retirement period. The firm deducts $100 from its taxable income, reducing its tax liability by $40. The employee pays $40 in taxes, and invests the aftertax income of $60 in an ordinary, nonqualified investment account. By the retirement period, the $60 grows to $120—a gain of $60. The employee pays a tax of $24 on the gain (40% of $60), leaving the employee with $96—$24 more than in example 4, where the employee received $100 from the firm in the preretirement period and saved the money outside the 401(k) plan. The $24 gain to the employee does not come at the expense of the employer. In both examples, the employer pays the employee $100 in the pre-retirement period, thereby reducing its taxable income by $100 and its tax liability by $40.

Example 5: The employee saves under a 401(k) plan. Now suppose that the employee contributes $100 of compensation income to a 401(k) account. The firm again deducts $100 from its taxable income, reducing its tax liability by $40. The $100 grows to $200 by the time the employee withdraws the funds from the 401(k) account. The employee pays a tax of $80 (40% of $200), leaving the employee with $120—$24 more than in example 4, where the employee received $100 from the firm in the preretirement period and saved the money outside the 401(k) plan. The $24 gain to the employee does not come at the expense of the employer. In both examples, the employer pays the employee $100 in the pre-retirement period, thereby reducing its taxable income by $100 and its tax liability by $40.

49. I.R.C. § 402(g)(1)(B).
hand, the deferred compensation had been distributed when it was originally owed the executive, the executive would have invested the money and paid taxes on any income or capital gains subsequently generated. Thus, as in the case of a SERP, the effect of executive deferred compensation is to shift some of the executive's tax burden to the firm.\footnote{A company can shelter from taxation investment income on funds set aside for financing executive pensions by investing these funds in insurance policies on the lives of its executives and other employees, but this will impose other costs on the firm. See SCHOLES ET AL., supra note 24, at 181-85.}

If the employee and the firm are subject to the same tax rate and are able to earn the same pretax rate of return on their investments, executive deferred compensation, like a SERP, cannot reduce the parties' joint tax burden. While every dollar of deferred compensation lowers the executive's taxes, it boosts the firm's taxes by one dollar. Like a SERP, and unlike qualified 401(k) and retirement plans, deferred-compensation plans for executives provide no tax-efficiency benefit when the firm and the executive share the same tax rate and investment opportunities.\footnote{To illustrate the effect of executive deferred-compensation arrangements on the tax burdens of the parties, consider the following example and explanation, which refer to examples 4 and 5 provided in note 48.}

As in the case of SERPs, of course, there will be many cases in which deferred compensation outside 401(k) plans can increase or reduce the total amount of value available to the executive and the firm.\footnote{For an explanation of the tax effects of deferred compensation under various scenarios, see SCHOLES ET AL., supra note 24, at 181–85.} The firm and the executive may face different tax rates. Even if the firm and the executive face

\begin{example}
6: The firm offers the executive deferred compensation outside a 401(k) plan. Assume, as in examples 4 and 5, that both the firm and the executive face a 40% tax rate on all of their income, including capital gains. And assume that both are able to earn, between the pre-retirement and retirement periods, a pretax return of 100% on their investments.

Suppose the firm seeks to use deferred compensation to give an executive the same (100%) return that the firm provides the employee in example 5 using a 401(k) plan. As in the case of the employee, the firm sets aside $100, which grows to $200 by the time the executive withdraws the deferred compensation and the buildup credited to the designated amount of deferred compensation. The $200 is distributed to the executive. Like the employee, the executive pays 40% tax on the retirement distribution—a tax of $80. This leaves the executive, like the employee in example 5, with $120, or $24 more than the employee saving on his own ended up with in example 4.

Now, let us consider the effect of the executive's deferred compensation arrangement on the firm. In examples 4 and 5, the firm reduces its tax liability by $40 in the pre-retirement period when it pays the worker $100 or contributes $100 to the worker's qualified pension plan. In example 6, the firm reduces its tax liability by $80 in the retirement period when it pays the executive $200. However, the firm must add to its taxable income in the retirement period the $100 generated to boost the executive's withdrawal payout from $100 to $200—which in turn increases the firm's tax liability by $40. The net effect of the $100 gain and the $200 payment to the executive is to reduce the firm's tax liability by $40 during the retirement period. The firm is thus worse off than in example 2, where it received the same reduction in its tax liability in the pre-retirement period.

Had the firm reduced its tax liability by $40 in the earlier period, it could have invested the $40 and earned a pretax return of $40 (100%) by the retirement period. The $40 would have been taxed at 40%, leaving the firm with $64. By reducing its tax liability in the retirement period, the firm has only an extra $40, or $24 less. Thus, the $24 gain to the executive from the use of a deferred-compensation arrangement designed to put the executive in the same position as an employee under a qualified 401(k) comes at the expense of the firm.

\end{example}
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the same tax rate, the investment returns available to the firm may be higher than those available to the executive (although, as we noted in our discussion of SERPs, this is unlikely to be the case for companies with easy access to capital). However, there is no reason to believe that, absent the tax subsidy provided by qualified plans, there is generally a benefit to the parties when the firm defers the executive’s compensation. In many cases, the tax burden on the firm is greater than the tax benefit to the executive, increasing the total tax that the two parties pay to the government.

Consider, for example, the case in which an executive of a profitable company is promised a return that is linked to a stock index. If the executive invests the money in shares of a stock index fund, the gains will be taxed at the long-term federal capital-gains rate, which in the highest bracket is 15% (as of 2004).\(^3\) If, instead, the firm invests the money—in those shares, other investments, or its own business—the gains could be taxed at the marginal corporate rate of 35%.\(^4\)

Thus, it is puzzling that over 90% of firms offer deferred-compensation programs to their executives.\(^5\) As in the case of SERPs, there are good reasons to think that, in many firms, such programs are not an efficient form of compensation. It is curious that firms offering nonqualified deferred-compensation arrangements to executives do not offer such nonqualified plans to other employees. After all, if nonqualified deferred compensation is an efficient form of compensation for the executives of certain firms—say, because the firms have better investment opportunities than the executives—nonqualified deferred compensation should also be an efficient form of compensation for the nonexecutive employees of these firms. But firms rarely, if ever, provide nonexecutive employees with the option of nonqualified deferred-compensation arrangements in addition to their 401(k) plans. This pattern suggests that, in most cases, offering nonqualified deferred compensation to an executive does not increase the joint wealth of the executive and the firm.

\(^3\) I.R.C. § 1.

\(^4\) I.R.C. § 11. As in the case of SERPs, a firm can reduce the tax cost of deferred compensation by using company-owned life insurance. Under this strategy, the firm uses after-tax dollars to buy insurance on the lives of its executives and other employees. Part of the premium is invested, increasing the “cash value” of the policy. The policy is then cashed out when funds are needed to pay deferred compensation. The tax savings come from life insurance policies’ capacity to shelter from taxes the buildup of the cash value. However, because the insurance company charges fees, the use of a life insurance policy to avoid taxes gives rise to transaction costs. A 1996 study found that 70% of the 1,000 largest firms did not use insurance for funding deferred compensation, which suggests that these costs can be quite high. See Christopher Drew & David Cay Johnston, Special Tax Breaks Enrich Savings of Many in the Ranks of Management, N.Y. TIMES, Oct. 13, 1996, § 1, at 1.

\(^5\) Clark Consulting, supra note 21, at 2.
B. Camouflage Benefits

While it is far from clear that deferred-compensation arrangements provide efficiency benefits, their camouflage value is substantial. The compensation being deferred must be reported in the summary compensation table in the year in which it would otherwise have been received. However, the substantial benefits that have been conferred by the deferred-compensation plan—the tax-free (and sometimes above-market) buildup over time—are not evident to outsiders.

Even assuming that the nominal rate of return used by a deferred-compensation arrangement is no higher than the market rate, the effective interest rate earned by executives is higher than it appears because of the substantial tax benefits. Executives must pay taxes on investment income earned outside deferred-compensation arrangements, but investing within such plans provides them—at the expense of the firm—with a tax-free buildup. Thus, as long as the rate of return in deferred-compensation arrangements is above the executive’s after-tax rate of return, the executive makes substantial gains that do not show up in the compensation tables. The New York Times reported, for example, that CEO Roberto Goizueta of Coca-Cola was able to defer taxes on $1 billion of compensation and investment gains over a seventeen-year period. Coca-Cola picked up the tab, paying taxes on the earnings needed to cover the returns credited to Goizueta’s deferred-compensation account.

Furthermore, while 401(k) plans offer lower-level workers returns equivalent to those available in the bond or stock markets, many deferred-compensation arrangements have provided executives with substantially higher returns. These executives have thus received investment income that was not only tax-free for them (at the expense of the firm) but also above-market. The benefits from these above-market returns have also been hidden to a significant extent.

The SEC requires firms to include in the summary compensation table the above-market interest earned that year by each executive on deferred compensation. In the case of a guaranteed interest rate, “above-market” interest is defined as returns in excess of 120% of the applicable federal rate (AFR) used by the IRS at the time the guaranteed interest rate is set, multiplied by the amount of deferred compensation. By exploiting the SEC’s definition of “above-market rate,” firms have sometimes been able to provide their executives with rates of return that are higher than those they could get on their own without including this benefit in the compensation tables.

57. According to Coca-Cola’s annual reports to shareholders, it paid taxes on its income in every year of Goizueta’s tenure except in 1992.
The threshold used by firms for “market” long-term rates of return is especially generous because boards can reset interest rates whenever doing so benefits executives. If market interest rates and the AFR rise so that the current guaranteed rate is not especially attractive, the firm can simply adopt a new, higher, guaranteed rate. As long as the reset rate is lower than 120% of the new, higher AFR, the additional interest accruals need not be reported in the summary compensation table. If, however, market interest rates and the AFR fall, the firm can continue to pay at the old guaranteed rate, which is now above market. And because the AFR used for the disclosure threshold is that prevailing when the guaranteed interest rate was initially set, no matter how low market rates drop, the above-market interest paid to the executive never appears in the compensation table.

Finally, even benefits that have come from rates of return exceeding the SEC’s threshold are unlikely to be fully reflected in the compensation tables. The reporting requirement ends when the executive retires, but the executive often has the option to continue enjoying the above-market rates after retirement. Such a stream of post-retirement benefits—which could be quite substantial in value—would never appear in the firm’s publicly filed compensation tables.

As in the case of SERPs, deferred-compensation plans could expose executives to the risk of firm bankruptcy. While 401(k) plans must be backed by their assets, which cannot be seized by the firm’s creditors, deferred-compensation arrangements are simply a promise by the firm to pay compensation in the future. The executives owed this compensation are unsecured creditors who may not be paid in full if the firm becomes insolvent. As in the case of SERPs, Congress is considering legislation that would make it difficult for firms to shield executives from this possibility. To date, however, firms have often taken steps to insulate executives from insolvency risk. Many firms have used “security devices,” such as trusts, to ensure that funds will be available to the executives. In addition, firms have usually permitted executives to withdraw deferred compensation at any time—such as when inside information suggests that a firm is about to fail. Shortly before Enron filed for bankruptcy, for example, its executives withdrew millions of dollars of deferred compensation.

For executives and their friends on the board, SERPs and deferred compensation have been very useful. They have provided a means for channeling large amounts of performance-insensitive compensation in a way that, under current disclosure regulations, has not been highly visible to outsiders. As one compensation analyst pointed out: “The disclosure of the myriad executive compensation plans—pension, supplemental executive retirement plans, deferred compensation, split-dollar life insurance—is not adequate in answering a fundamental question: what is the projected value of
these plans to the executive upon his retirement?"58

V. POST-RETIREMENT PERKS AND CONSULTING CONTRACTS

We now turn to consider the use of post-retirement perks and consulting contracts to convey a significant amount of performance-decoupled value to executives in a way that is not transparent to shareholders. Part V.A describes some of the perks provided to executives and explains why they are unlikely to result from arm's-length bargaining between the parties. Part V.B examines the use of post-retirement consulting agreements.

A. Perks

Many compensation contracts promise executives a substantial stream of perks after retirement. For example, many executives receive a certain number of hours of corporate aircraft use annually for themselves, and sometimes for their families and guests as well. Some executives have even received unlimited lifetime use of corporate aircraft.59 Other perks that often follow the executive into retirement include chauffeured cars, personal assistants, financial planning, home-security systems, club memberships, sports tickets, office space, secretarial help, and cell phone service.60 Outgoing IBM CEO Louis Gerstner, for example, was given access to apartments, planes, cars, home-security services, and financial planning. Terrence Murray, former CEO of FleetBoston, received 150 hours of company aircraft use, a chauffeured car, an office, office assistants, financial planning, and a home-security system.

Another common benefit is giving contributions to charities designated by the retiring executive. FleetBoston gave retiring CEO Murray the ability to direct $3.5 million of the firm's charitable contributions to Murray's favorite institutions.61 In addition, Ford promised retiring CEO Jacques Nasser to endow a scholarship in his name at the educational institution of his choice (in addition to providing Nasser a new car each year, financial-planning assistance, an office, and an assistant).62

Most of these perks cost the company more than may be apparent at first

60. See Lublin, supra note 34; Gary Strauss, CEOs Cash In After Tenure, USA TODAY, Apr. 25, 2002, at 1B.
glance. Consider retiree use of corporate jets, now a common perk. Although
the marginal cost of allowing a retired executive to use the company jet may
appear limited,\textsuperscript{63} it can run quite high. Consider the use of a company plane for
a flight from New York to California and then back several days later. Because
the New York-based aircraft and flight crew will return to the East Coast after
dropping the retired executive off, the actual charge to the company is two
round trips: a total of eight takeoffs and landings and approximately twenty
hours of flying time, most likely costing—for fuel, maintenance, landing fees,
extra pilot and crew fees, incidentals, and depreciation (an aircraft’s operating
life is reduced for every hour it flies and, more important, for every takeoff and
landing)—at least $50,000.\textsuperscript{64} Henry R. Silverman, CEO of Cendant, was
promised lifetime use of the corporate aircraft or, if the plane was in use, an
equivalent chartered plane at a direct cost of thousands of dollars per hour.\textsuperscript{65}

Firms usually do not provide post-retirement perks to nonexecutive
employees. There is good economic logic to avoiding such in-kind
compensation. Promising a retiring employee $10,000 a year for certain travel
expenses is less efficient than providing $10,000 in cash. The reason is
straightforward. If the retiree views travel as the best way to spend $10,000, the
cash and the travel coverage will have identical utility. However, cash is
superior if there are any possible circumstances in which the retiree would
prefer spending some or all of the money on goods or services other than travel,
because the retiree will receive greater utility at the same cost to the firm.

A retiree’s needs and preferences are likely to change over time. Thus,
economic logic suggests that if in-kind retirement benefits are provided, they
should not be provided for long periods. Yet such long-term, in-kind benefits
are often provided to retired CEOs: for example, Louis Gerstner of IBM
received use of a plane, cars, offices, and financial planning services for ten
years.\textsuperscript{66}

Although post-retirement perks are unlikely to be an efficient form of
compensation, they offer an effective means of camouflaging compensation.
The value of post-retirement perks is not reported when they are agreed to, and
the firm incurs costs only after the executive has left, at which point any value
provided is no longer included in the salient summary compensation table.
Post-retirement perks thus offer yet another way of providing additional value
to executives without ever having to include the benefits in compensation
tables or even place a dollar value on them.

\textsuperscript{63} This misperception led one compensation consultant, Yale D. Tauber, to label jet use as “an
efficient way of delivering something of value to the executive.” Lublin, supra note 34.

\textsuperscript{64} We thank Marc Abramowitz and Yitz Applebaum for useful discussions on the cost of
operating corporate jets.

\textsuperscript{65} Minow, supra note 59.

\textsuperscript{66} Strauss, supra note 60.
Firms in the past have sometimes grudgingly provided vague descriptions about post-retirement perks, but these descriptions did not generally allow shareholders to form a good picture of the scope and value of these benefits. For example, former General Electric CEO Jack Welch received approximately $2.5 million in benefits in his first year of retirement, including access to GE aircraft for unlimited personal use and for business travel, exclusive use of a furnished New York City apartment, and unrestricted access to a chauffeured limousine (among other things). However, GE's proxy statements revealed only that in retirement Welch would be entitled to "continued lifetime access to Company facilities and services comparable to those that are currently made available to him by the Company." Thus, GE not only failed to put a dollar value on the perks, but did not bother even to describe them.

B. Consulting Contracts

Like perks, consulting contracts provide substantial value to retired executives. They usually offer the retiring CEO an annual fee for "being available" to advise the new CEO for a specified amount of time per year. Approximately 25% of CEOs negotiate a post-retirement "consulting" relationship with their old firm.

For example, AOL Time Warner is paying retired CEO Gerald M. Levin $1 million a year to serve as an adviser for up to five days a month. In 2000, retiring Carter-Wallace CEO Henry Hoyt was promised annual payments of $831,000 for a similar monthly obligation. Verizon co-CEO Charles Lee negotiated a $6 million consulting contract for the first two years of his retirement. Delta Airlines CEO Ronald Allen's 1997 retirement package provided him with a seven-year, $3.5 million consulting deal under which, according to Delta's public filings, he was "required to perform his consulting services at such times, and in such places, and for such periods as will result in the least inconvenience to him." Allen or his heirs will be entitled to the annual fee of $500,000 even if he is totally disabled or dies.

