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Independent Yet Captured: Compensation Committee Independence After Dodd-Frank

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Independent Yet Captured: Compensation Committee Independence After Dodd-Frank

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In response to the financial crisis of 2008 to 2009, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 includes several far-reaching executive compensation reforms. Because most scholars have focused on the so-called "say-on-pay" provision, they have not sufficiently analyzed another Dodd-Frank reform that requires public companies to have compensation committees composed entirely of independent directors. This Article fills that void. Although it is sensible to make compensation committee members independent of management, the reform does not go far enough to achieve its goal. The independence requirement is not sufficient to prevent directors from being captured by management because it does not take into account organizational behavior literature regarding group dynamics. Ostensibly independent directors might still be subject to organizational behavior factors—such as norms of reciprocity, groupthink, polarization, social cascades, and herding—that could lead them to approve excessive compensation packages.

This Article thus proposes two additional reforms to augment the independence of compensation committee members: (1) mandatory continuing professional education regarding compensation issues and (2) a rotation system for compensation committee membership. Directors will be less susceptible to the organizational behavior factors noted above if they are equipped with knowledge about complex compensation issues and tasked with approving compensation for only a limited period of time. These recommendations draw on similar requirements under the Sarbanes-Oxley Act of 2002, which mandate that (1) all members of the audit committee be financially literate, (2) at least one audit committee member have financial expertise, and (3) the lead and concurring partners of a company's auditing firm rotate off the client engagement after five years.

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Introduction

Millions of Americans lost their jobs, their homes, and, moreover, their belief in the American dream during the financial crisis of 2008 to 2009. This despair was exacerbated by reports that executives of prominent financial institutions were receiving high amounts of compensation, even as the companies they led were failing and, in some cases, being bailed out by the federal government using taxpayer dollars. Many critics voiced concern that the magnitude and design of executive compensation at financial institutions and other large companies played a critical role in causing the financial crisis.[1] Eventually, public outrage over executive compensation reached a boiling point, which led Congress to consider reforms to improve executive compensation specifically, and corporate governance more generally.[2]

In response to such concerns, when Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") in July of 2010, it included several far-reaching executive compensation reforms.[3] Indeed, one author stated that "[t]aken together, the provisions in Dodd-Frank that affect the executive pay process quite arguably will have the broadest and most significant impact on the pay process of any set of new rules ever contained in one law."[4]

The most prominent executive compensation reform is the so-called "say-on-pay" provision, which gives shareholders of U.S. public companies a nonbinding, advisory vote on executive compensation.[5] While scholars have extensively analyzed that provision,[6] they have not sufficiently analyzed another important executive compensation provision: the requirement that U.S. public companies have a compensation committee composed entirely of independent directors. This Article ventures into

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1. *See, e.g.*, Jay Lorsch & Rakesh Khurana, *The Pay Problem*, Harv. Mag., May–June 2010, at 30.

2. *See, e.g.*, *Compensation in the Financial Industry: Hearing Before the Comm. on Fin. Servs., U.S. H.R.*, 111th Cong., Serial No. 111-98 (2010).

3. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, §§ 951–54 (2010) (codified as amended in scattered sections of 7, 12, and 15 U.S.C.).

4. *See* Joseph E. Bachelder III, *Dodd-Frank Provisions Affecting Executive Pay*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Oct. 5, 2010, 9:05 AM), http://blogs.law.harvard.edu/corpgov/2010/10/05/dodd-frank-provisions-affecting-executive-pay; *see also* Aon Hewitt, *Conference Committee Issues* Dodd-Frank Wall Street Reform and Consumer Protection Act, Executive Compensation Alert, June 29, 2010, at 1 (2010), *available at* http://www.aon.com/attachments/thought-leadership/executive_compensation_alerts/ ECA_2010_03v2.pdf ("Of the over 2,000 pages, less than 25 pages apply to executive compensation and corporate governance. However, those few pages have a major effect.").