These consulting arrangements provide flat, guaranteed fees for the retired executive's "being available" rather than payment for work actually done, and for a good reason: companies generally make little use of the availability for

68. Id.
69. Strauss, supra note 60 (quoting Ira Kay of consulting firm Watson Wyatt).
70. Lublin, supra note 62.
71. Strauss, supra note 60.
72. Id.
73. Lublin, supra note 62.
which they pay generously. For better or worse, new CEOs are usually not inclined to seek advice from their predecessors. Allen, for example, reportedly “rarely talks” with the new Delta chief executive, Leo Mullin. Even compensation consultants acknowledge that retired executives add little if any value to the firm under these arrangements. According to Frank Glassner, CEO of Compensation Design Group, most of these consulting contracts are merely a way of increasing the severance payment to the departing executive. According to another executive compensation expert, Alan Johnson, “Most former CEOs are doing very little for what they’re getting paid . . . . Usually, the demands [from new management] are miniscule.”

Like post-retirement perks, the consulting payments to retired executives never find their way into the summary compensation tables because they are provided when the executives are no longer officers. However, in contrast to post-retirement benefits, these contracts enable boards to provide retired executives with cash rather than in-kind benefits. Retirement consulting fees are essentially a cash severance payment, turned over in installments, disguised as compensation for post-retirement work.

If these fees are just a form of cash severance, what is the advantage of packaging them as consulting agreements? Besides ensuring that the payments are kept out of the compensation tables, dressing them up as consulting fees obscures their nature as severance payments that essentially increase the total compensation received by executives for their pre-retirement work. Some observers might believe that the outgoing CEO will in fact provide valuable advice to new management, and therefore view the payments as legitimate consideration for post-retirement services. Needless to say, these consulting agreements do not tie the retired executive’s pay to any personal contribution to shareholder value either before or after retirement.

VI. TRANSPARENCY

A. The Critical Role of Transparency

We turn in this Section to discussing the policy implications of our study. Our study highlights the importance of making compensation arrangements in general, and compensation via retirement benefits in particular, transparent to public investors. Although we argue elsewhere for reforms that would increase

74. Id.

75. Of course, there are cases where even these outlays are hidden by the provision of in-kind value rather than cash. For departing CEO Hugh McColl’s continuing “advice and counsel,” Bank of America is providing him or members of his family with 150 hours of flying time on corporate aircraft. See Strauss, supra note 60. This perk has a value of $500,000 or more.
shareholder power, shareholders do already have some power. This power is in part why the outrage constraint matters. The greater outsiders' understanding of compensation arrangements, the tighter the outrage constraint. Improving the transparency of compensation arrangements is therefore desirable.

Financial economists have paid insufficient attention to transparency because they often focus on the role of disclosure in getting information incorporated into market pricing. It is widely believed that information can be reflected in stock prices as long as it is known and fully understood by even a limited number of market professionals.

In the case of executive compensation, there is already significant disclosure. As we have discussed, SEC regulations require detailed disclosure of the compensation of a company's CEO and of the four most highly compensated executives other than the CEO. In our view, however, it is important to recognize the difference between disclosure and transparency, and it is transparency that should receive more attention.

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

The ability of plan designers to favor managers depends on how compensation arrangements are perceived by a wide group of investors and other outsiders. Because of market forces and social dynamics, managers and directors are concerned about disapproval (threatened or actual) from institutional investors or other reference groups, such as the business press or popular media. We have seen that compensation designers often seek to make the amount of pay, or the extent to which pay is decoupled from performance, less transparent. For disclosure to constrain compensation effectively, the disclosed information must reach more than just a select group of market professionals and arbitrageurs. Raw facts buried in a mountain of technical disclosure probably will not suffice. The salience of disclosure and degree of transparency are important.

B. Putting Retirement Benefits on the Radar Screen

Public officials and governance reformers, therefore, should work to ensure that compensation arrangements are and remain transparent. Having shown that pensions, deferred compensation, and post-retirement perks and consulting contracts have been used to camouflage a significant amount of performance-

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76. See BEBCUK & FRIED, PAY WITHOUT PERFORMANCE, supra note 1, at ch. 16.
decoupled compensation, we now put forward several proposals designed to put these forms of compensation on investors’ radar screens.

As we explain in more detail below, firms should be required to report each year the (present) dollar value of the future benefits to which executives become entitled during the year in connection with SERPs, deferred compensation, and post-retirement perks and consulting arrangements. These monetary values should be included in the firm’s annual summary compensation table. The SEC should also require firms to provide a separate table disclosing the present value of all the retirement benefits—SERP payments, deferred compensation balances, and post-retirement perks and consulting arrangements—to which the CEO and other high ranking executives would be entitled were they to separate at year end (under each of the various termination scenarios contemplated in their employment contracts). Before proceeding, it is worth noting that SERPs, deferred compensation, and post-retirement perks and consulting contracts are not necessarily the only forms of stealth compensation. Firms have provided—and will continue to look for ways to provide—other forms of stealth compensation. Thus, while our proposals will substantially reduce the ability of firms to provide stealth compensation, they will not eliminate it completely.

**Disclosing the Full Details of Executive Compensation Contracts.** Firms should be required to disclose in their annual proxy filing the full text of the most recent versions of the employment contracts that the firm has entered into with high-level executives. Firms often file such agreements with forms other than the annual proxy statement that are not as closely followed. Requiring firms to attach executive compensation contracts to their most important SEC filing, which contains the summary compensation table and other key details about compensation, will make executive compensation agreements more accessible and salient.

However, requiring firms to disclose in an accessible and salient way the text of executive compensation contracts is far from enough. While experts who take the time to do so may be able to calculate the monetary value of the various forms of stealth compensation provided in these contracts, these values are not as transparent to investors as the dollar values reported for many other forms of executive compensation. To make the information contained in these compensation contracts more transparent and accessible, firms should be required to attach monetary values to each of the types of compensation we have discussed. That is, the SEC should require firms to report compensation via retirement payments, deferred compensation, and post-retirement perks and consulting contracts in the same manner as other forms of compensation: by putting a dollar value on these amounts and including them in the compensation tables accompanying firms’ proxy filings. We explain below, for each type of retirement benefit we have discussed, how this can be accomplished.
SERPs. As we explained, SERP payouts are generally based on years of service and historic compensation levels. The actuarial value of SERPs therefore usually increases each year. The annual buildup in value of an executive’s SERP is not, under current rules, reported in firms’ annual summary compensation tables. Nor are the payments themselves, which are made after the executive retires.

We propose requiring firms to add a column in the annual summary compensation table for SERPs. This column would indicate, for each of the firm’s highest-paid executives, the amount by which the actuarial value of the executive’s SERPs increases each year. Firms should also provide an accompanying explanation of the reasons for the increases in actuarial value reported in the compensation tables.

Deferred Compensation. Recall that firms currently must report in the publicly filed summary compensation tables only “above-market” returns credited to executives’ deferred compensation accounts. As we explained, however, firms have been able to exploit the SEC’s definition of “above-market” to provide above-market returns without disclosing them in the compensation tables. Moreover, firms have not been required to report the tax benefit to the executive—which comes at the expense of the firm—provided by deferred compensation arrangements.

We propose adding disclosure requirements that would provide outsiders with a clear and full picture of the gains to executives from deferred compensation programs. Firms should be required to disclose each year the value of an executive’s deferred compensation account at the beginning of the year, the amount of earnings credited to this account by the end of the year, and the basis on which these earnings were determined. This information will enable outsiders to decide for themselves whether and to what extent executives enjoy above-market returns.

Firms should also report to investors the tax cost to the firm of covering the earnings. For example, if a firm in the 33% tax bracket credits $600,000 to an executive’s deferred compensation account, the firm should disclose not only the $600,000 credited to the account, but also the $300,000 in taxes that the firm must pay on the $900,000 in pre-tax income needed to cover the $600,000 earnings credited to the executive’s account.

Finally, it is necessary to ensure that summary compensation tables include the full monetary value executives derive from deferred compensation. We propose that compensation tables include a column reporting this monetary value. In calculating this value, firms should be required to regard as “above-market” any returns exceeding the AFR—not only returns exceeding 120% of this rate. For this purpose, firms should be required to use the AFR for short-term loans in effect at the beginning of the firm’s fiscal year. Furthermore, and perhaps more importantly, the monetary value included in the compensation
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tables should include any gains to the executive that come from having returns accumulate tax-free at the company's expense.

Post-retirement Perks and Consulting Contracts. Post-retirement perks and consulting contracts never appear in the summary compensation tables because the value is provided to the executive after she retires. This is the case even when such arrangements are promised in the executive's contract long before the executive retires—either when she is initially hired or later when she negotiates a new contract.

The SEC should modify the compensation tables to include a column for post-retirement perks and consulting contracts. Firms should be required to report, in this column, the actuarial present value of post-retirement perks and consulting contracts promised to executives. Critically, these amounts should be disclosed as soon as the executive is promised these payments—not when the payments are made and the executive is already out the door. Thus, for example, if an incoming CEO negotiates a package that includes the use of a corporate jet for ten years after he retires, the firm should place a dollar amount on the value of this arrangement and include that amount in the entry for non-SERP retirement payments.

Disclosing the Retirement Kitty. The proposals we have just offered would require firms to report the compensation executives receive each year in the form of buildup in pension value, earnings, and tax benefits associated with deferred compensation, and promises of post-retirement perks and consulting contracts. In addition, firms should be required to put all this information together to provide a complete picture of how much the executive would receive from the firm if she were to separate at the end of the year, under each of the termination scenarios described in her employment contract.

In particular, the SEC should require firms to publish a table showing the actuarial value of each high ranking executive's SERP at the end of the year, the balances in any deferred compensation accounts, and the value of any post-retirement perks and consulting contract to which the executive would be entitled if she were to resign, retire, or otherwise separate from the firm at year's end. This picture will better enable shareholders to form a judgment as to whether it is necessary for the firm to continue spending money to ensure that the executive has a comfortable retirement. The table will also enable shareholders to easily see whether executives will enjoy a "soft landing" even if they are pushed out for failure.

We should emphasize that a retirement-payout table is not a substitute for our proposals to expand the annual summary compensation tables to include the yearly monetary value associated with SERP buildup, deferred compensation programs, and promises of post-retirement perks and consulting contracts. These measures are necessary to make transparent to investors how much executives have been paid during the past year, as well as to help
investors estimate the relationship between annual pay and the executives' own performance. In contrast, the retirement-payout table is necessary to make transparent to investors the extent, if any, to which it would be necessary for subsequent pay packages to provide executives with additional retirement benefits.

 Transparency and Improved Compensation Arrangements. The measures above would provide shareholders with a more accurate picture of total executive compensation. They will thereby reduce the total amount of compensation executives could get below the radar screen. These measures could thus help constrain total compensation levels. More importantly, these measures also would reduce the distortions that arise when companies choose particular forms of compensation for their camouflage value rather than for their efficiency. Improving transparency in this area could thus substantially increase shareholder value.

Our analysis has focused on the most important forms of stealth compensation via retirement benefits that have been used by firms to date. Of course, designers of compensation plans may find and use new ways to make compensation, or its insensitivity to performance, more opaque. As new practices (and new means of camouflage) develop, disclosure arrangements should be updated to ensure transparency. Regulators adopting the measures we propose should continue to monitor compensation arrangements and to refine disclosure requirements as new ways of making pay less salient are developed.

VII. CONCLUSION

This Article has explained how retirement benefits and payments have been used to camouflage the payment of large amounts of performance-insensitive compensation to executives of public companies. Our study has highlighted the significant role that camouflage and stealth compensation play in the design of compensation arrangements, as well as the importance of ensuring that information about compensation arrangements be communicated in a way that is transparent and accessible to outsiders.

We have also proposed several measures aimed at putting retirement benefits on investors' radar screens. Among other things, firms should make transparent, on a timely basis, both the monetary benefits to executives and the cost to firms of the various arrangements we have described. In particular, the summary compensation table firms must publicly file should include entries that indicate: (1) the amount by which the actuarial value of executives' SERP plans increases each year; (2) the monetary value executives derive that year from the firm's deferred compensation plans, including the value of a tax-free buildup at the firm's expense; and (3) the present value of post-retirement perks and consulting contracts promised to the executives during the year. Firms should also be required to include a separate table showing how much of each
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form of retirement compensation a high ranking executive would receive if she were to separate at the end of the year under each of the termination scenarios contemplated by her contract. By making it more difficult to camouflage pay through retirement benefits, the proposed requirements would contribute to improving compensation arrangements.
A New Product for the State Corporation Law Market: Audit Committee Certifications

Lawrence A. Cunningham†

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† Professor of Law & Business, Boston College. © 2004. All rights reserved. Thanks to Eleanor Bloxham, Tamar Frankel, David Henry, Renee Jones, Malcom Schwartz, Bob Thompson, Rod Ward, and Chuck Yablon.
In the swirling corporate governance reforms led by the Sarbanes-Oxley Act (SOX), the Securities and Exchange Commission (SEC), so-called self-regulatory organizations (SROs), and the Public Company Accounting Oversight Board (PCAOB), states are playing minor roles at best. State absence leaves missing a potentially critical link in the evolving U.S. corporate governance circle. The circle is drawn as follows: state corporation law charges boards of directors with managing corporations and authorizes board committees; SOX charges audit committees with certain tasks, including supervising external auditors; the SEC and SROs require audit committee characteristics like independence and compel disclosure; and the PCAOB now requires external auditors to evaluate audit committee effectiveness. This last step could close the circle except that auditors performing this evaluation generate conflicts with state corporation law, conflicts between auditors and audit committees, and face other limitations. These conflicts and limitations can be neutralized in an audit committee evaluation exercise conducted by newly-created state agencies staffed with experts in state corporation law, such as retired lawyers, judges, or academics. These newly-created state agencies could thus square the newly-forming corporate governance circle.

This Article presents and evaluates this concept. It reviews the central role audit committees play in corporate governance and considers existing mechanisms that promote committee effectiveness—state fiduciary duties, SEC-SRO disclosure rules, and traditional auditing—noting the limits of each. It considers PCAOB’s new auditing standards requiring auditors to evaluate audit committee effectiveness, showing both the perceived need for such an evaluation and the inherent limits on auditor capabilities to render this evaluation effectively. This review leads to state agencies as possible providers of this evaluation and certification. The Article sketches the outlines for creating and running such state agencies. It then assesses the likelihood that this concept would be accepted by various corporate constituents. Likely supporters include users and producers of financial information and the auditing and legal professions. More uncertain is SEC support, given a new model of corporate-governance production in which the SEC uses various instrumentalities, like SROs and PCAOB, to federalize corporate governance. State receptivity depends in part upon and is evaluated according to rival corporation law production models (a race to the top or bottom, interest group,
or state versus federal). The Article concludes by lamenting that in the evolving corporate-governance production model, missing links like this one are unlikely to be corrected by state or federal law—unless private-sector agents likely to support such concepts lobby for them.

INTRODUCTION

Audit committees of corporate boards of directors are central to corporate governance for many corporations. Their effectiveness in supervising financial managers and overseeing the financial reporting process is important to promote reliable financial statements. This centrality suggests that it is likewise important for investors and others to have a basis for justifiable confidence in audit committee effectiveness. At present, there is no such mechanism. This Article explains why, considers a way states can provide it, and assesses as low the likelihood that states will do so.

State corporation law is designed to produce justifiable investor confidence in board audit committees through a simple structure: shareholders elect boards of directors and state fiduciary duty law requires directors to manage corporations in the best interests of shareholders and the corporation. The business judgment rule invests governance power in boards to decide whether to use an audit committee, which directors should serve on the audit committee, the scope of its duties, and how it should operate.

Perceived failures in the traditional state corporation law approach led Congress to enact federal law mandating a particular approach to the role of audit committees. The federal approach includes mandates under the Sarbanes-Oxley Act (SOX) to staff audit committees with independent directors and to vest them with power to supervise a corporation’s external auditors. Other federal requirements impose reporting and disclosure obligations under rules of the Securities and Exchange Commission (SEC) and its instrumentalities—the New York Stock Exchange and the Nasdaq Stock Market (misleadingly dubbed self-regulatory organizations or SROs).

2. State corporation law is thus the foundation of corporate governance. It provides that corporations are managed by a board of directors and authorizes, but does not require the board to act through committees. E.g., Del. Code Ann. tit. 8, § 141(c)(2) (2003).
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SOX also created a new audit standard-setting body, the Public Company Accounting Oversight Board (PCAOB), to provide standards governing audits of public companies. In a proposed standard, the PCAOB proposed to require external auditors to review audit committee effectiveness. This proposal could be useful, but would raise conflicts between auditors and audit committees and would be difficult to square with state corporation law. While the PCAOB’s final standard was retracted in part, it still requires external auditors to consider audit committee effectiveness as part of their overall review of a corporation’s internal control over financial reporting.

The PCAOB’s proposal reveals a hole in the corporate governance system that this admixture of state and federal law creates. Audit committees are central, but no one other than boards—and, after the fact, shareholders and courts—has power to oversee them. All SOX does is mandate characteristics and functions; all the SEC and SROs do is mandate characteristics, reports, and disclosure. All the PCAOB ended up doing—after flagging the issue of audit committee review—was requiring auditors to include an audit committee review as part of their more general assessment of a company’s internal control over financial reporting.

The resulting corporate governance system reveals major tensions that this Article considers. The first is the tension between state and federal law. State corporation law trusts boards of directors to choose the right set of management tools for a corporation. Federal law now provides governmental mandates specifying parameters of the audit function, whether or not a board believes them necessary. But neither alone is complete and, even when combined, remains incomplete.

While the federal regime specifies audit committee composition and function, it respects federalism limits by not further specifying how that

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are not really standards but excruciatingly specific rules. See William B. Chandler III & Leo E. Strine, Jr., The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State, 152 U. PA. L. REV. 953 (2003); see infra note 47.

5. PROPOSED STANDARD CONCERNING AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (2003) [hereinafter Proposed Standard].

6. See infra Part II.

7. AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS, Auditing Standard No. 2, ¶¶ 55-59 (PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD 2004) [hereinafter Auditing Standard No. 2]. The PCAOB adopted Auditing Standard No. 2 to require external auditors to evaluate the effectiveness of the audit committee’s oversight of a corporation’s financial reporting and related internal control. This evaluation will be part of the auditor’s new task, under the Sarbanes-Oxley Act, of attesting to managerial assertions concerning the effectiveness of internal control over financial reporting. When Auditing Standard No. 2 was released for public comment as a proposed standard, the proposal appeared to require a separate and complete evaluation. For a comprehensive analysis of the auditor’s task concerning internal control, see Lawrence A. Cunningham, Facilitating Auditing’s New Early Warning System: Control Disclosure, Auditor Liability and Safe Harbors, 55 HASTINGS L. J. 1451 (2004).
committee's effectiveness is to be evaluated. While state corporation law provides a framework for this evaluation, it does not provide any mechanism to conduct ongoing review. This missing link creates an opportunity for states to contribute meaningfully to the types of corporate governance reform SOX initiated.

As Congress, the SEC, SROs and the PCAOB—along with hundreds of assorted professionals—have developed a range of policies, proposals, and ideas, Delaware and other states have stayed on the sidelines (apart from perceived adjustments in their approach to the common law of fiduciary obligation). States interested in retaining and attracting corporate chartering business, from Delaware to Nevada, have a golden opportunity here: to provide a mechanism for a mandatory or optional audit committee evaluation and effectiveness certification.

Beyond this tension between federal and state law lies an additional tension between law and quasi-public standard-setting. The federally-prescribed audit committee is directed to supervise the external auditor while the PCAOB has proposed to have the external auditor evaluate the audit committee. While such 360-degree evaluations can ultimately work, the PCAOB's proposal was both jarring and difficult to square with state corporation law. The PCAOB's final standard, despite its more modest form—in having auditors review audit committee effectiveness as only one part of the auditor's overall review of internal control—remains both jarring and difficult to square with state corporation law.

To address the problems these tensions produce for audit committee functions, this Article considers a state-agency based approach to audit committee evaluation. A branch of state government could be vested with power to conduct a periodic evaluation and provide certification; this could be made mandatory or optional. If made optional, corporations could signal to investors a higher level of confidence in the integrity of their audit committees. This signal could be conveyed in how a state's corporations are denominated. In Delaware, for example, corporations opting out would continue to be called "Delaware corporations"; those opting in would enjoy the boosted designation "certified Delaware corporation."

The state-agency approach would avoid many of the thorny issues of


9. Delaware is the country's leading state of incorporation for large companies. Some see Nevada as attempting to compete with Delaware. E.g., Dave Berns, Shareholders Win ITT Decision: Will Judge Pro's Decision Help Nevada Become the "Delaware of the West"?, 5 NEV. LAW. 22 (Dec. 1997).

10. Other approaches are possible. For example, state corporation law statutes could be amended to require boards of directors periodically to evaluate and certify their audit committees as effective; these amendments could make the exercise mandatory or optional (e.g., an opt-out based on a shareholder vote).
having auditors evaluate audit committees. It would eliminate conflicts with state corporation law, eliminate conflicts of interest between auditors and audit committees, and give responsibility to those possessing requisite expertise using objective criteria. It would also create a mechanism furnishing publicly-disclosed affirmative assurance. This would contrast with the opaque, negative assurance the PCAOB enables auditors to provide in their reports on internal control over financial reporting.

The state-agency approach, however, has limits. Some see SOX's partial federalization of corporate governance as rejecting the existing state law system of implicit audit committee oversight of auditors and implicit auditor oversight of audit committees and management. If so, the state agency concept can be criticized as simply a return or reenactment of that weak world. On the other hand, the current SOX approach—perhaps too respectful of some federalism limits—is incomplete. A proper balance might include a system where states retained a significant role in corporate governance but where audit committee evaluations could help them play it—and could even lead to reinvigorating traditional conceptions of fiduciary obligation.

Despite the likely appeal of this concept to users and preparers of financial statements documented in Part IV below, the concept is not likely to be adopted by many states (or perhaps any) absent substantial encouragement from those constituents. Regulators, including the PCAOB and the SEC, may also be less than receptive to the concept. The PCAOB projects itself as an additional source of corporate governance. It will have territorial interests in maximizing its regulatory reach. The SEC, which oversees the PCAOB, may wish to preserve maximum power in the PCAOB as an additional means for its own ability to control corporate governance, as it does using SROs, without direct encroachment on state corporation law.11

Apart from uncertain regulatory support, states also may lack incentives to pursue this concept. Predictions of state inclinations regarding this concept depend on adopting one of several rival theories of state corporation law production: states compete with each other in a race to the top or bottom; they compete to benefit interest groups such as lawyers and investment bankers; they compete against the federal government; or they comprise one component of a multi-pronged model involving state, federal, and SRO sources.12

If the race is to the bottom, states likely will reject the concept. But if the race is to the top or states attempt to help interest groups, they might accept it. Under the more complex models, predictions are more difficult. However, it appears that the SEC is developing an elaborate method of creating corporate

11. See Thompson, supra note 4, at 968-69.
12. See infra Part V.
governance using instrumentalities such as SROs and the PCAOB. Thus, it may prefer using these arms over which it has direct statutory power rather than states, over which it holds only indirect power. States facing even this indirect SEC pressure may be reluctant to initiate corporate governance reform the SEC would disfavor, even if they are in the best interests of corporations, investors, and the public. This is one price of the increasing functional federalization of corporate governance.

Part I of this Article assesses the need for any formal evaluation of audit committee effectiveness in light of existing alternatives providing assurance; Part II reviews the PCAOB's standard for auditor evaluation of audit committee effectiveness to show how its limits point directly to creating state mechanisms for this function; Part III sketches the outlines of such a program's design and administration; Part IV draws from public comments made on the PCAOB's proposed standard to suggest that a state-agency approach would garner widespread support from investors and managers and from the auditing and legal professions; and Part V concludes by lamenting that despite virtues and probable field support, regulators and states may not support the concept.

I. NEED AND PARTIAL SOLUTIONS

The audit committee plays a central role in overseeing management, financial reporting, and internal control over financial reporting, among other duties. Effective audit committees can be important components of corporate governance by aiding in deterring, detecting, and preventing fraudulent financial reporting, thus protecting investors and other constituents. In addition, investors benefit from an understanding of audit committee roles in general and within particular organizations. Although these propositions are uncontroversial, an unresolved issue is how best to promote understanding and effectiveness. A combination of substantive duties, disclosure rules, and independent assurance is desirable—much of which is in place.

A. Existing Substantive Duties

Longstanding principles of state corporation law provide that boards of directors manage the business and affairs of a corporation as fiduciaries. Audit committee members are members of the board of directors. As such, they are obliged to discharge state corporation law's fiduciary duties of loyalty and care, subject to deference under the business judgment rule. Their duties include assuring a corporation's compliance with applicable law. Breach of these duties exposes directors to liability to shareholders in private litigation, subject to state law provisions authorizing corporate charters to exculpate them

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from personal liability in certain cases. These principles provide a measure of discipline on audit committee members in performing their duties. But given the business judgment rule and the prevalence of exculpatory charter provisions, critics regard this arrangement as insufficient.

B. Existing Disclosure Rules

SRO rules address the disclosure aspect of audit committee functions. These rules require that audit committees have a charter, disclose it publicly, evaluate their own performance, affirm charter compliance, and report on these matters to the full board of directors and to the SRO. These rules seek to impose accountability and discipline on audit committees. The charter-and-disclosure components also provide investors and other users with sources to understand audit committee operations. Whether these requirements are sufficient to assure audit committee effectiveness is not entirely clear. An independent evaluation and certification could provide valuable additional assurances.

C. Existing Audit Practice

Who might provide such assurances? The auditor is a logical choice, in part, because it also needs to assess audit committee effectiveness to complete its primary audit functions. Thus an existing solution is traditional audit practice. Auditors conducting traditional financial statement audits apply tests of internal control to help plan the scope of their audits. This type of probing typically includes some dealing with the audit committee. Many financial calamities that brewed during the late 1990s are attributed to internal control failure, however, including within audit committees. These audit failures cast doubt on the reliability of traditional audit practice to provide requisite assurances.

D. Audits of Internal Control

Responding to these audit failures, SOX directed PCAOB to develop auditing standards concerning attestations of managerial assertions of internal control effectiveness. A key feature of the attestation process requires

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14. E.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (2004) (money damages for breaches of the duty of care, but not for injunctive relief or for breaches of the duty of loyalty or acts not taken in good faith); MODEL BUS. CORP. ACT § 2.02(b)(4) (2002) (similar, but without the limitations for breaches of duty of loyalty or good faith).


auditors to assess the effectiveness of audit committee oversight concerning internal control over financial reporting. The chief justification for this assessment is the central role that audit committees play in financial reporting.

The PCOAB proposed a standard providing for such an auditor assessment of audit committee effectiveness. For reasons considered in the next section, however, the PCAOB's final standard (Auditing Standard No. 2) retracted from this full assessment in favor of a partial assessment as a component of the auditor's more general audit of internal control over financial reporting.

The PCAOB's proposed and final standards differ significantly. A major example of this variance concerns transparency. As a separate evaluation, the proposed standard appeared designed to produce disclosure concerning an audit committee's effectiveness; this was in order to provide a form of positive assurance to users of financial statements. The final standard makes the exercise a mere component of the auditor's overall evaluation of internal control over financial reporting. It is a form of negative assurance—that the auditor did not find the audit committee ineffective. The result is far more opaque than the transparent approach originally proposed.

These, and other differences between the proposed and final standards, minimize some of the difficulties associated with auditors performing this function, including conflicts, expertise, and objectivity problems, which are discussed next. However, the differences also raise the question of whether audit committee evaluation assignments that auditors are institutionally incapable of performing should be performed by another party.

II. INHERENT LIMITS OF THE AUDITOR EVALUATION

PCAOB Auditing Standard No. 2 requires auditors to evaluate audit committee effectiveness in overseeing external financial reporting and internal control over financial reporting. This raises questions concerning the relationship of this exercise to state corporation law requirements that boards perform this function (a duty that SRO listing standards restate). It also creates conflicts between the auditor and the audit committee, which SOX anoints as the auditor's supervisor. The PCAOB's proposed standard elicited criticism along these lines. Auditing Standard No. 2 responds by emphasizing that (1) it does not intend to supplant the board's responsibilities; (2) the auditor's evaluation is not separate or distinct but part of its control environment assessment; and (3) conflicts are inevitable. These responses leave open major issues concerning inherent limits of the auditor evaluation exercise and invite

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17. Auditing Standard No. 2 triggers public disclosure of ineffective audit committee oversight only when this failure of oversight amounts to a "material weakness" in internal control over financial reporting. Auditing Standard No. 2, supra note 7, at ¶ 59. See infra note 30.

18. See infra Part IV.
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the consideration of alternative providers of audit committee evaluation services.

Auditing Standard No. 2 provides that auditors evaluating audit committees assess committee member independence. This raises questions concerning whether auditors possess requisite expertise to make what are essentially legal judgments. The PCAOB's proposed standard directed auditors to evaluate audit committee compliance with requirements of SOX, the SEC, and SROs. Auditing Standard No. 2 deleted these provisions in response to criticism that they are beyond an auditor's expertise. This raises questions concerning whether these elements are important for evaluating audit committee effectiveness and, if so, also indicates the need to consider alternative service providers. Auditing Standard No. 2 specifies a variety of other factors relevant to the evaluation, none of which lends itself to measurement by objective criteria usually used in auditing. This raises two sorts of questions: whether auditors possess requisite expertise and whether alternative providers of audit committee evaluations should be sought.

A. Conflicts

Two classes of conflicts arise from having auditors evaluate audit committee effectiveness: (1) legal conflicts between Auditing Standard No. 2 and various laws and (2) structural conflicts between auditors and audit committees and between management and audit committees.

1. Legal

Auditing Standard No. 2's audit committee evaluation provisions can interfere with the allocation of responsibilities established under state corporation law and SOX. Under state law, boards of directors must manage the business and affairs of a corporation. Under SOX, audit committees must discharge the board-oversight duty concerning the external auditor's qualifications and performance.

SOX's approach was designed to correct for the conflict between auditors and managers that could be seen as a systemic weakness (auditors became beholden to management and softened their professional skepticism). The evaluation role Auditing Standard No. 2 assigns to auditors puts them in the position of evaluating the audit committee, an organ of the board of directors. This may reintroduce the conflict in a different guise, and thus may be seen to conflict with the goals of those laws.

The nature of audit committee oversight adds to legal conflicts. Consider the nature of director obligations under state corporation law compared with professional techniques auditors are trained to apply. Directors have fiduciary
duties to their corporations and stockholders. They must act in the stockholders' best interests when discharging statutory responsibilities to manage the business and affairs of a corporation. A well-developed body of common law applies. Doctrines include the duty of loyalty and the duty of care, along with the business judgment rule. These doctrines provide a judicial framework allowing directors some leeway to exercise business judgment, while rebuking behavior outside acceptable boundaries.\footnote{Commentators disagree whether state corporation law draws the boundaries faithfully to legitimate norms. Despite disagreement, there is no question that the auditor review would apply a fundamentally different approach.}

In contrast to judicial approaches to supervising directors, auditors use professional skepticism in their tasks, routinely second-guessing management decisions.\footnote{E.g., \textit{THE AUDITOR'S RESPONSIBILITY TO DETECT AND REPORT ERRORS AND IRREGULARITIES}, Statement on Auditing Standards No. 53 (AMERICAN INST. OF CERTIFIED PUB. ACCOUNTANTS 2000); \textit{see also} VINCENT M. O'REILLY ET AL., MONTGOMERY'S AUDITING 4.5 (12th ed. 1998) (due professional care of auditors requires the auditor to exercise professional skepticism).} This approach, when applied to audit committee evaluations, threatens to alter audit committee behavior from that contemplated under state corporation law, with deference to business judgments, into a more rule-oriented and constricting arrangement perhaps not in the best interests of a corporation or its shareholders.\footnote{See generally William W. Bratton, \textit{Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents}, 48 VILL. L. REV. 1023 (2003) (assessing limits of Sarbanes-Oxley Act-inspired regulatory urge to develop standards-based accounting concepts as opposed to rules-based concepts to constrain managerial and auditor rent-seeking).} It could lead to highly disruptive and unnecessary disagreements. Hence Auditing Standard No. 2 is somewhat at odds with state corporation law.\footnote{See, e.g., \textit{Ernst & Ernst v. Hochfelder}, 425 U.S. 185 (1976) (discussing scienter standard and due diligence defense); \textit{Herman & MacLean v. Huddleston}, 459 U.S. 375 (1983) (adopting preponderance of the evidence standard rather than clear and convincing standard for SEC § 10(b) violation); \textit{SEC v. Arthur Young & Co.}, 590 F.2d 785 (9th Cir. 1979) (discussing negligence standard and requirements of pleading fraud with particularity).}

Consider also the different standards of legal obligation owed by directors compared to auditors. When acting through audit committees, these state corporation law fiduciary duties remain applicable to directors. Auditors are not fiduciaries for their clients or client stockholders. At best, law requires auditors to act professionally and not to commit negligence or fraud.\footnote{The Sarbanes-Oxley Act interferes with state corporation law on specific subjects. For example, it bans loans to corporate insiders and authorizes federalized derivative lawsuits to recover profits generated in violation of new blackout rules. Sarbanes-Oxley Act, §§ 306, 402. But it does not purport to preempt the business judgment rule or alter state corporation law's charge that directors manage the business and affairs of the corporation. Congress may have the prerogative to take these steps; the PCAOB does not.} They are contract parties, not fiduciaries. Having contract parties supervise fiduciaries turns a traditional legal hierarchy upside-down. It creates an incoherent corporate governance system.

Obligations of directors and auditors under federal securities laws differ as
A New Product for the State Corporation Law Market: Audit Committee Certificationswell. Under Section 11 of the Securities Act of 1933,24 for example, both are entitled to assert due diligence defenses to defeat claims of negligence in discharging their responsibilities.25 However, directors are responsible for the entire contents of a registration statement and exposed to related liability. Auditors are subject to liability only for those portions of the registration statement they are responsible for preparing as experts.26

Auditing Standard No. 2 grapples with these challenges in limited ways. First, it implores auditors to recognize that boards are responsible for evaluating the performance and effectiveness of audit committees.27 This is of course an obvious statement of law, fact, and authority that the PCAOB cannot change. Second, Auditing Standard No. 2 declares that it “does not suggest” that auditors are responsible for performing a “separate and distinct” audit committee evaluation.28 Equally important, however, it emphasizes that auditors assess committee effectiveness because of the central role audit committees play in a corporation’s control environment.29

These provisions are helpful in minimizing conflicts between Auditing Standard No. 2 and state corporation law; to be sure, however, they do not eliminate them. Suppose a board makes a business judgment not to appoint a financial expert to the audit committee—an option open to it under SOX and


26. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 207-08 (1976): Section 11 of the 1933 Act unambiguously creates a private right of action for damages when a registration statement includes untrue statements of material facts or fails to state material facts necessary to make the statements therein not misleading .... [E]xperts such as accountants who have prepared portions of the registration statement are accorded a ‘due diligence’ defense. In effect, this is a negligence standard. An expert may avoid civil liability with respect to the portions of the registration statement for which he was responsible by showing that ‘after reasonable investigation’ he had ‘reasonable ground[s] to believe’ that the statements for which he was responsible were true and there was no omission of a material fact. See also Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 758 (codified as amended at 15 U.S.C. § 78u-4 (2004)) (shifting to proportional from joint-and-several liability).