5. Dodd-Frank Act § 951(a).

6. *See, e.g.*, Minor Myers, *The Perils of Shareholder Voting on Executive Compensation*, 36 Del. J. Corp. L. 417 (2011); Randall S. Thomas et al., *Dodd-Frank's Say on Pay: Will it Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 Cornell L. Rev. 1213, 1226 (2012).

this void by critiquing that reform and proposing additional reforms for increased efficacy.[7]

The compensation committee of a company's board of directors approves the compensation of the company's top executives. The compensation committee independence requirement is intended to diminish conflicts of interest that can occur when the compensation committee is "captured" and thus lacks the independence and objectivity that is necessary to determine executive compensation in an arm's length fashion. The term "captured board" refers to a board that is serving the interests of management rather than shareholders.[8]

While it is sensible to increase the compensation committee's independence from management, the reform does not go far enough because it fails to take into account relevant insights from organizational behavior literature regarding group dynamics. Directors who are nominally independent from management might still be subject to organizational behavior factors such as norms of reciprocity, groupthink, polarization, social cascades, and herding, which can lead them to approve excessive executive compensation packages.

To counteract this issue, this Article proposes two reforms: (1) continuing professional education regarding compensation issues for compensation committee members and (2) implementing a rotation system for compensation committee members, or at least the chairperson. The first reform—continuing education—should be mandatory, but the second reform—rotation system—should be recommended for companies that have a sufficient number of independent directors on their boards.[9]

The rationale for this proposal is that directors will be less susceptible to the organizational behavior factors described above if they are knowledgeable about compensation issues and are tasked with approving compensation for only a limited period of time. These recommendations draw on similar features of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") that require (1) financial literacy of all members of the audit committee, (2) financial expertise of at least one audit committee member, and (3) the lead engagement partner and concurring partner of a company's independent auditors to rotate off the engagement after a fixed period of time.[10]

This Article contributes to the existing scholarly literature by developing and modernizing reforms that practitioners considered in connection with Sarbanes-Oxley, grounding the reforms in organizational

7. Some scholars have analyzed the compensation committee independence requirement, but in general, the articles are primarily descriptive rather than prescriptive. *See* discussion *infra* Parts II–III.

8. *See, e.g.*, JONATHAN R. MACEY, CORPORATE GOVERNANCE 65 (2008).

9. *See* discussion *infra* Subpart III.C.2.b.

10. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15, 18, 28, and 29 U.S.C.).

behavior theory to provide a scholarly framework, and applying these adaptations to the compensation committee requirements of Dodd-Frank. From a broader standpoint, this Article highlights some of the ways in which organizational behavior theory affects the actions of corporate boards, executives, and shareholders. It also illustrates why regulatory reform in the corporate governance field must take such organizational behavior factors into account. The Article focuses on executive compensation, which many scholars regard as the primary issue in corporate governance.[11] However, the organizational behavior issues described herein have broader implications for other aspects of corporate governance, such as corporate social responsibility.

Part I of this Article describes the scholarly debate concerning executive compensation and the resulting Dodd-Frank reforms. Part II explores organizational behavior literature regarding group dynamics of boards and discusses insights from that literature that affect the compensation-setting process. Finally, Part III critiques the compensation committee independence requirement, proposes two additional reforms that draw on the insights from Part II, and provides a comparative law perspective.

I. Executive Compensation Reforms in Dodd-Frank

As noted above, this Part describes the background that led to the executive compensation reforms in Dodd-Frank and provides further detail regarding such reforms.

A. Scholarly Debate Concerning Executive Compensation

In response to the financial crisis of 2008 to 2009, President Obama signed Dodd-Frank into law on July 21, 2010. Dodd-Frank aimed to "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."[12] Dodd-Frank also reformed executive compensation and corporate governance, responding to the perception that these issues played a role in causing the financial crisis.

As a threshold matter, there is room for debate as to whether the magnitude and/or the design of executive compensation played a role in the financial crisis and, as a corollary, whether further regulation of

11. Daniel J. Morrissey, *Executive Compensation and Income Inequality*, 4 Wm. & Mary Bus. L. Rev. 1, 3 (2013) (quoting NECA-IBEW Pension Fund *ex rel.* Cincinnati Bell, Inc. v. Cox, No. 1:11-0451, 2011 WL 4383368, at *1 n.1 (S.D. Ohio Sept. 20, 2011)).

12. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, pmbl (2010).

executive compensation was needed. There is significant disagreement among scholars over whether executive compensation is, in fact, excessive and/or inappropriately designed. While this Article does not seek to resolve such debate, it summarizes some of the arguments and provides compensation data for the period up to the financial crisis in 2008 to provide the necessary background for evaluating the resulting reforms.