27. Auditing Standard No. 2, ¶ 56; see also Auditing Standard No. 2, supra note 7, App. E ¶ E69 (explaining the PCAOB’s conclusion that the standard should explicitly acknowledge that the board of directors is responsible for evaluating the effectiveness of the audit committee and that the auditor’s evaluation of the control environment is not intended to supplant those evaluations).

28. Auditing Standard No. 2, ¶ 56; see also PCAOB Release Accompanying Auditing Standard No. 2, at 20-21 (explaining the same point).

SRO listing standards and permitted by state corporation law—and makes a legal judgment concerning how and when to disclose this—as required by SOX. Now suppose the auditor disagrees with both conclusions. What result?

In a traditional audit of financial statements, similar disagreements are resolved simply: the board’s judgments control. The auditor uses its opinion when planning the scope of its audit—typically one of broader scope than if it concurred in the board’s judgments. In an audit of internal control over financial reporting, however, additional processes follow.

The auditor must come to an opinion on internal control over financial reporting. If the auditor concludes that these judgments amount to an ineffective audit committee, Auditing Standard No. 2 instructs him or her to consider this, at minimum, a significant deficiency and perhaps a material weakness. These requirements can lead an auditor to issue an adverse opinion on internal control over financial reporting. In this circumstance, directors will feel pressure to submit to the auditor’s opinion rather than exercise their own judgment.

2. Structural

Under SOX § 301 and implementing measures of the SEC and the SROs, listed company audit committees are directly responsible for appointing, compensating, and overseeing the work of the company’s external auditors. This investment of power in the audit committee presents a structural conflict with Auditing Standard No. 2’s mandate that auditors evaluate audit committee effectiveness.

The body directly responsible for appointing and determining compensation of the auditors, and overseeing their work, is subject, in turn, to that auditor’s scrutiny as part of its audit of internal control over financial reporting. A committee so supervising an auditor, charged with evaluating the committee, can be impaired in performing its duties; an auditor charged with evaluating the committee’s effectiveness, in its supervisory and other tasks, can be impaired in performing this evaluation and its other work.

The circular approach can violate the independence concept at the

30. Id., ¶¶ 59, 140. Auditing Standard No. 2 defines the central concepts as follows:

A **significant deficiency** is a control deficiency, or combination of control deficiencies, that adversely affects the company’s ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company’s annual or interim financial statements that is more than inconsequential will not be prevented or detected.

Auditing Standard No. 2, ¶ 9.

A **material weakness** is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Auditing Standard No. 2, ¶ 10.
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foundation of auditing. Auditors are not independent if they act in a managerial capacity. A formal assessment of audit committee effectiveness is a management role, a board responsibility. Even when the evaluation is described as part of the auditor’s overall assessment of a corporation’s control environment, this raises issues of “independence impairment” in fact and in appearance. This violates longstanding principles of federal law expressed by the Supreme Court, specific SEC rules, and voluminous professional auditing literature defining generally accepted auditing standards.\(^3\)

It should be noted that not all such 360-degree reviews are inherently suspect. Many managerial review exercises at major corporations are conducted in precisely this manner. But given the central function of auditors and audit committees in the financial reporting process, any structures that may deter frank assessments should be resisted. Moreover, devices that may tend to weaken an audit committee should also be resisted. When auditors are vested with implicit directive power over board audit committees, this dilutes a board’s similar power, which may have the effect of diminishing an audit committee’s effectiveness.

If an auditor’s evaluation of audit committee effectiveness is memorialized in audit opinions, moreover, consideration would be necessary concerning whether management would also have to formally evaluate the audit committee. This multiplies conflicts. A technical case can be made that when audit committees are part of an auditors’ formal scope of review, they would likewise be within management’s formal scope of review.\(^3\) If so, managers would become obligated to evaluate audit committees. But audit committees are typically charged with evaluating management. An additional conflict therefore arises where management is reviewing the audit committee and vice versa.

An even more severe problem may also arise. If managers must evaluate the audit committee, auditors will seek to rely on management’s evaluation in preparing their own evaluation or reevaluation. This adds yet another circularity problem where auditors rely on management. The result is a series

\(^3\) See 17 C.F.R. § 210.2-01 (2004) (stating that “[s]ection 210.2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance”) (emphasis added); see also SEC. AND EXCH. COMM’N, FINAL RULE: REVISION OF THE COMMISSION’S AUDITOR INDEPENDENCE RULES, Release Nos. 33-7919 & 34-43602, at notes 38-39 (citing numerous sources that emphasize the requirement of the appearance of auditor independence, including professional auditing literature and legal precedents like United States v. Arthur Young & Co., 465 U.S. 805, 819 n.15 (1984)).

\(^3\) The technical case would run as follows. Under Auditing Standard No. 2, an ineffective audit committee is a significant deficiency. This in turn is a strong indicator of a material weakness in internal control over financial reporting. In such cases, management must review and address the issue to make its own internal control assessment adequate. This would imply that management would have to review the audit committee in order for the auditor to furnish an unqualified control audit opinion.
of tangled circles studded with conflicts that risk undermining the systemic utility of both auditors and audit committees.

The PCAOB addresses these concerns obliquely. Its key structural response is to emphasize that the auditor’s evaluation of the audit committee is “not a separate evaluation” but part of evaluating the control environment and monitoring components of internal control over financial reporting.\(^{33}\) It opined that this would partially address the structural conflict and that the part unaddressed is simply inherent in professional auditing.\(^{34}\)

The PCAOB’s release accompanying Auditing Standard No. 2 sought to minimize conflict concerns. It opined that “[n]ormally, the auditor’s interest and the audit committee’s interests will be aligned” in pursuing fair financial statements and effective control and auditing.\(^{35}\) It characterized the conflict between SOX § 301 and Auditing Standard No. 2 as “theoretical.”\(^{36}\) PCAOB appealed to auditing custom and investor knowledge, saying “experienced auditors are accustomed to bearing” such conflicts and “that investors expect an auditor to address” them.\(^{37}\)

Accordingly, the PCAOB does not ultimately resolve the conflict, but says instead that it is inevitable (and/or merely theoretical), that auditors are accustomed to operating with such conflicts, and that investors are content with this arrangement. This result creates deep tension with fundamental concepts of auditor independence and the heavy stress that SEC regulations and SOX place on auditor independence. Despite its efforts, the PCAOB does not adequately respond to these concerns. An additional or alternative mechanism that avoids these fundamental problems thus remains appealing.

**B. Expertise**

Two additional concerns relate to whether auditors possess requisite expertise to comply with Auditing Standard No. 2’s requirement that they evaluate audit committee effectiveness as part of assessing the control environment. The first is whether auditors possess necessary knowledge concerning the legal concept of independence, which Auditing Standard No. 2 directs auditors to assess in this evaluation.\(^{38}\) The second involves audit committee compliance with SOX, SEC, and SRO requirements, which

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34. Id.
35. Id. (explaining that emphasizing the context of the auditor’s evaluation would “address, to some degree, the conflict-of-interest concerns” but that the conflict “is, to some extent, inherent in the duties that society expects of auditors.”).
36. PCAOB RELEASE ACCOMPANYING AUDITING STANDARD No. 2, at 21.
37. Id.
38. Auditors must evaluate their own independence from a client to satisfy requisite auditing and SEC standards, but independence is a protean concept with different meanings in different contexts.
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PCAOB's proposed standard required auditors to assess but which Auditing Standard No. 2 deletes. The deletion solves one question but raises another: auditors are not directed to reach legal conclusions concerning compliance, but are these conclusions in fact necessary to form opinions concerning audit committee effectiveness?

1. Independence

The PCAOB's proposed standard stated that auditors should evaluate committee member independence, along with evaluating the independence of their nomination, selection, and action. Auditing Standard No. 2 retains a provision concerning evaluating member independence, but deletes the latter more detailed provisions without explanation. It likewise dropped without explanation a statement to the effect that the more independent the nominating process, the more independent a committee is likely to be.

Identifying the PCAOB's reasons for the deletions requires some speculation. Reasons may include concerns that assessing the independence of a nomination or selection process or of director action involves judgments concerning corporate governance and law beyond an auditor's expertise. SRO listing standards require boards to determine the independence of each outside director, using specific criteria supplemented by general principles rooted in state corporation law. Establishing links between the independence of the nomination and selection process and member independence is difficult. It is likewise a matter of corporate governance and legal judgment. Determinations are made with reference to state corporation law, SOX § 301, SEC regulations, and SRO listing standards, all likely beyond an auditor's expertise.

If the reason the PCAOB deleted the supplemental requirements concerned expertise and matters of law, it is difficult to justify retaining the factor calling for auditors to evaluate the "independence of the audit committee members from management." This is likewise a question of law and corporate

40. Id.
41. Supporting this guess are some comment letters on the PCAOB's Proposed Standard, including those provided by some auditing firms. See infra Part IV.
42. NEW YORK STOCK EXCH. LISTED CO. MANUAL § 303A.02 (Nov. 4, 2003); NASDAQ MARKETPLACE RULES § 4350 (2003).
43. Another possible reason for the deletion is that SEC rules also require corporations to disclose nominating committee processes. See SEC AND EXCH. COMM'N, FINAL RULE: DISCLOSURE REGARDING NOMINATING COMMITTEE FUNCTIONS AND COMMUNICATIONS BETWEEN SECURITY HOLDERS AND BOARDS OF DIRECTORS, RELEASE NO. 33-8340 & 34-48825 (Nov. 24, 2003). However, if this justifies deleting nomination-selection process independence from an auditing standard, it suggests PCAOB serves as more than an auditing standard-setter. It is a component of an SEC-directed regulatory regime combining various instruments including disclosure. See infra Part IV.
44. Auditing Standard No. 2, supra note 7, ¶ 57.
governance, not auditing.

In fact, the appearance and use of this factor in Auditing Standard No. 2 are driven entirely by legal rules. This is clear from the following note contained in Auditing Standard No. 2, stating that companies whose securities are not listed "may not be required to have independent directors for their audit committees [and that] the auditor should not consider the lack of independent directors at these companies indicative, by itself, of a control deficiency."

The purpose of the note is clear and accurate: when not required by listing standards, absence of independent directors is not alone a control deficiency. The negative implication is less clear and quite possibly wrong: when required by listing standards, absence of directors is alone a control deficiency. Whether this negative implication is correct is a legal question. The issue is whether an audit committee's role and relative effectiveness varies with exchange listings and related requirements. That, in turn, depends on the purpose and meaning of the relevant requirements, including, in this context, the director-independence concept. The purpose and meaning of legal concepts, including the concept of director independence, are questions requiring legal analysis and interpretation.

Relative to auditing, moreover, why should the lack of independent directors indicate a control deficiency? The foregoing note implies that the presence or absence of independent directors is not relevant to internal control, much less to an auditor's assessment of audit committee effectiveness. Rather, for listed companies, the issue is whether they are in compliance with listing standards, not whether that compliance promotes committee effectiveness. The directive that auditors evaluate audit committee member independence is therefore also fundamentally a matter of complying with those listing standards imposing the requirement.

It is not possible to escape the fact that auditor evaluations of these characteristics are therefore legal judgments, not auditing judgments. In any event, these challenges indicate, again, that a search may be warranted to find alternative or additional providers of audit committee evaluation and certification services.
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2. Compliance

Independent audit committee members are required by SRO listing standards. While Auditing Standard No. 2 retains provisions directing auditors to assess this factor, it deleted two other provisions expressly requiring auditors to evaluate compliance with applicable laws and regulations, including SRO listing standards. The deleted provisions directed auditors to assess audit committee compliance with the excruciatingly detailed SRO listing standards under SOX § 301 and whether an audit committee included a financial expert (called an audit committee financial expert) as contemplated under SOX § 407. Materials accompanying Auditing Standard No. 2 indicated three reasons for these deletions, as follows:

The factors that addressed compliance with listing standards and sections of SOX were deleted, because those factors were specifically criticized in comment letters as being either [1] outside the scope of the auditor's expertise or [2] outside the scope of internal control over financial reporting [and PCAOB believed] that [3] those factors were not significant to the type of evaluation the auditor was expected to make of the audit committee.

Explanation [1] is easy to accept; but the other two raise additional issues.

Concerning the first explanation, consider that audit committees must comply with various SRO listing standards and judge applicable best-practice guidelines established by SROs, the SEC, and other engines of corporate governance. Whether a committee complies with SRO listing standards is a legal judgment, and whether a board of directors opts to have its audit committee adhere to formally-articulated best practices is a business judgment.

turn to auditors when they lack guidance for Sarbanes-Oxley Act § 404 compliance and that "[i]t is possible that auditors providing this guidance might be misconstrued as providing legal advice . . . .". Compare Auditing Standard No. 2, ¶ 2 (noting that the standard summarizes legal requirements to provide context and understanding, not to interpret them).


49. Proposed Standard, supra note 5, ¶ 57. SOX § 301 directed the SEC to direct the SROs to adopt various corporate governance standards as listing requirements, which the SROs have done. Resulting listing standards, including for example the New York Stock Exchange's section 303.A.00, specify such minutia as audit committees must have at least three members and such procedures as audit committees having charters containing specified details. SROs traditionally described their listed company manuals as containing "listing standards," accurate in the pre-federalization era but a misnomer now that these manuals are laden with dense, excruciatingly-detailed provisions bearing no resemblance to the concept of "standards."

Consider again SOX’s provision concerning including an audit committee financial expert (ACFE). Rules permit, but do not require, this feature and provide that a board opting not to include an ACFE disclose its reasons for declining to do so. Whether to include an ACFE is essentially a matter of business judgment. Issues include whether that expertise is necessary and whether relevant SEC standards are appropriate for the corporation. Auditors are not in a position to assess this business judgment.

Rules requiring disclosing whether audit committees include an ACFE are essentially legal rules. The remedy for failure to comply is delisting, and possibly other sanctions. These are legal results posing business consequences. They are not elements within the auditor’s purview, which is concerned ultimately with fair financial reporting and indirectly with effectiveness of internal control over financial reporting.

The PCAOB’s second and third justifications for deleting compliance assessment factors are more difficult to understand and interpret. If these are “outside the scope of internal control over financial reporting” and “not significant” to the auditor’s evaluation, why were they included in the PCAOB’s proposed standard? A possible reason is that the proposed standard envisioned an auditor evaluation that was “separate and distinct” and encompassed review beyond effectiveness concerning internal control over financial reporting. The review contemplated by Auditing Standard No. 2 is narrower. This interpretation may be satisfactory in terms of understanding and applying Auditing Standard No. 2 as an auditing standard.

But the PCAOB’s explanation is unclear. It bases its conclusion in part on comment letters critical of the concept as either beyond an auditor’s expertise or outside the scope of internal control over financial reporting; it separately states its opinion that these are not significant to the auditor’s expected evaluation. It leaves unclear whether the PCAOB believes they are outside the scope of internal control over financial reporting and leaves unexplained why they are not significant.51

Whatever weight one assigns to the relative significance of compliance as a measure of audit committee effectiveness regarding internal control over financial reporting, what is clear is that the PCAOB is directing auditors not to treat this as a factor. Whether auditors will do so or not is another question, since Auditing Standard No. 2’s list of factors is not exhaustive. More importantly, if compliance is significant to audit committee effectiveness, in terms of internal control over financial reporting or more generally, this again suggests reasons to consider searching to identify additional or alternative

51. Opacity in the PCAOB’s explanation suggests another possible account of its decision to delete these items, echoing points noted above (in notes 43 and 47): the PCAOB is a component of a broader federalized corporate governance regime managed by the SEC. See infra Part IV.
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providers of audit committee evaluations.

C. Objective Criteria

Auditing Standard No. 2 mentions numerous other factors bearing on auditor assessment of audit committee effectiveness in overseeing external financial reporting and internal control over financial reporting. Most of these factors, as well as most audit committee activities, are not measurable using objective criteria—a foundation of traditional auditing standards. In fact, many are quite subjective.

One factor Auditing Standard No. 2 mentions is the clarity boards use in articulating the audit committee’s responsibilities and how well managers and committee members understand them. Measuring linguistic clarity is not easy. Although teachers measure reading comprehension routinely and assign grades based on examinations, it is unclear whether auditors possess objective tools such as examinations—and whether audit committee members and managers would sit for them.

Auditing Standard No. 2 states that auditors assess the audit committee’s involvement and interaction with the external auditor. Apart from this metric’s circularity and conflict-creation, measuring involvement and interaction is highly subjective. The PCAOB’s proposed standard spoke of the “level” of these factors, language which Auditing Standard No. 2 drops. Though “level” may be no more objectively measurable, at least it hinted at some standard. Auditing Standard No. 2 also deletes illustrations appearing in the PCAOB’s proposed standard concerning involvement relating to the auditor’s retention, appointment, and compensation. No reason for the deletion is provided.

Auditing Standard No. 2 also states that auditors assess the audit committee’s involvement and interaction with the internal audit team. The same criticism applies. Auditing Standard No. 2 also dropped the proposed standard’s use of the word “level” in this context. Similarly, it deletes illustrations appearing in the PCAOB’s proposed standard concerning involvement relating to the audit committee’s line of authority and role in appointing and compensating internal auditors, also without explanation.

In Auditing Standard No. 2, the PCOAB deleted a catch-all evaluation metric appearing in its proposed standard: the amount of time a committee devotes to internal control issues and the amount of time members “are able” to

52. Auditing Standard No. 2, supra note 7, ¶ 57 (“[T]he clarity with which the audit committee’s responsibilities are articulated (for example, in the audit committee’s charter) and how well the audit committee and management understand those responsibilities . . . .”).

53. No doubt many auditors excel in linguistic clarity and most of Auditing Standard No. 2 is written clearly, but consider the definition it provides for “significant deficiency,” supra note 30 (quoting definition of significant deficiency from Auditing Standard No. 2, ¶ 9).
devote to committee activity. It likewise does not explain why it does this, perhaps because the metric so obviously ignores quality of time. By definition, efficient committees spend little time with greater effectiveness and inefficient committees spend more time with lesser effectiveness.

Auditing Standard No. 2 also adds factors not contained in the PCAOB’s proposed standard: (1) committee interaction with key members of financial management, including the chief officers of finance and accounting; (2) the degree to which difficult questions are raised and pursued with management and the auditor, including critical accounting policies and judgmental accounting estimates; and (3) the committee’s responsiveness to issues that an auditor raises. While likely probative of audit committee effectiveness, none of these is measurable using objective criteria that are staples of traditional auditing practice and assurance.

Despite many comment letters on the PCAOB’s proposed standard criticizing the absence of objective measurement criteria, Auditing Standard No. 2 does not come to grips with the reality that these factors elude measurement by objective criteria. This does not mean the factors or even subjective testing of them are unimportant or useless. It suggests that traditional auditing tools are not well suited to conducting the evaluation.

D. Liability Risks

Finally, two issues arise concerning the liability effects of auditor evaluation of audit committees. First, auditors evaluating audit committee effectiveness may expose themselves to liability for violation of professional standards. Suppose an auditor evaluates a corporation’s audit committee as effective. Subsequently a major financial fraud is uncovered within the company. Auditors are likely defendants in lawsuits by shareholders now armed with an additional liability theory. This auditor liability risk may unduly raise the requirements auditors insist that audit committees meet before drawing a favorable assessment. This bias would accentuate conflicts of interest.

Second, auditors evaluating audit committee effectiveness may expose audit committee members to liability for violation of fiduciary obligations. Suppose an auditor evaluates a corporation’s audit committee as ineffective. Whether or not fraud exists within the corporation, shareholders are now armed with a theory of liability against those directors. This audit committee liability

54. See infra Part III.
55. In a separate paper, I discuss and analyze liability risks that auditors face under Auditing Standard No. 2. See Cunningham, supra note 7.
56. Director-liability risk is real for any Delaware corporation lacking charter provisions exculpating directors from personal liability for money damages due to breaches of the duty of care. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2003) (authorizing such charter provisions). For corporations
risk may unduly lower the requirements auditors insist that audit committees meet before drawing a favorable assessment. This bias cannot be counted on to offset the bias created by auditor liability risk. Taken together, the conflicts again compound.

E. Summary of Limits and Gaps

The following are the limits of auditor evaluation of audit committee effectiveness shown by Auditing Standard No. 2 as elaborated fully in this Part:

- evaluations are not disclosed unless ineffectiveness constitutes a material weakness;
- evaluations are part of an overall control environment review related to internal control over financial reporting, not a full-scale effectiveness evaluation;
- even this partial and non-public method poses conflicts with state corporation law;
- evaluations create conflicts between auditors and audit committees;
- auditors must assess legal issues such as independence and cannot assess legal issues such as compliance;
- auditors lack objectively measurable criteria; and
- liability risks of auditors and audit committees can impair optimal evaluation, compounding conflicts.

Within these limits, auditors must nevertheless gain some level of assurance as to audit committee effectiveness. Auditors require an understanding of audit committee effectiveness to attest to internal control over financial reporting, to attest the veracity of managerial assertions concerning it, and to attest to financial statement assertions.

The issues are (1) whether the gap between what auditors can do and the ideal can be filled using additional providers of audit committee effectiveness evaluations and/or (2) whether alternative providers should be sought for the entire exercise, both to provide assurance to financial statement users and for

governed by law based on the Model Business Corporation Act, the risk is less meaningful. See MODEL BUS. CORP. ACT § 2.02(b)(4) (1990) (stronger version of the exculpation authorization, containing no reservation for breaches of the duty of loyalty and the limitation concerning intentional conduct lacks a good faith alternative). Even for Delaware corporations boasting such charter provisions, director-liability risk is meaningful because charters do not exculpate for breaches of the duty of loyalty or intentional conduct. Lack of independence required by SROs as interpreted by auditors can indicate the former, and disagreement with auditors required to evaluate audit committee effectiveness could indicate the latter. Risks include litigation uncertainty arising from judicial treatment of charter exculpations as affirmative defenses, putting the burdens of pleading and proof on directors as to good faith and absence of duty of loyalty breaches. See Emerald Partners v. Berlin, 787 A.2d 85 (Del. 2001). But see Black et al., supra note 25 (discussing that given indemnification and insurance, outside directors face virtually no risk of actual personal liability for damages arising from good faith conduct evaluated under the duty of care).
auditors to rely upon.\textsuperscript{57} Accordingly, it is fruitful to consider other parties to supplement or substitute in this exercise to overcome these inherent limits of auditor evaluations of audit committee effectiveness.

\section*{III. State Agencies}

The framework of the evolving corporate governance regime is as follows: state law provides that boards, including through audit committees, manage corporations; SOX directs that audit committees oversee auditors, but otherwise imposes no substantive duties on or regulatory oversight of audit committees; SROs provide disclosure rules related to audit committee responsibilities and performance;\textsuperscript{58} and the PCAOB provides a partial, limited and non-transparent auditor evaluation of audit committee effectiveness in overseeing financial reporting and internal control over financial reporting.

In this evolving circle of corporate governance, one arc remains to be included: a mechanism for a full, public audit committee evaluation by a party other than the board of directors. While not obviously necessary,\textsuperscript{59} the arc is missing from the circle chiefly due to federal deference to states: SOX and the other federal engines (the SEC, SROs, and the PCAOB) have not filled it. Congress could, however. For example, it could direct that audit committees be evaluated and certified, perhaps by the SEC, the PCAOB, or the United States General Accounting Office (GAO).\textsuperscript{60}

This is not likely and may not be wise. It is unlikely to occur because at the time that Congress enacted SOX, it acted under unusual public pressure, suggesting a limited capacity to return to subjects other than those it expressly

\textsuperscript{57} See Auditing Standard No. 2, \textit{supra} note 7, ¶ 108-126 (expressly authorizing auditors to rely upon the work of others in conducting audits when such other work is competent and objective).

\textsuperscript{58} SRO listing “standards” specify in excruciating detail how boards of directors are obliged to supervise and evaluate audit committee performance, though the basic standard is at heart a principle of state corporation law.

\textsuperscript{59} See \textit{supra}, Part I. The issue recalls the famous exchange between Senator Alben Barkley and the auditor Colonel Carter during hearings on the original federal securities acts:

\begin{quote}
Senator Barkley: “You audit the controller?”

Mr. Carter: “Yes, the public accountant audits the controller’s account.”

Senator Barkley: “Who audits you?”

Mr. Carter: “Our conscience.”
\end{quote}


\textsuperscript{60} A historical parallel supports both identifying and rejecting such governmental entities as candidates for the job. Early drafts of the federal securities laws from the 1930s so provided. \textit{See} O’Connor, \textit{supra} note 59 (discussing using the Federal Trade Commission for this function). As for the General Accounting Office, in 1945, Congress established the GAO’s Division of Corporate Audits and mandated that it audit all government corporations. Resulting laws dramatically increased the GAO’s workload. The GAO continues to play an important watchdog function over public company auditors. \textit{See} Previts & Merino, \textit{supra} note 59, at 330-31, 403, 410.
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directed various governmental entities to study. The wisdom of federal certification of audit committee effectiveness depends on relative expertise. While SOX adopts as federal law certain areas traditionally within state law, the vast majority of the relevant subject matter to be addressed remains one substantially of state corporation law, not federal law.

Private suppliers could be tapped. A corporation could engage a separate external auditing firm for this function. This would ameliorate conflicts, but not expertise problems. Or a corporation could retain an outside law firm. This would solve expertise problems. But lawyers' interests in other work would pose conflict issues. Specialty firms are unlikely to emerge as major sophisticated providers, given that the service would likely produce low profit margins. Higher-quality providers measured by higher opportunity costs would likely not participate. For all three such alternative providers, moreover, liability risks would be significant. Unless they priced their services at premiums equivalent to functional insurers, this market would unlikely become vibrant or useful to the public capital markets.

Other candidates include rating agencies. They escape or neutralize some problems (although not all—especially not liability risks), but they also pose an additional significant issue. Certifications will appeal to corporations when they lower their cost of capital (by an amount greater than the agency's fee). Rating agencies provide a service that strongly influences the cost of capital. Accordingly, selling these services to rated clients poses a conflict. Involving rating agencies in internal evaluations of audit committees could also impair the rating agency's objectivity and independence when providing credit rating services. Finally, the fact that rating agencies have not emerged to offer this service suggests the low likelihood that they will do so. Other organizations, such as Institutional Investor Services, may offer assessments, but without internal access these assessments may be of limited utility.

61. Cf. U.S. GEN. ACCOUNTING OFFICE, REPORT ON MANDATORY ROTATION OF AUDIT FIRMS (2004) (study required by Sarbanes-Oxley concluding that a panoply of governance reforms needs to be given time to determine whether additional federal steps, such as mandatory rotation of audit firms at companies, are indicated).


63. See Johnson & Sides, supra note 46.

A. Inherent Appeal and Some Limits

States can likely fill the gap. This section outlines how a state agency would overcome or neutralize all of the inherent limits associated with an auditor evaluation of audit committee effectiveness. Advantages of this approach include public disclosure, completeness, lack of conflicts, assessment of legal and compliance issues (performed using criteria with which relevant experts are familiar), and elimination of liability risks posed by auditor evaluations. Each of these advantages is evaluated below.

The first two advantages are nearly self-evident. First, state agencies could provide public evaluations of audit committee effectiveness. Corporations could disclose the certifications as part of their public securities filings. Second, the service could examine overall committee effectiveness, not just areas related to external financial reporting and internal control over financial reporting.

States may be superior to auditors and other private actors because they are free of conflicts. Limiting conflicts is inherent in the concept of a state-chartered agency conducting the certification exercise. Both conflicts posed by Auditing Standard No. 2 are neutralized: there is no conflict between the state and its corporation law and no conflict between a state agency and boards of directors, audit committees, corporate management, or auditors. This would diminish the circumstances in which disagreements arise, limiting them to situations in which major concerns about effectiveness exist, not merely quarrels over business or legal judgments.

An equally significant advantage is that states have at their disposal the expertise and requisite criteria to apply. Experts in state corporation law would draw on the reservoir of fiduciary concepts. These require independence (a duty of loyalty concept) and competence, including a measure of financial expertise (duty of care concepts). They encompass the particulars specified in SEC and SRO rules emanating from these bedrock concepts, as well as compliance with law.

Critics hold different interpretations concerning the teeth of modern fiduciary duty law, especially as articulated and applied by the Delaware Supreme Court. Traditional fiduciary duty law had teeth. Current state law applications may be seen as lax. State agency affirmations of audit committee effectiveness could arise depending on how the state agency was funded, a point discussed in the next section.

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effectiveness based on adherence to weak state law principles would not mean very much.

These points suggest possible virtues of a state-agency approach to audit committee evaluations. Certification could help reinvigorate traditional fiduciary obligation. If so, state agencies reviewing the relationship of their laws to audit committee effectiveness could facilitate development of state law more congruent with standards necessary to make audit committees effective. This could not only invigorate competition among states for optimal governance arrangements, but also an internal competition within states towards the same end.\(^6\)

In addition, state corporation law’s fiduciary obligations, including independence and competence (loyalty and care), are standards-based. This provides an attractive alternative to the dense rule-bound approach that invariably emanates from federal sources, including SROs, as well as from accounting and auditing standard setters, including the PCAOB.\(^6\)

One major appeal of a state agency approach to audit committee evaluation is liability risk limitation. State agencies attesting to audit committee effectiveness can be designed to enjoy the benefits of sovereign immunity, for both the agency and its employees.\(^6\) An agency’s certification would not expose it to liability in the event of subsequent financial misstatements at the corporation. The result is to eliminate liability risks from the tasks of the agency and the audit committee.

Nor should agency certifications carry any legal significance in subsequent litigation concerning a company, its board of directors, audit committee, or shareholders. Positive certifications should not be available to insulate boards or committees from liability and negative certifications should not provide a basis to support shareholder claims of director breach of fiduciary duty or other liability. In each case, however, courts could admit related evidence when deemed appropriate under judicial notice concepts.\(^7\) These provisions would likewise prevent injecting new liability risks into the tasks of the agency and the audit committee.

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67. Probabilities here depend on which of several rival theories of corporation law production one holds, discussed infra, Part IV.
68. See Chandler & Strine, supra note 4.
69. See Alden v. Maine, 527 U.S. 706 (1999) (discussing and endorsing the concept of state sovereign immunity). This treatment would be akin to the absolute immunity enjoyed by SROs and their officials. See D’Alessio v. N.Y. Stock Exch., 258 F.3d 93, 105 (2d Cir. 2001) (holding that the N.Y. Stock Exch. is entitled to the same immunity as the SEC); Barbara v. NYSE., 99 F.3d 49, 59 (2d Cir. 1996) (providing “absolute immunity”); Austin Mun. Sec., Inc. v. Nat’l Ass’n of Sec. Dealers, 757 F.2d 676, 690-91 (5th Cir. 1985) (holding that NASD officers receive the same immunity as the SEC).
70. Using judicial notice concepts would enable judges to draw upon knowledge developed by the state agency as to what constitutes an effective audit committee. This could enhance judicial articulation of fiduciary duty law, without turning the device itself into a liability-determining mechanism.
A final advantage to the state agency approach is that the agency could also experiment with a variety of designations. These can include a pass-fail assessment or more refined gradations. A refined scale would offer more valuable information to the user community and provide superior feedback to audit committees on their effectiveness.71

The advantage of a graded scale, on the other hand, implicates complex measurement challenges. State agencies interested in providing graded evaluations would need to develop adequate criteria by which to provide them. This raises a related and broader question that those agencies would need to answer: what constitutes audit committee effectiveness? This can of course vary with contexts, corporations and committees. Officials would need to recognize this informed by an appreciation of fiduciary law principles embracing this reality.72 Officials would also need to understand that the audit committee is an element of the overall corporate governance system of which board-effectiveness is likewise a key element. Evaluating and certifying this broad functionality may be difficult.

Finally, there may be areas where auditors are better positioned than state agency officials to evaluate aspects of audit committee effectiveness. These may relate to technical matters concerning internal control over financial reporting. State agency officials would need to develop an understanding of these areas or themselves rely upon auditors for assistance in their evaluation. Whether one or the other of such evaluations is adequate would require investigation,73 if each contributes unique expertise, both may be necessary and each would rely upon the other to complete the respective assignments.74 Advantages to the state agency approach remain in affording this additional assurance auditors cannot provide.

B. Implementation

From the states' viewpoint, a key attraction of a state-agency audit

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71. The PCAOB expresses a more modest goal, necessary by virtue of inherent limits on what auditors can do in the exercise. See Auditing Standard No. 2, supra note 7, App. E, ¶ E67 (the goal is "not to grade the effectiveness of the audit committee along a scale," but to detect any audit committee ineffectiveness for purposes of the auditor's overall control evaluation).

72. For "ten rules for really effective audit committees" offered by a corporate lawyer, see John F. Olson, How to Really Make Audit Committees More Effective, 54 Bus. Law. 1097, 1106-12 (1999).

73. State agencies may wish to draw on professionals in addition to lawyers and academics. This may be necessary to address the full range of tasks audit committees must undertake. Lawyers may have a comparative advantage concerning law and aspects of corporate governance, but need additional expertise from experts in business management, risk management, financial reporting and control, and other areas. Similarly, academics, while potentially resourceful, may as a class lack practical skills necessary to perform this evaluation effectively. On balance, however, groups led by lawyers and aided by other professionals, including academics, should be capable of devising requisite protocols for useful evaluations.

74. Cfr. Auditing Standard No. 2, supra note 7, ¶¶ 108-126 (expressly authorizing auditors to rely upon the work of others in conducting audit when such other work is competent and objective).
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committee evaluation program is to create and/or leverage a brand name. Whether one agrees or disagrees with the structure and content of state corporation law or particular cases, states command legal expertise, especially as to concepts of independence, loyalty, competence, and governance. Delaware has a brand name that attracts corporate chartering business to the state; Nevada appears interested in creating one; the larger states with more in-state corporations and a rich corporate law tradition also boast a brand name in the corporate world, including California and New York.