1. Compensation Amount

The debate over executive compensation concerns both the *amount* of compensation and the *design* of compensation. Various critics have argued that the amount of executive compensation has risen to excessive levels, and that this played a role in the financial crisis. For example, Paul Volcker, the former chair of the Federal Reserve, blamed "excessive pay packages" for the failing financial markets in 2008.[13] As it is difficult to prove empirically that executive compensation is "excessive," the literature in support of this claim usually relies on indirect evidence. Some scholars argue, for example, that the dramatic rise in CEO pay in comparison to the average worker's pay is evidence of income inequality.[14] These scholars also devised a formula indicating that pay is excessive to the extent that it exceeds the amount of pay attributable to a CEO's ability, effort, and a risk premium.[15]

Indeed, the gap between the pay of CEOs and that of other employees has expanded dramatically. For example, in 1980 the ratio of average CEO pay to average employee pay was 44:1, but by 2007 it had risen to 344:1.[16] A more recent study of the 300 largest companies in America revealed that this ratio remained steady at 343:1 in 2010.[17] Accordingly, one of Dodd-Frank's reforms requires U.S. public companies to disclose internal pay equity—the ratio between CEO and employee pay.[18] Nonetheless, the ratio of CEO pay to average employee

13. Kathryn J. Kennedy, *Excessive Executive Compensation: Prior Federal Attempts to Curb Perceived Abuses*, 10 HOUS. BUS. & TAX L.J. 196, 208 (2010).

14. *See, e.g.*, John E. Core & Wayne R. Guay, *Is There a Case for Regulating Executive Pay in the Financial Services Industry?*, *in* AFTER THE CRASH 115 (Yasuyuki Fuchita et al. eds., 2010).

15. John E. Core & Wayne R. Guay, *Is CEO Pay Too High and Are Incentives Too Low? A Wealth-Based Contracting Framework*, 24 Acad. MGMT. PERSP. 5, 15 (2010) (providing the formula: "Pay = CEO ability + cost of effort + incentive risk premium + excess pay").

16. *See* Lorsch & Khurana, *supra* note 1, at 30, 31; *see also* Morrissey, *supra* note 11, at 13 ("In 1965, the typical American CEO made 24 times the average worker. By 2007, that differential had increased by more than tenfold to 275, and it has continued to grow."). Results of various studies differ somewhat due to the composition of companies that were included in the sample and how compensation was determined.

17. *See* Morrissey, *supra* note 11, at 13 (noting that the ratio of pay for the CEOs of the 300 largest companies in America compared to the average worker was 343:1 in 2010).

18. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 953 (2010). *But see* Steven M. Davidoff, *A Simple Solution that Made a Hard Problem More Difficult*, N.Y. TIMES DEALBOOK (Aug. 27, 2013, 4:53 PM), http://dealbook.nytimes.com/2013/

pay at large companies grew to 354:1 in 2012.[19] This suggests that further reform might be needed, though the internal pay equity disclosure requirement has not yet been finalized or implemented by regulators.[20]

Further, data indicates that the compensation level of executives of U.S. public companies has, indeed, risen dramatically. For example, in 1990 the average total compensation for CEOs was approximately $2.6 million, but by 2008—when the financial crisis hit—it had risen to approximately $14.1 million.[21] The persistence of large amounts of executive compensation, particularly in the absence of correspondingly high levels of corporate financial performance, led to calls for executive compensation reform. Moreover, a recent study for the period from 1993 to 2012 revealed that "[a]bout 40 percent of the highest-paid CEOs in the United States over the past 20 years eventually ended up being fired, paying fraud-related fines or settlements, or accepting government bailout money."[22]

Interestingly, many members of corporate boards also believe that executive pay is excessive, even though they determine such pay. For example, a majority of directors who attended the National Association of Corporate Directors conference in October 2008 agreed that CEO pay was too high.[23] In addition, a, August 2009 survey of 140 directors of U.S. public companies found that fifty-nine percent believed that there should be decreases in executive benefits and perquisites, fifty-two percent felt that retirement packages should be reduced, and seventy-three percent felt that severance pay should be reduced.[24] Part II of the Article discusses why some directors approve compensation that they believe is excessive.

08/27/a-simple-solution-that-made-a-hard-problem-more-difficult/?_r=1 (noting that problems in calculating various types of compensation make it difficult to compare compensation amounts, especially for multinational conglomerates with employees in different countries).

19. Nadia Damouni, *Highest-Paid U.S. CEOs Are Often Fired or Fined: Study*, REUTERS (Aug. 28, 2013, 2:12 PM), http://www.reuters.com/article/2013/08/28/us-companies-pay-idUSBRE97R10C20130828 (describing a 2013 report by the Institute for Policy Studies).

20. *Id.*

21. FORBES, *Two Decades of CEO Pay*, http://www.forbes.com/lists/2012/12/ceo-compensation-12-historical-pay-chart.html.

22. *Id.*; *see* SARAH ANDERSON ET AL., INST. POL'Y STUD., EXECUTIVE EXCESS 2013: BAILED OUT, BOOTED, BUSTED 1 (2013) (examining the 241 CEOs who were the twenty-five highest paid CEOs in America in one or more of the past twenty years).

23. NACD Directorship, *Directors Agree: CEO Pay Too High*, DIRECTORSHIP (Oct. 23, 2008), abstract *available at* http://governancefocus.blogspot.com/2008/10/directors-agree-ceo-pay-too-high.html.

24. Jena McGregor, *Even Most Directors Think CEO Pay is Too High*, BLOOMBERG BUSINESSWEEK (Sept. 30, 2009), http://www.businessweek.com/careers/managementiq/archives/2009/09/even_most_directors_think_ceo_pay_is_too_high.html (describing a survey conducted by the University of Southern California Marshall School of Business). However, forty-nine percent of the directors surveyed did not support the imposition of say-on-pay and seventy-one percent did not support the imposition of caps on the amount of pay. *Id.*

Of course, many everyday Americans are outraged by the disparity between the income of the wealthiest one percent and the rest of the population.[25] Politicians were sensitive to that public sentiment, which was later catalyzed by the related Occupy Wall Street movement. For example, President Obama called the $18.4 billion in bonuses that Wall Street financial executives received in the midst of the 2008 financial crisis "shameful."[26] Moreover, a recent economic study reveals that the largest group of the highest-income earners are executives and other managers in companies, in finance as well as in other industries.[27] This supports the notion that high levels of compensation have fueled income disparities.[28]

In contrast, some finance scholars argue that pay levels are efficient. One scholar suggests that "despite some notable outliers, executive compensation on the whole correlates to results."[29] Scholars also argue that although many features of pay packages might appear inconsistent with standard optimal contracting theory,[30] "optimal contracting theories can explain the recent rapid rise in pay, the low level of incentives and their negative scaling with firm size, pay-for-luck, the widespread use of options (as opposed to stock), severance pay and debt compensation, and the insensitivity of incentives to risk."[31] Other scholars note "that the sharp growth in executive compensation after the 1970s is accompanied by a similar growth in the stock market value of the firms."[32] Since executives have increasingly been compensated in stock rather than cash during that period, they have benefited from the increase in the value of their companies' stock.[33]

25. *See, e.g.*, Tami Luhby, *Who Are the 1 Percent?*, CNNMoney (Oct. 29, 2011, 8:40 AM), http://money.cnn.com/2011/10/20/news/economy/occupy_wall_street_income/index.htm (noting that in 2009, the top one percent of American taxpayers made a minimum of $343,927 but an average of $960,000; they accounted for seventeen percent of the nation's income).

26. Sheryl Gay Stolberg & Stephen Labaton, *Obama Calls Wall Street Bonuses 'Shameful'*, N.Y. Times, Jan. 30, 2009, at A1.

27. Morrissey, *supra* note 11, at 6 (citing Peter Whoriskey, *With Executive Pay, Rich Pull Away from Rest of America*, Wash. Post (June 18, 2011), http://articles.washingtonpost.com/2011-06-18/business/35234600_1_income-gap-personal-income-capital-gains (describing a landmark analysis of tax returns that revealed that forty-one percent of the top 0.1 percent of earners are executives, managers, and supervisors at non-financial companies, and eighteen percent are in finance).

28. *Id.* at 5–6.

29. Knowledge @ Wharton, *Outrage over Outsized Executive Compensation: Who Should Fix It and How?*, Wharton Sch. Univ. Penn. (Feb. 4, 2009), http://knowledge.wharton.upenn.edu/Article.cfm?Articleid=2151.

30. *See* discussion *infra* Subpart II.A.

31. Alex Edmans & Xavier Gabaix, *Is CEO Pay Really Inefficient? A Survey of New Optional Contracting Theories*, 15 Eur. Fin. Mgmt. 486, 486 (2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1265067.