States adopting the concept would signal interest in developing the gold standard in corporate governance. The signal is superior to any similar signals the judiciary could offer through enhanced fiduciary enforcement. After all, judges resolve specific cases and controversies after-the-fact, but cannot provide general corporate governance assessments before-the-fact. Exploiting this opportunity by creating a state agency to provide audit committee evaluations and certifications entails facing design and administration issues, the outlines of which are sketched as follows:

**Organization and Authorization.** The agency could be created as part of an existing arm of state government or a newly-created agency. It could be part of the executive or legislative branches of state government; and it should certainly be separate from the judicial branch. Separation from the judiciary is important to achieve several goals: to protect against using agency certifications in subsequent litigation, to incubate intra-state competition between the agency and the judiciary and, in certain states such as Delaware, to strengthen the judiciary against the power of the state bar association. To enjoy sovereign immunity, the agency should be created as part of the state, rather than any political sub-division. The agency could be created either by an act of the governor or through particular legislation. Ideally, the agency would be designed to maximize insulation from political pressures.

**Staffing and Training.** Relevant experts within a state include active and retired lawyers, judges and academics. These experts could be appointed to the agency in the same manner as other state officials or judges. Or alternative appointment mechanisms could be devised, such as the governor appointing officials directly with or without approval of the state legislature. Some experts may opt for this role rather than going on the bench. Some limited additional training would be necessary (as to internal control over financial reporting

75. In Delaware, this task could be assigned to the existing Division of Corporations within the Department of State, or a newly-created corporations auditing office.
77. In Delaware, the process of amending the state corporation law is straightforward, managed virtually entirely by the Corporation Law Section of the Delaware State Bar Association. See Alva, supra note 76.
perhaps). States could also experiment with outsourcing portions of the exercises using professional organizations that match experts with assignments.\textsuperscript{78}

Certifications and Designations. Corporation codes could be amended to require or make optional a periodic audit committee evaluation and public certification. A range of certifications could result depending on the scope of the related evaluation, from simple compliance to overall effectiveness. Corporations could disclose the certifications in any forum they wished, including as part of their public securities filings.

Optional Approach Suggested. Whether to make the approach optional or mandatory requires deliberation. While this choice should be left to individual states, there is a strong case for the optional approach given absence of a compelling systemic need for the certification.\textsuperscript{79} If optional, corporations would decide on frequency; if mandatory, states would specify whether it should be done annually, bi-annually, tri-annually, or perhaps at different frequencies for corporations of different sizes, complexities, and financial-reporting track records.\textsuperscript{80} If made optional, two categories of domestic corporations could be designated, one for those opting in and one for those opting out. In Delaware, for example, corporations could describe themselves as a “Delaware corporation” for those opting out, and a “certified Delaware corporation” for those opting in.

Extending to Out-of-State Corporations. States could offer this service for locally-chartered corporations and could even offer it for corporations chartered elsewhere. Extending the service offers the advantage of enhancing competition among states, with the partial disadvantage of requiring experts in one state’s corporation law to become expert in another. (There is little variation across states, however, so this should be of limited significance.) If offering the service to out-of-state corporations, these could be authorized to use the designation in a similar way to in-state corporations. A California corporation opting for the Delaware certification, for example, could describe itself as a “Delaware-certified California corporation.”\textsuperscript{81}

\textsuperscript{78} The Gateway to Educational Materials and Round Table Group (see http://GEMinfo.org and http://www.roundtablegroup.com) are two such organizations. This approach may be valuable to address the start-up costs associated with developing new agencies. It would also provide resources to the state agency when demand for services periodically spikes, as it may at the program’s outset and during periods of unusually high investor anxiety.

\textsuperscript{79} See supra, Part I.

\textsuperscript{80} Unlike the SEC or SROs, states also could offer this product to all corporations, not just those with registered and/or listed securities. Appeal for widespread use is suggested by proliferation of SOX-type governance practices among various non-SEC registrants (a phenomenon known as “Sarbanization”). E.g., Dana Brakman Reiser, \textit{Enron.org: Why Sarbannes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability} Soc. Sci. Res. Network Electronic Libr., available at http://ssrn.com/abstract=515682 (last visited Nov. 14, 2004).

\textsuperscript{81} Some may find such designations confusing, at first. But nearly all complex novelties are confusing, at first. E.g., \textit{ALVIN TOFFLER, FUTURE SHOCK} (Bantam Books, 1970).
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**Self-Funding.** The agency could generate funds from those corporations using its certification service. Pricing of services could be proportional to SOX’s public company accounting support fee, given work required and information being generated and conveyed. It would certainly be a small fraction of those fees and likewise a small fraction of ongoing audit costs (especially now that they have risen significantly).\(^2\) Pricing could be in part a function of the agency’s expenses. The largest agency expenses would likely be for salaries and office space. Travel expenses could be charged to corporations using the service.

**Supplemental Budgets.** The agency need not be self-sustaining from service fees it generates. A portion of the state budget funded by corporation franchise fees could be allocated to underwrite the agency’s budget. This would be a prudent budgetary measure to the extent the certification becomes a signal of a states’ interest in the most effective audit committees and corporate governance generally. States offering the service to domestic and foreign corporations could offer a discount for domestic corporations, a device to lure additional chartering business to the state and offset such supplemental budgeting.

**Funding Conflicts.** A potential conflict arises when corporations pay a state to provide this service, however, on grounds of capture. There is no complete way around such conflicts. However, they are less significant in the context of an agency certification apparatus since this vehicle would not be a regulator as much as a reviewer. In addition, one way to further minimize the conflict in this context is to provide shareholders a voice in making the decision whether to use the service. After all, the service would be primarily for their benefit. Alternative tools to facilitate shareholder voices on the subject include state law voting mechanisms such as charter opt-ins or opt-outs and federal proxy mechanisms providing for more pro-active shareholder proposals on the subject.

**Other Factors.** This is not an exhaustive catalogue of relevant features of a state agency audit committee evaluation function. It outlines only key features. States would be entitled and encouraged to experiment with variations on these and other features. The possibility of variations on these themes and particular models would induce competition among the states. Corporations, acting through their boards of directors and audit committees, would consider which programs, if any, offer the best product in terms of signaling credibility to the

\(^{82}\) See [Financial Executives Institute Survey on Sarbanes-Oxley Section 404 Implementation (Jan. 2004), available at http://www.fei.org/download/SOXSurveyJuly.pdf](http://www.fei.org/download/SOXSurveyJuly.pdf) (last visited Nov. 11, 2004) [survey of 321 companies of various sizes shows that under SOX (a) on average annual costs rise $1,322,200 ($590,100 for internal control audits and $732,100 for new systems) and (b) for companies with revenues exceeding $5 billion, average annual costs rise $6.2 million ($4.7 million for new internal control audits, $1.5 million for new systems)].
market and minimizing the corporation’s cost of capital.  

IV. ANTICIPATING SUPPORTING CONSENSUS FROM THE FIELD

Comments offered publicly on the PCAOB’s Proposed Standard provide a strong basis for inferring that the state-agency concept would garner substantial support from a wide variety of constituencies, including users, producers, and professionals.

A. Users and Producers

Several comments on behalf of investors and other financial statement users were supportive of the PCAOB’s Proposed Standard in theory, while recognizing the difficulty auditors face in discharging the assignment. They emphasized the need for an independent review, which excludes auditors. Suggestions included that boards of directors hire specialists from another CPA firm or from a non-CPA firm.

Not all investor groups supported the PCAOB’s Proposed Standard. The California State Teachers’ Retirement System emphasized conflicts, limited auditor competencies, and existing sources of supervision and information. Even it, however, concluded by suggesting that the “PCAOB may want to review the charters and opine on the audit committee’s diligence in mitigating risks to the public.”

A residual user concern focused on the importance of auditors understanding audit committee effectiveness. Absent this, one said, it would be “wrong and misleading to investors” for an auditor to report that it has assessed effectiveness of internal control over financial reporting without assessing the

83. See Hollis S. Ashbaugh et al., The Effects of Corporate Governance on Firms’ Credit Ratings, Soc. Sci. Res. Network Electronic Libr., at http://ssrn.com/abstract=511902 (March 3, 2004) (citing data on the relationship between certain corporate governance features and ratings - and hence the cost of capital). The researchers find that credit ratings are unaffected by audit committee member independence, are positively related to board independence and negatively related to CEO power over the board. Audit committee certifications would provide more refined information to rate credit quality and possibly improve credit ratings and reduce the cost of capital.

84. PCAOB recorded 194 comment letters on its Proposed Standard leading to Auditing Standard No. 2, all of which are available at www.pcaobus.org (click Rulemaking to link to PCAOB Docket, number 8). Aside from a handful of polemical screeds, the letters are thoughtful analyses providing numerous perspectives, some 60 of which are cited in the following discussion by letter number in the PCAOB docket.

85. These included the Commonwealth of Virginia, CalPERS, the AFL-CIO, Ohio Retirement Systems, and Glass, Lewis & Co.

86. Despite these qualifications, the PCAOB asserted in explanations accompanying Auditing Standard No. 2 that “investors supported this provision.” Auditing Standard No. 2, supra note 7, App. E, ¶ E63.

87. This is contrary to the PCAOB’s assertion in explanations accompanying Auditing Standard No. 2 that “investors supported this provision.” Id.


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audit committee.\textsuperscript{89} This can be solved, however, by providing an independent and competent review upon which auditors can rely.

The PCAOB’s proposed standard drew comments from issuers that nearly unanimously recognized the need for effective audit committees, while generally opposing having auditors perform the evaluation.\textsuperscript{90} Only a few issuer comment letters supported using the auditor to perform this task, noting conflicts.\textsuperscript{91} Another hinted at the state agency possibility that the evaluation be done “on a periodic basis by a party other than the external auditor.”\textsuperscript{92}

The vast majority of issuers opposing the PCAOB’s proposed auditor evaluation of the audit committee cited conflicts with SOX § 301\textsuperscript{93} (some of these also cited conflicts with SRO rules requiring boards to conduct audit

\textsuperscript{89} Comment Letter from Glass, Lewis & Co., LLC, to PCAOB (Dec. 2, 2003) (on file with PCAOB as “PCAOB Rulemaking Docket No. 8, Letter No. 184”). Glass Lewis is an independent proxy and financial research firm that provides research to institutional investors. \textit{Id.} Its letter is signed by Lynn E. Turner, former SEC Chief Accountant.

\textsuperscript{90} Collective expressions of corporate America’s opinions sounded themes similar to those particular corporations offered and summarized here. \textit{E.g.}, Comment Letter from Business Roundtable, to PCAOB (Nov. 26, 2003) (on file with PCAOB as “PCAOB Rulemaking Docket No. 8, Letter No. 181”) (concept is “particularly inappropriate” given Sarbanes-Oxley Act § 301 and SRO listing standards). Business Roundtable is an association of chief executive officers of corporations with a combined work-force of more than 10 million US employees and $3.7 trillion in annual revenues. \textit{Id.}


\textsuperscript{92} Comment Letter from Texas Instruments Inc., to PCAOB (Nov. 21, 2003) (on file with PCAOB as “PCAOB Rulemaking Docket No. 8, Letter No. 114”).

committee evaluations). Many emphasized that audit committee effectiveness is a board of directors’ responsibility, questioned whether auditors possess requisite expertise, and noted that SROs are addressing the subject. Issuer comment letters that suggested tying the need to the board of directors returns the question to state doorsteps. On balance, therefore, the issuer community would likely support the state agency concept. If made optional, several would likely opt for it.

Few directors offered comments on the PCAOB’s proposed standard; those commenting said little concerning specifics of auditor evaluation of audit committee effectiveness. In general, however, one could expect directors to prefer a state agency approach rooted in common law principles. There is nothing new in these concepts. They are also standards-based and include the business judgment rule. This contrasts with the auditor’s professional skepticism that would lead to second-guessing and the PCAOB’s heavily rule-based approach that suffocates business judgment. While not possible to predict every director’s opinion, it seems reasonable to expect that a critical mass would support it.

B. The Auditing Profession

Auditing’s Big Four firms generally opposed PCAOB’s proposed

94. E.g., Comment Letters from Commercial Federal Corp., to PCAOB, supra note 93; E. I. duPont de Nemours and Co., supra note 93.; Bank of America, supra note 93.
97. Comments from board consultants furnish support. One proposed to overcome inherent limitations of auditor evaluations by suggesting that audit committee evaluation be done by a “third party approved by shareholders, in a separate evaluation.” Comment Letter from The Value Alliance and Corporate Governance Alliance, to PCAOB (Nov. 21, 2003) (on file with PCAOB as “PCAOB Rulemaking Docket No. 8, Letter No. 127”).
98. The firms and the number of their letters in PCAOB’s comment-letter docket are Deloitte & Touche LLP (71); Ernst & Young LLP (E&Y) (144); KPMG LLP (91); and PriceWaterhouseCoopers LLP (PWC) (82).
standard requiring auditor evaluations of audit committees, but also recognized that it has a certain degree of appeal.\textsuperscript{99} Deloitte and PWC sympathized in principle but held deep reservations as to implementation; KPMG and E\&Y made the practical objections more explicit. All accepted that audit committee effectiveness is an important component of the control environment, but found that, as a mere component, it did not warrant separate auditor evaluation. PWC emphasized that the board of directors is responsible for audit committee effectiveness; E\&Y observed that internal control should function without audit committee involvement; and Deloitte recognized that many see the audit committee as outside the scope of internal control over financial reporting.

Deloitte and KPMG both expressed concern about evaluation capabilities, given that auditors lack full, complete, and unfettered access to audit committee members, meetings, and information. E\&Y identified the following areas where it believes auditors are capable of evaluation using objective criteria: clarity of responsibility articulation; assessment of the committee's management approach to designing, implementing, and monitoring internal control over financial reporting; and reaction to management's failure to respond to deficiencies. KPMG disagreed concerning whether auditors have these and other capabilities, noting in particular that it is not clear how auditors would assess member understanding of duties or the significance of time devoted.

The Big Four singled out areas clearly beyond their capabilities or competence. Leading the list of institutional shortcomings are those involving legal determinations like independence and listing standard compliance. Deloitte characterized testing compliance with listing standards under SOX § 301 as testing for compliance with laws and regulations, which is outside the scope of internal control over financial reporting. It also indicated the lack of auditor capability in evaluating whether the audit committee nominating process was independent. KPMG opined that compliance with listing standards under SOX § 301 or concerning audit committee financial experts under SOX § 407 are legal interpretations of regulatory requirements outside the scope of reliable financial reporting.\textsuperscript{100}

\textsuperscript{99} This view is contrary to PCAOB's assertion in explanations accompanying Auditing Standard No. 2 that auditors "were generally supportive" although they sought clarity that the evaluation was "not a separate and distinct evaluation" but "one element" of the auditor's overall understanding and that auditors would have difficulty given lack of total access. Auditing Standard No. 2, supra note 7, App. E, ¶ E64.

\textsuperscript{100} Deloitte and KPMG both suggested that if the concept is retained, then management's report would also need to assess audit committee effectiveness. Deloitte cited for support SOX § 407's requirement that boards determine whether to have an ACFE and listing standards that require boards to perform annual audit committee assessments. KPMG concurred (as did the mid-sized auditing firm, McGladrey & Pullen, LLP), adding that auditors should be permitted to rely upon management's assessment in preparing their own evaluation. The Big Four also all agreed that the listed factors need refinement.
Auditing's three mid-sized firms\textsuperscript{101} offered opinions similar to the Big Four. BDO Seidman also emphasized that because corporate governance—not just the audit committee—is a critical component of the control environment, board effectiveness is critical. It also cautioned against having auditors provide implicit assurance on audit committee effectiveness.\textsuperscript{102} Grant Thornton added that effective audit committees are not necessary to effective internal control over financial reporting and effective oversight is not sufficient for effective internal control over financial reporting. McGladrey & Pullen expressed greater optimism, opining that legal compliance matters aside, auditors possess objectivity and technical competence to judge audit committee effectiveness, but wanted the duty limited to "consideration of observable information and behavior."

The AICPA substantially replicated comments of the Big Four.\textsuperscript{103} An Illinois CPA group was divided, though even supporters noted that auditors face a "difficult task" in evaluation, including as to legal and regulatory compliance.\textsuperscript{104} A Texas CPA group favored it, admitting that the audit committee's power over the auditor may deter objective assessment, but noting that ineffective audit committees can cause significant problems.\textsuperscript{105} A New York CPA group noted conflicts and competency issues; but once more paving the way toward a state approach, the group concluded that this task should be performed by the board of directors, the SEC, or "some other body that is not in the employ of the audit committee."	extsuperscript{106} One professional auditors' group believed the proposal is appropriate, but required more guidance;\textsuperscript{107} another took the opposite position, urging its deletion.\textsuperscript{108} The latter cited the litany of factors posing inherent limits, all of which would be neutralized by the state agency concept.

International associations of accountants expressed reservations, drawing

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  \item[101.] The firms and the number of their letters in PCAOB's comment-letter docket are BDO Seidman, LLP (136); Grant Thornton LLP (101); and McGladrey & Pullen, LLP (142).
  \item[102.] BDO Seidman was the only major accounting firm to cite Sarbanes Oxley Act § 301's directive as driving a conflict between the audit committee and the auditor and hindering communication, the dominant points offered by nearly every issuer comment letter and many others. \textit{See supra} note 85 and accompanying text.
  \item[103.] Comment Letter from American Institute of Certified Public Accountants, to PCAOB (Nov. 21, 2003) (on file with PCAOB as "PCAOB Rulemaking Docket No. 8, Letter No. 105").
  \item[104.] Comment Letter from Audit and Assurance Services Committee of the Illinois CPA Society, to PCAOB (Nov. 21, 2003) (on file with PCAOB as "PCAOB Rulemaking Docket No. 8, Letter No. 103").
  \item[105.] Comment Letter from Texas Society of Certified Public Accountants, to PCAOB (Nov. 21, 2003) (on file with PCAOB as "PCAOB Rulemaking Docket No. 8, Letter No. 78").
  \item[106.] Comment Letter from New York State Society of Certified Public Accountants, to PCAOB (Nov. 21, 2003) (on file with PCAOB as "PCAOB Rulemaking Docket No. 8, Letter No. 140").
  \item[107.] Comment Letter from National State Auditors Assc., to PCAOB (Nov. 21, 2003) (on file with PCAOB as "PCAOB Rulemaking Docket No. 8, Letter No. 113").
  \item[108.] Comment Letter from Institute of Internal Auditors, to PCAOB (Nov. 21, 2003) (on file with PCAOB as "PCAOB Rulemaking Docket No. 8, Letter No. 112").
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on learning that likewise points towards a state solution. The largest group of international accountants observed that it is a difficult question: in theory, auditors cannot perform this task; in practice, someone must perform it; and on balance, the optimal solution is to require auditors to perform an evaluation linked narrowly to their assessment of the overall control environment. A U.K. accountancy group noted that the U.K. Combined Code on Corporate Governance requires boards to conduct performance evaluations of audit committees. A European group emphasized the need to address the conflict, not shrink from it, suggesting using a threats-safeguards approach similar to that of the IFAC Ethics Code which would involve requesting an "independent colleague (review partner) to assist."

Among accounting academics, the leading group, the American Accounting Association (AAA), opined: "one radical and perhaps cost-prohibitive suggestion is to require a second audit firm to perform the audit committee assessment on a less frequent basis (e.g., every 3-5 years)." As noted at the beginning of this Part, this would solve the problem of independence, but not of expertise. It indicates, however, a willingness that should lead the AAA to support the state agency approach—a willingness likewise strongly indicated by substantially all the other comment letters the auditing profession provided to the PCAOB on its proposed standard, as summarized above.

C. The Legal Profession

The American Bar Association (ABA) concluded that the PCAOB's Proposed Standard was "not consistent with" SOX § 301 and "appear[ed] flawed and circular." Beyond these general fatal flaws, the ABA identified three more negotiable flaws: many requirements are beyond an auditor's expertise or are better handled by others, are not measurable by objective criteria, or require legal judgments.

The Association of the Bar of the City New York reported similar objections to PCAOB's Proposed Standard. It also objected on the grounds that the listed evaluation factors "would require a much greater degree of

109. Comment Letter from Assoc. of Chartered Certified Accountants, to PCAOB (Nov. 21, 2003) (on file with PCAOB as "PCAOB Rulemaking Docket No. 8, Letter No. 88"). The Association of Chartered Certified Accountants boasts that it is the world's largest professional association of accountants. Id.

110. Comment Letter from Inst. of Chartered Accountants in England and Wales, supra note 93.

111. Comment Letter from Fédération des Experts Comptables Européens, to PCAOB (Nov. 21, 2003) (on file with PCAOB as "PCAOB Rulemaking Docket No. 8, Letter No. 79").

112. Comment Letter from American Accounting Assoc., to PCAOB (Nov. 17, 2003) (on file with PCAOB as "PCAOB Rulemaking Docket No. 8, Letter No. 31").

involvement by the auditors in the internal operation of the audit committee” and observation requiring skills beyond auditor expertise, including knowledge of listing standards and interpretations. The New York State Bar Association expressed similar concerns, citing both independence-impairment when auditors perform this essentially managerial function and questioning whether auditors are in a good position to carry out the duties.

No other bar association commented on PCAOB’s proposed standard, though an informed guess suggests that most would concur with the views expressed by the ABA and the two New York associations. On the other hand, certain bar associations might have more specific concerns, including for example the Delaware State Bar Association, whose expertise in corporation law and corporate governance may equip and incline it to provide more detailed insights. In any event, if the comments these bar associations provided are representative, it is reasonable to infer that the legal profession as a body would support the state agency concept.

V. ANTICIPATING REGULATORY HESITATION

Despite predicting likely support for the state agency concept from users and preparers of financial statements and from the auditing and legal professions, it is uncertain whether regulators or states would support it. These predictions can be informed by evaluating the overall prevailing framework of corporate governance and alternative models of how its components are produced. The current array is dominantly federal, with states residing in the background, a relationship that tends to support predicting federal regulatory hesitation and state reluctance or indifference. But there may be hope.

A. Federal

Generations of corporate law scholars have debated whether state corporation law is a product of horizontal competition among the states and, if so, whether the competitive output showed a race to the top, to the bottom, or to somewhere else. As the intellectual and empirical debate stalemates on this

115. Comment Letter from New York State Bar Association, Business Law Section, Committee on Securities Regulation, to PCAOB (Nov. 25, 2003) (on file with PCAOB as “PCAOB Rulemaking Docket No. 8, Letter No. 180”). The American Society of Corporate Secretaries echoed the points, also emphasizing how the SROs are addressing the questions. Comment Letter from American Society of Corporate Secretaries, PCAOB Sub-Committee of the ASCS Securities Law Committee, to PCAOB (Nov. 21, 2003) (on file with PCAOB as “PCAOB Rulemaking Docket No. 8, Letter No. 106”).
116. The debate dates to the 1930s, led by Justice Brandeis and Professors Berle and Means, continued through the 1970s in a noted exchange between SEC Chairman Cary and Judge Winter, and endured through the 1990s and today with scores of articles devoted to numerous aspects of the subject.
horizontal competition among states, an alternative sees a vertical competition between federal securities regulation and state corporation law, with the federal hand dominant but still limited. In this story, SROs either (a) fill a gap between federal and state corporate governance sources or (b) operate as an extension of the federal regulatory hand into territory better reached through superficially-private means, or where federal courts would not allow federal administrative agencies to venture.

Recent debates concerning SROs resemble the hoary corporate law debate in asking whether competition among SROs, plus foreign securities exchanges, are running a horizontal race of their own, and whether this is to the top or bottom. A similar debate concerns competition among other regulatory bodies, such as accounting standard-setters like the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB).

With the PCAOB's creation, a similar conversation is likely to emerge with regards to its obvious competitors—such as the International Auditing Standards Board. To the extent the PCAOB also engages in standard-setting associated with corporate governance, however, a new conception of horizontal competition emerges: the PCAOB can compete with states and SROs. The PCAOB's product market is less clear than Delaware's (charters for franchise fees) or the SROs (listings for listing fees). But power to set the agenda and to control the processes of standard-setting may be intrinsically valuable, and despite SOX's effort to insulate the PCAOB from the auditing profession, rents may remain available for the PCAOB to allocate, at least in part.

In the case of evaluating audit committees, which body should set the agenda and specify required elements: the SEC, SROs, the PCAOB, or states? The SEC may fear that direct efforts to do this would extend beyond the power Congress granted it in SOX (or, more precisely, that a federal court might accept this argument); it may recognize that using SROs would be impracticable given their distance from the operational activities of audit.


117. See, e.g., Mark J. Roe, Delaware's Competition, 117 Harv. L. Rev. 588 (2003); Jones, supra note 8.

118. See Thompson, supra note 4.


120. See Bratton, Rules Versus Principles Versus Rents, supra note 21.

committees. By default or design, therefore, the PCAOB fits the bill.

Some evidence from the evolution of the PCAOB’s Proposed Standard into Auditing Standard No. 2 suggests that the PCAOB is operating as a component of a more general federal-based corporate governance system. Whether the SEC would want the states to do this is unclear. Some evidence suggests that federal regulators disfavor competition among SROs, if so, they may likewise object to horizontal competition by states against these SEC instrumentalities.

Suppose we indulge a naïve perspective, however: if federal regulators were acting in the best interests of the nation, it would seem that they would welcome the state agency approach to audit committee certification as well. Congress, the SEC, and the SROs exhibited some federalism restraint in their provisions concerning audit committees—all conferred substantial power in boards to review effectiveness and imposed disclosure requirements. The PCAOB offers enhanced review by auditors, but is clearly aware of inherent limitations. None of these groups offers the solution best suited to the task.

But now let us return to federal regulators’ self-interest. Assigning this function to states would relieve these regulators of the particular associated burdens, while leaving them in a position to monitor the concept in action. The SEC operates using a restricted budget, after all, and must appeal to Congress to secure funding for its activities. When facing budget constraints, the SEC may prefer additional funds to support its enforcement activities rather than to develop or support new initiatives such as audit committee certification.

Permitting states a meaningful role in corporate governance offers the SEC another advantage. When systems fail and public protests ensue, federal regulators can blame the states for laxity in fiduciary standards or other weaknesses. The states are thus also useful to Congress as scapegoats for scandal. Thus, Congress may be willing to encourage the SEC to support a state-agency approach to audit committee certifications.

In fact, this view may explain what are otherwise SOX’s half-measures. That is, why not preempt state corporation law for public companies, subjecting directors and audit committees to federal corporation law standards and review? Though complex political and legal explanations arise, a simple and plausible explanation is this: maybe the half-steps reflect knowledge that no regulatory regime is capable of preventing fraudulent shenanigans and regulatory laxity like that of the late 1990s and early 2000s.

Leaving the state hole enables the federal apparatus to point to state laxity

122. See supra notes 43, 47 and 51 (discussing Auditing Standard No. 2’s deletion of factors appearing in PCAOB’s Proposed Standard concerning independence of audit committee nomination and selection process and compliance while retaining factor of member independence).

123. See Thompson, Collaborative Corporate Governance, supra note 4.
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when the next wave of corporate malfeasance is revealed. If federalization of corporate governance were made complete today, then when the next scandal appears there would be no one but the federal apparatus to blame. Under this view, states as a whole have an incentive to participate in reshaping corporate governance with the same visibility and commitment the federal engines have exhibited. Whether individual states have requisite incentives is considered next.

B. States

Estimating the likelihood that particular states would pursue the state-agency audit committee certification product depends on a theory of state corporation law production. The traditional models—race to the bottom, or top, or an interest group model—offer ready predictions. If a race to the bottom best explains state corporation law production, states are unlikely to support the concept to the extent it imposes discipline and transparency on management. If a race to the top or an interest group model explains state corporation law production, then states are likely to embrace the concept. They would embrace the concept under the race to the top theory to the extent that it lowers the cost of capital by reducing agency costs and serves the interests of capital markets and investors. They would embrace it under the interest group theory to the extent that it produces additional revenue for states and their lawyers, keeping services in the legal profession and out of the auditing and accounting professions.

Predictions of state inclination are more difficult if one embraces the two variations on the model, which appear increasingly more capacious and accurate descriptions of the observed federalization of corporate governance production. Under the vertical competition model, states only act when pressured and when federal authorities provide an omnipresent preemption threat. The only way to prevent preemption is to fall into line; the state-agency concept would constitute an innovation rather than a capitulation. Under the disguised-federalization model, states may have a role, but may lack incentives to play it. A limited incentive would genuinely compete with the federal apparatus in standard-setting leadership, but the federal hand might be so powerful that this would require unusual political fortitude.

Within some states, such political skill might exist. States are not necessarily monolithic. They are political institutions populated by people holding differing views. Within a state, some lawyers and judges may favor the concept while others oppose it. Supporters could recognize that using a state agency along with the judiciary could cause a friendly internal competition as the state’s standard-bearer. If the state agency achieved a degree of national recognition as a thoughtful and practical leader in good corporate governance
within the boundaries afforded by state corporation law, this could incrementally induce superior judicial decision-making as well. States could compete with the federal apparatus in a real vertical competition amounting to a race to the top, and when next season’s scandals hit, states could blame federal authorities.

CONCLUSION

Auditing Standard No. 2’s emphasis on audit committee effectiveness returns federal law’s ambitions for audit committees to the foundation, to state corporation law from which directors get their power and duties. The federal return to state corporation law leaves an incomplete and possibly incoherent corporate governance system. The incompleteness is epitomized by the federal emphasis on audit committee effectiveness and the lack of a mechanism—state, federal, or private—to provide requisite assurance.

This Article’s analysis underscores the limits of half-measures. If the federal approach leaves open such an obvious hole in the framework, then it is just as deficient as the state corporation law it purports to correct. Either the federal regime must be complete and fully preempt state corporation law, or states must be given incentives and space to participate in developing corporate governance. Congressional reticence against complete preemption of state corporation law suggests a need to give states space, incentives, and support to contribute meaningfully to improving corporate governance.

State-agency audit committee certifications provide a vehicle for state contributions. The concept would form a logical part of a complex—and unplanned—regulatory model of corporate governance production. It would embrace an emerging horizontal competition among different types of competitors, invigorate vertical competition between state and federal producers, reinvigorate interstate competition, and even possibly ignite intrastate competition. Getting these processes rolling would require only a single state to move first. Getting a state to move would probably require lobbying by the private-sector leaders likely to be supportive, including financial statement users and preparers as well as the auditing and legal professions. Given audit committee centrality in financial reporting and governance processes, failure to address this gap likely will facilitate future financial reporting and corporate governance scandals.
Measuring the Effects of Mandated Disclosure

Allen Ferrell†

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Measuring the Effects of Mandated Disclosure

Allen Ferrell

I. INTRODUCTION

A recurring debate among corporate and securities law scholars is whether mandated disclosure, the heart of U.S. securities regulation, is necessary. One set of commentators contends that market forces will generally ensure that the optimal level of disclosure occurs without any regulatory intervention. Other scholars have defended mandated disclosure as both necessary and beneficial focusing on informational externalities associated with firm disclosures. What is needed at this point in the debate is more empirical research on the actual effects of mandated disclosure.

The "classic" econometric studies of mandated disclosure, heavily relied upon and debated by legal academics in their analysis of mandated disclosure, consist largely of three studies: George Stigler's 1964 study; George Benston's 1973 study; and Carol Simon's 1989 study. All three studies analyzed either the effect the Securities Act of 1933 (Stigler and Simon) or the Exchange Act of 1934 (Benston)—collectively known as the Securities Acts—had on stock prices.

Stigler examined the stock price performance of new stock issues before and after the Securities Act of 1933. Benston examined the impact of the Exchange Act of 1934 on a sample of 466 NYSE-listed firms which he divided into two groups: 290 firms that were already disclosing sales information before passage of the Exchange Act of 1934 mandated such disclosures (the "disclosure group") and a group of 176 firms that were not (the "non-disclosure group"). Simon examined, as Stigler did, the performance of new issues before and after the Securities Act of 1933. She divided her sample into seasoned

3. There are also several important recent studies on the effects of mandatory disclosure in cross-country studies. See e.g., Rafael LaPorta et al., What Works in Securities Regulation?, (2004) (working paper), available at http://post.economics.harvard.edu/faculty/shleifer/papers/securities_0907.pdf (last visited Dec. 21, 2004).
NYSE companies, unseasoned NYSE companies, seasoned non-NYSE companies, and unseasoned non-NYSE companies.

Finally, a recent empirical study by myself, building on this literature, looked at the effects of the 1964 imposition of mandated disclosure on the over-the-counter market, the only other fundamental change in the U.S. in the scope of mandated disclosure besides the original Securities Acts.\(^7\)

This piece will argue that Stigler, Benston, and Simon's failure to convincingly arbitrate the debate over mandated disclosure is largely attributable to two shortcomings: (1) a lack of convincing theory justifying the particular measures of stock price performance employed in these studies; and (2) the inability to control for changing market conditions when comparing pre- and post-mandated disclosure periods.

Part II will discuss the main potential benefit of mandated disclosure in the United States emphasized by advocates of mandated disclosure: greater stock price accuracy. Part III will then discuss the lack of theory connecting stock price accuracy to the various aspects of stock market performance measured in the empirical literature. After this discussion, Part IV will conclude by addressing the second main shortcoming of the empirical literature: the lack of adequate controls to distinguish time-series effects from the effects of mandated disclosure laws.

## II. THE BENEFITS OF STOCK PRICE ACCURACY

As a conceptual matter, an important test for whether mandated disclosure "works" is whether the informational content of stock prices, post-mandated disclosure, is greater than it would otherwise have been. The more information is impounded into the price of a stock, the more the price of a stock correctly anticipates the future prospects of the company. The concept of stock price accuracy is well accepted and commonly employed in the accounting and finance literature.\(^8\) Following Merritt Fox, I will refer to the level of informational content of stock prices as "stock price accuracy."

Improved stock price accuracy is potentially valuable for at least two separate reasons. First, to the extent that capital is allocated based on stock prices, the more accurate stock prices are, the better that allocation will be. "Better" in this context means that capital will be more likely to be allocated to

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Measuring the Effects of Mandated Disclosure

the highest-valued user of that capital. Second, to the extent that corporate governance decisions depend on the accuracy of stock prices, the more accurate stock prices are, the better corporate governance will be. Economists often focus on the first reason while legal academics commonly focus on the second.

A. Capital Allocation and Stock Prices

Measuring the extent to which investment decisions are driven by stock prices has proven very difficult. Any given investment decision might be based on stock prices or, alternatively, could be based on the underlying business fundamentals. Separating the two is not easy if stock prices actually reflect, as is likely the case, business fundamentals. This is a pressing problem, as stock prices are traditionally thought of as reflecting the marginal product of capital, a concept that captures the business fundamentals that should ideally be driving investment decisions.9 A central question, then, is whether fundamentals drive investment decisions solely, or, alternatively, whether stock prices play an independent role in affecting investment.

Different studies have applied various techniques in trying to disentangle the two, arriving at different conclusions on the extent to which stock prices factor into investment decisions. Some researchers have found that stock prices play only a limited role in investment decisions.10 Other researchers, in contrast, have found that stock prices can play an important role in the allocation of capital.11

Recent empirical research, however, has been supportive of the view that stock prices can matter for investment decisions.12 An interesting recent study by Durnev, Morck, and Yeung investigated the relationship between the stock price accuracy of an industry’s stock and the allocation of capital in that industry.13 The study used firm-specific stock price variation as a proxy for stock price accuracy. Firm-specific stock price variation is the fraction of stock price variation that is left “unexplained” by some baseline asset-pricing model, such as the CAPM. Such variations cannot be attributed to broader fluctuations in the markets, and are, hence, firm specific. Using this proxy for stock price accuracy they found in this study that capital was allocated with greater precision in industries with more accurate stock prices.

Researchers have also inquired into the second potential effect of improved stock price accuracy: improved corporate governance. One important corporate governance mechanism is mergers and acquisitions, which can serve as an important disciplinary device. Shleifer and Vishny argue that the cost of equity—which is derived from stock prices—is an important variable capable of helping to explain the incidence of merger and acquisition activity across industries and over time. Likewise, the effectiveness of executive compensation, another important corporate governance mechanism, depends on stock prices accurately reflecting an individual firm’s success.

In short, more accurate stock prices can serve the dual function of ensuring better investment decisions and improving corporate governance.

III. THE LACK OF THEORY

Given the potential importance of stock price accuracy for the allocation of capital and corporate governance, there is a real need for proxies for stock price accuracy. Unfortunately, the job of empirical researchers has been frustrated, to a certain extent, by a lack of theory that could help identify good proxies. What has been measured to date are stock returns, stock volatility, the cross-sectional variance of stock returns, and, in two recent studies, stock return synchronicity measures. A solid theoretical connection between these proxies and stock price accuracy would be quite useful.

This Part will examine the possible theoretical bases for the use of these different measures.

A. Stock Returns

All three of the classic econometric studies, as well as my own study of the effect of the Securities Act Amendments of 1964, looked at changes in stock returns pre- and post-mandated disclosure. Each had different assumptions about how mandated disclosure would manifest itself in stock returns. Stigler reasoned that the purpose of mandated disclosure is to improve shareholder welfare and, therefore, a natural place to look is the relationship between

16. See, e.g., Ferrell, supra note 7.
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mandated disclosure and stock returns. Benston reasoned that if managers were adequately disclosing pre-mandated disclosure, then mandated disclosure might be viewed by investors as imposing a net cost on the firm, which would manifest itself in lower stock returns. Given the consistent use of stock returns in the literature, I also measured stock returns pre- and post-mandated disclosure.20

All four studies (including Carol Simon's study that looked at the dispersion of stock returns) controlled for market fluctuations in order to determine whether stock returns were affected by the imposition of mandated disclosure. Stigler compared the average returns on new stock issues floated between 1925 and 1929 with those issued in 1949-1953. He deflated the ratio of the value of the new-issues portfolio by the value of a broad market index to control for market fluctuations. Benston used a market model that enabled him to also control for fluctuations in the overall market. Simon and I used a more extensive specification of the return generating process enabling them to control for overall market fluctuations, time effects, and industry effects. In addition, I included additional controls for book-to-market effects and firm size effects. Both Simon and I also used an alternative specification of abnormal returns—net-of-market returns (individual stock return minus the market return)—as a robustness check.

Stigler and Benston found no differences in stock returns pre- and post-mandated disclosure after employing their various controls. Simon found that the stock returns of NYSE-traded issuers, unseasoned as well as seasoned, was statistically identical pre- and post-mandated disclosure. However, I tested both the change in average abnormal as well as the median abnormal return pre- and post-mandated disclosure and found evidence consistent with an increase in stock prices resulting from mandated disclosure.21

These findings raise two questions. First, are changes in abnormal returns a good test for whether or not mandated disclosure is beneficial? Second, are changes in the abnormal returns pre- and post-mandated disclosure a good proxy for stock price accuracy?

Asset pricing theory implies that the expected return on an asset is the risk-free rate of return plus a premium based on the risk inherent in holding that asset. In order for changes in stock returns to serve as a proxy for changes in stock price accuracy, one would need to show that stock price accuracy has a meaningful effect on the risk-free rate of return or the premium associated with holding undiversifiable risk. This effect is neither straightforward nor obvious. Further explanation of the mechanisms by which mandated disclosure affect stock prices would therefore be useful.

20. Ferrell, supra note 7.
21. Id.
It is possible, of course, that in the immediate aftermath of mandated disclosure companies would experience stock price changes as new information came to light. However, this does not mean that the average stock price reaction would be positive or negative. The value of some firms might be revised downward after negative information is released while other firms might experience upward revisions after investors realize there is no unreleased, or concealed, negative information.

Such reasoning suggests that one possible test for determining whether mandated disclosure is resulting in new information being released—and hence improving stock price accuracy—is the change in the dispersion of abnormal returns in the immediate aftermath of mandated disclosure. There are, however, several other candidates for explaining how stock returns are affected by the release of new information required by a mandated disclosure regime.

One possibility developed in the accounting literature is the potential that there is "estimation" risk when an investor purchases a stock for which there is inadequate information.22 Because the CAPM model assumes a security's payoff distribution is known by investors, this estimation risk is not reflected in the traditional CAPM model.

An open question concerning whether estimation risk is significant or not has centered on whether estimation risk is diversifiable or not. This remains a point of debate in the literature, with some commentators arguing that estimation risk should be diversifiable given the breadth of modern securities markets.23 If estimation risk is diversifiable then it should have no affect on stock returns. If this is so, then improvements in stock price accuracy would not affect stock returns or prices through reducing estimation risk.

A second possibility, explored by Amihud and Mendelson among others, is that more information leads to a reduction in bid-ask spreads.24 The adverse selection component of the bid-ask spread, a well-established component of the bid-ask spread, should fall as more information becomes publicly known about a stock.25 Reduced bid-ask spreads, in turn, should result in lower stock returns as the transaction costs facing investors are reduced. Of course, at the time the bid-ask spreads are reduced, stock prices should increase capitalizing the savings to investors resulting from smaller bid-asks spreads in the future.

B. Stock Volatility Over Time

Stigler, Benston, and Ferrell also measured the effect of mandated

23. Id.
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disclosure on the volatility of abnormal returns of stocks over time. Stigler found that stock return volatility was significantly lower in the period following the passage of the Securities Act of 1933. Benston measured the effect of mandated disclosure on the volatility of abnormal returns—those returns unexplained by the market model. He found that the variance of securities prices declined substantially after the imposition of mandated disclosure. At the same time, he found no statistically significant changes in the variance of abnormal returns of stocks in his disclosing and non-disclosing group that can be associated with passage of the Exchange Act of 1934.

Many commentators have argued that the “most logical conclusion to draw from this evidence is that [stock price accuracy] was enhanced and that investors thereby benefited.”26 This argument ignores, however, the fact that Benston found no statistically significant differences between the reaction of the disclosure group to mandated disclosure and the non-disclosure group. Benston reported that the change in variance was “almost the same for those corporations that were and were not affected by the Act.”27

On the other hand, I found that the volatility of abnormal stock returns in the over-the-counter (“OTC”) market experienced a substantial decline in the post-mandated disclosure period.28 The control group, exchange-listed companies, actually experienced an increase in volatility in the post-mandated disclosure period. As a result, the volatility of listed and OTC stock returns were virtually identical in the period following the imposition of mandated disclosure on OTC firms. In contrast, in the pre-mandated disclosure period OTC volatility was significantly higher than that of the listed market.

However, the findings on volatility, while suggestive, beg the question: is decreased variance necessarily indicative of improved stock price accuracy? We still need a convincing theoretical framework connecting the two in order to interpret the empirical findings. Consider the following four possibilities and their differing predictions concerning the relationship between volatility and stock price accuracy.

1. All Information is Revealed Eventually

One could easily imagine a model where all information, good as well as bad, is eventually revealed even if disclosure is not mandated. In such a model, managers might be able to hide information for a while, but eventually investors will learn the true state of affairs. If a customer cancels a large order,

28. See Ferrell, supra note 7.
say, management might be able to hide the bad news for a while, but eventually investors will learn of the effect of the cancellation on the company's profitability, even if only through a bankruptcy filing.

The imposition of mandated disclosure in such a model might result in the possible release of information at a date earlier than would have otherwise occurred (and, hence, improve stock price accuracy). Any piece of information will eventually be revealed and, at that point, will affect the stock price.

One potentially useful implication of such a model is that mandated disclosure, after the initial adjustment period is over, will produce fewer “stock blow-ups,” i.e., stocks with very large negative abnormal returns in a single month. Without disclosure, management may conceal deteriorating company conditions, surprising investors with dramatically bad news. Disclosure suggests that such negative information about a company will be released more gradually over time. I found that there were in fact fewer “stock blow-ups” in the OTC market after mandated disclosure was imposed. Conversely, during the period immediately following the imposition of mandated disclosure (the adjustment period) there might, in fact, be more “stock blow-ups” given the sudden forced revelation of bad news that managers had been able to conceal until that point.

2. Mean Reversion in Fundamental Value

Some scholars have suggested that the firm-specific component of fundamental firm value is mean reverting. If there is mean-reversion, then it is possible that firm-specific information will eventually become, over time, stale and uninformative. This would imply that mandated disclosure could increase variance above what it would otherwise be as well as increase stock price accuracy. Mandated disclosure might ensure that information is released while it is still timely, and, hence, have an impact on stock prices. In the absence of mandated disclosure, that information might not have been released until it was stale and uninformative, and hence have no impact on stock prices. While there is no current evidence that such mean reversion does or does not take place, the topic is an active area of research.

3. Constant Discount Rates

Academics have also done rigorous theoretical work on the effects of adding a constant discount rate to a model where all information is revealed eventually. Such research takes into account the fact that the future cash-
flows/profits of a firm are discounted by market participants into current dollars. Models by West and LeRoy and Porter indicate that the release of information on a more timely basis would, in fact, reduce stock return volatility in a world where all information is eventually released. More timely information about future cash-flows/profits of the company will have less of an impact on return volatility than would information released at a later point in time, as the cash-flows/profits are more heavily discounted earlier in time. Interestingly, these models also indicate that while more timely information reduces return volatility, it actually increases the volatility of the stock price level. These interesting predictions underscore the need to formalize intuitions concerning the impact of mandated disclosure on stock returns and prices under different assumptions.

4. Noise Associated with Information

Alternatively, one could also have a model that would lead one to associate increased variance with improved stock price accuracy. This could occur in a model in which there is a noise trader reaction associated with the release of information. In other words, the stock price reaction to the release of information would have two components: a reevaluation of the company's prospects in light of new information and the price impact of noise traders. Depending on how the noise component is modeled, it is possible to have a situation in which increased variance of stock prices is associated with an increase in stock price accuracy. Of course, improved stock price accuracy would result only if the price impact of noise traders was not too large relative to the price impact of the new information.

C. Cross-Sectional Variance

In her study of the effect of the Securities Act of 1933 on stock price behavior, Carol Simon used the cross-sectional variance of abnormal returns as a proxy for stock price accuracy. For each stock in the pre-mandated disclosure period (pre-1933), she calculated the abnormal return for a given period of time, again controlling for market, industry, and time effects. She then calculated the variance of the abnormal returns for stocks in the pre- and post-mandated disclosure period for four groups: seasoned NYSE-listed firms; unseasoned NYSE firms; seasoned non-NYSE firms; and unseasoned non-

34. See Fox, supra note 19.
NYSE-listed firms. By comparing the variance of the abnormal returns for these four groups pre- and post-mandated disclosure, Simon found that the variance of abnormal returns was smaller in the post-mandated disclosure period for unseasoned non-NYSE-listed firms.

Simon gives the following intuitive justification for using the variance of abnormal returns as a proxy for stock price accuracy: "The availability of quality information will . . . affect the riskiness of [stocks]. As such, the effects of legislation aimed at increasing investor information should be reflected in changes in the dispersion of market-adjusted returns."36 This justification is, at best, incomplete, as it fails to connect the cross-sectional variance of returns with an explanation of how increased information at an earlier period of time interacts with the dispersion of abnormal returns. As before, the nature of this interaction will depend on one's assumptions concerning discount rates, when information is revealed if disclosure is not mandated, and, possibly, the actions of noise traders.

While the theoretical connection between the cross-sectional variance of abnormal returns and stock price accuracy is undeveloped, Simon's results are consistent with the view that there is such a connection. She found that the seasoned NYSE firms had the lowest cross-sectional variance of abnormal returns, followed by unseasoned NYSE firms, then seasoned non-NYSE firms and, finally, unseasoned non-NYSE firms. Unseasoned firms had the largest variance of abnormal returns of all four groups.37 The fact that seasoned NYSE-listed firms had the smallest variance while unseasoned non-NYSE firms had the largest is consistent with using cross-sectional variance as a proxy for stock price accuracy. On a similar note, I found that the cross-sectional variance of abnormal returns in the OTC market pre-mandated disclosure (1962-1965) was significantly larger than the cross-sectional variance of abnormal returns in the listed market for the same time period.38

IV. THE LACK OF SATISFACTORY CONTROLS

A second shortcoming of the empirical literature is its general lack of control groups that would allow analysis to take into account changes in market conditions over time. Such a lack of adequate controls is a serious problem with all three of the "classic" econometric studies.

A. Stigler Study

Stigler's controls for changing market fluctuations are unconvincing. First,

36. *Id.* at 295.
37. *Id.* at 309.
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he simply divided the new-issues portfolio value by a market index value. He does not control for other factors, besides the market index, that might change over time. Moreover, his post-mandated disclosure sample is from the 1950s, some twenty years after the passage of the Securities Act of 1933. Both of these facts call into serious question his findings given the well-documented fact that stock returns and volatility vary significantly over time.

B. Benston Study

As noted before, Benston found a reduction in stock-price variance in the Security Act of 1933’s post-mandated disclosure period. Did the Securities Acts cause this reduction as defenders of mandated disclosure contend or did it result from the impact of the Great Depression and other changes in the markets over time? This is an extraordinarily difficult question to answer.

Conceivably, the effects of the Great Depression and the Securities Acts could be disentangled if a good control group were available. Benston’s group of companies that apparently disclosed sales information voluntarily before disclosure was mandated would arguably serve this function. The problems with using this group as a control, however, are serious. First, several commentators have noted that many firms in the non-disclosing group did, in fact, disclose basic financial information such as net income and balance sheet data. This throws into question whether the disclosing group can serve as a good control group if it was not all that different from the non-disclosing group.

Second, commentators have argued that the important change wrought by the Securities Acts was primarily in the liability imposed for fraud and non-disclosure, given the arguably poor quality of voluntary disclosures. The SEC found, for instance, that prior to the imposition of mandated disclosure on the OTC market, there was a high level of fraud in the reports that were voluntarily issued. The increased exposure to liability for inadequate disclosure would have affected both groups of companies. Both these criticisms raise the question of whether measuring the differential effect that the disclosure requirements of the Securities Acts had on Benston’s two groups is a good measure of the Acts’ overall effect on the capital markets. If the two groups Benston uses are not all that different, then the differential effect of the Securities Acts on these two groups would not serve as a good measure of the Acts’ overall effect.

40. Id.
C. Simon Study

Simon's study used a different econometric technique than that of Benston's study to accomplish the goal of isolating the effects of mandated disclosure. Rather than using a control group, as Benston does, she tried to estimate econometrically the effect of "bull" and "bear" markets on the proxies for stock price accuracy—most importantly, the cross-sectional variance of abnormal returns—she employed. Simon measured how the cross-sectional variance of abnormal returns varied over three stock market cycles in the 1946-1960 period.

Isolating the effects of the Great Depression is as fundamentally important to Simon's analysis as it is to Benston's. The obvious need to account for the effects of the Great Depression are confirmed in her finding that the stock market as a whole experienced a substantial reduction in variance during the Great Depression.42

However, there are several problems with Simon's control approach, although it is certainly an improvement over ignoring the issue. First, the time period looked at, 1946-1960, is some fifteen to twenty years after the passage of the Securities Act, rendering it less useful as a control group than one tracked in the immediate aftermath of the Securities Act of 1933. Second, it is unclear whether the behavior of the variance of abnormal returns in the bear market of 1957-1958, for example, will tell us much concerning the impact of the Great Depression on variance. These two events were of entirely different orders of magnitude and duration.

In the end, prudentially, Simon concludes that, "[t]he coincident timing of [the Great Depression and the Securities Acts] makes it difficult to fully disentangle competing hypotheses."43

D. Ferrell Study

In terms of controls, there are some clear advantages in studying the 1964 extension of mandated disclosure to the OTC market. First, throughout the time period examined (1962-1968) there was no stock market event anywhere on the order of the Great Depression. Second, there exists a natural control group. Exchange-listed companies throughout this time period had already been subject to mandated disclosure requirements for some thirty years. It was the OTC market that was affected by the change in the coverage of mandated disclosure requirements.

In the course of measuring volatility, cross-sectional variance, average stock returns, and stock return synchronicity, I analyzed both the listed market

42. See Simon, supra note 35, at 309.
43. Id. at 311.
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and the OTC market. One can therefore control for changing market conditions over time by using difference-in-difference estimators.

V. CONCLUSION

Two of the main potential advantages of mandatory disclosure are more informed stock prices and better corporate governance. A crucial step in identifying the effects of mandatory disclosure is theoretical and empirical work that can enable empirical researchers to confidentially use proxies for increases in the informational content of stock prices and improved corporate governance in studying changes in mandatory disclosure regulation. Recent research on mandatory disclosure has started to fill in this gap.