32. Core & Guay, s*upra* note 14, at 118.

33. This is due in part to Congress' enactment of section 162(m) of the Federal Tax Code in 1993, which places a $1 million cap on the amount of compensation that public companies can deduct for

2. *Compensation Design*

Whereas the above criticisms address the *amount* of compensation, other criticisms address the *design* or *structure* of compensation. Various scholars have conducted studies indicating that the incentives created by the design of executive compensation caused excessive risk taking by banks, which led to the financial crisis of 2008 to 2009.[34] Moreover, the Financial Crisis Inquiry Commission (the "FCIC"), which was appointed by Congress to explore the financial crisis, reached a similar conclusion.[35] The FCIC found that compensation design played a role in inducing financial institutions to take reckless risks, which ultimately contributed to the firms' failure.[36] Compensation at financial institutions such as Merrill Lynch, AIG, Citigroup, Bear Sterns, and Lehman Brothers disproportionately rewarded short-term risk taking because it was often designed to reward short-term gain (e.g., return on equity) without proper consideration of long-term consequences.[37] For example, many mortgage brokers were paid based on the volume of loans originated rather than the long-term quality or performance of the loans.[38]

Other studies, however, find little relation between the financial crisis and executive compensation design. For example, one empirical study revealed that "a greater proportion of incentive pay does not increase the likelihood for a bank to be a problem or failed institution."[39] Other scholars note that many boards and executives did not understand the risk that they were taking, so a different pay structure might have led to the same outcome.[40] Another study found that "[t]here is no evidence that banks with CEOs whose incentives were better aligned with the

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certain executives but exempts performance-based compensation such as equity compensation. I.R.C. § 162(m) (2012).

34. *See, e.g.*, Letter from Sanjai Bhagat et al., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Apr. 25, 2011), at 5, *available at* http://www.sec.gov/comments/s7-13-11/s71311-13.pdf; *see also* Sanjai Bhagat & Brian Bolton, *Bank Executive Compensation and Capital Requirements Reform* 1 (Working Paper, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1781318 (studying the fourteen largest financial institutions from 2000 to 2008).

35. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 61–64 (2011).

36. *Id.*

37. *Id.*

38. *Id.* at 64.

39. Lin Guo et al., Bank Executive Compensation Structure, Risk Taking, and the Financial Crisis 6–7 (Oct. 10, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1664191. However, this study also noted that "[o]verall, the existing literature indicates that the empirical findings on the relation among executive compensation, risk taking, valuation and performance in the banking industry vary with the data and sample selection, regulatory environment, methodologies used and compensation measurements." *Id.* at 10.

40. *See, e.g.*, David F. Larcker & Brian Tayan, *Executive Compensation—Did High Pay Cause the Financial Crisis*?, STAN. U. CORP. GOVERNANCE & LEADERSHIP WIRE (Feb. 22, 2010, 6:00 PM), http://www.stanford.edu/group/gsb_corpgov/cgi-bin/blog/?p=1395.

interests of their shareholders performed better during the crisis and some evidence that these banks actually performed worse."[41]

In sum, although there is certainly room for disagreement over whether executive compensation contributed to the financial crisis, some evidence (particularly the FCIC study) indicates that it did. With that as background, this Article now examines the executive compensation and corporate governance reforms that Dodd-Frank implemented to address such concerns. Subpart I.B examines the compensation committee independence requirement, and Subpart I.C briefly summarizes the other reforms.

B. Compensation Committee Independence Requirement

Dodd-Frank states that the Securities and Exchange Commission (the "SEC") will require all U.S. public companies to have a compensation committee comprised of directors who are independent, as determined under standards to be promulgated by the national securities exchanges and associations (such as the New York Stock Exchange ("NYSE") and NASDAQ).[42] Companies that do not comply with the rules will be delisted after being given a reasonable opportunity to cure the defect.[43]

However, even before Dodd-Frank, the NYSE already required compensation committees to be composed entirely of independent directors,[44] and NASDAQ had a similar requirement subject to very limited exceptions.[45] Dodd-Frank essentially codified the preexisting listing requirements but imposed mandatory consideration of two factors that impact independence.

The preexisting independence rule had two parts: (1) a general, catch-all rule that prohibits independent directors from having material relationships with the company and (2) bright-line tests that prohibit

41. *See* Mark A. Calabria, *Did Bank CEO Compensation Cause the Financial Crisis?*, Cato Inst. (Aug. 18, 2009, 5:34 PM), http://www.cato-at-liberty.org/did-bank-ceo-compensation-cause-the-financial-crisis (quoting Rüdiger Fahlenbrach & René M. Stulz, *Bank CEO Incentives and the Credit Crisis* abstract (Nat'l Bureau of Econ. Research, Working Paper No. 15212, 2009)).

42. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 952(a) (2010).

43. *Id.* § 952(f).

44. N.Y. Stock Exch., Listed Company Manual §§ 303A.02, 303A.05 (2013), *available at* http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp%5F1%5F4%5F3&manual=%2Flcm%2Fsections%2Flcm%2Dsections%2F.

45. Under NASDAQ rules, one director who is not independent may be appointed to the compensation committee if, under "exceptional and limited circumstances," such membership is in the best interests of the company; however, such a member may not serve more than two years. NASDAQ, Stock Market Rules § 5605(c)(2)(B) (2013), *available at* http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_3&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F. Another exception applies to "controlled companies"—companies in which fifty percent or more of the stock is held by one individual, group, or company. *Id.* § 5615(c). For simplicity, this Article will focus on NYSE rather than NASDAQ rules.

(a) employment of the director or her immediate family members by the company, its auditor, or certain other related parties and (b) the director's receipt of more than $120,000 annually for fees from the company other than director fees or deferred compensation.[46] Boards were instructed to broadly consider all relevant facts and circumstances in determining material relationships, which "can include commercial, industrial, banking, consulting, legal, accounting, charitable, and familial relationships, among others."[47]

Effective July 1, 2013, the SEC approved new listing standards to implement Dodd-Frank's requirement, adding to the preexisting rule.[48] Under the new rule, when assessing whether compensation committee members have any material relationships that would preclude the directors' independence, boards must now consider whether those directors (1) received any consulting, advisory, or other fees beyond director fees (the "Fees Factor"), or (2) have any affiliate relationships with the company (the "Affiliate Factor").[49] These requirements apply to companies listed on either the NYSE[50] or NASDAQ.[51] To place this compensation committee independence requirement in context, this Article now briefly describes the other executive compensation reforms

46. N.Y. Stock Exch., *supra* note 44, § 303A.02.

47. *Id.* § 303A.02(a)(i)(B) cmts.

48. *See, e.g.*, Self-Regulatory Organizations, Exchange Act Release No. 34-68639; 2013 WL 166322, at 18 (Jan. 11, 2013) (noting that the listing standards commence July 1, 2013, but, due to a transition rule, "listed companies would have until the earlier of their first annual meeting after January 15, 2014, or October 31, 2014, to comply with the new standards for compensation committee director independence").

49. N.Y. Stock Exch., *supra* note 44, § 303A.02.

50. N.Y. Stock Exch., *supra* note 44, §§ 303A.05(a), 303A.02(a)(ii); *id.* § 303A.02(a)(ii) cmts ("When considering the sources of a director's compensation in determining his independence for purposes of compensation committee service, the board should consider whether the director receives compensation from any person or entity that would impair his ability to make independent judgments about the listed company's executive compensation. Similarly, when considering any affiliate relationship a director has with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company, in determining his independence for purposes of compensation committee service, the board should consider whether the affiliate relationship places the director under the direct or indirect control of the listed company or its senior management, or creates a direct relationship between the director and members of senior management, in each case of a nature that would impair his ability to make independent judgments about the listed company's executive compensation.").

51. NASDAQ Listed Company Manual § 5605. The fees factor was initially stricter for NASDAQ-listed companies (they had a bright line prohibition on compensation committee members receiving any compensatory payments other than directors' fees, whereas such fees were only a factor that went into the overall independence analysis for NYSE-listed companies) but NASDAQ eventually amended its rule to conform to the more lenient NYSE rule. David A. Sirignano & Albert Lung, *NASDAQ Amends Compensation Committee Independence Rules*, Morgan Lewis (Jan. 16, 2014), https://www.morganlewis.com/index.cfm/publicationID/c83e5ed6-d867-4dbc-9d64-13add1a130d6/ fuseaction/publication.detail (citing the amended rule, SR-NASDAQ-2013-147, *available at* http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2013/SR-NASDAQ-2013-147.pdf).

in Dodd-Frank before exploring the organizational behavior issues that impact independence.

C. Other Executive Compensation and Corporate Governance Reforms

In addition to the compensation committee independence requirement described above, Dodd-Frank imposes several other executive compensation and corporate governance reforms on U.S. public companies.[52] Because the independence requirement cannot be properly analyzed without considering these accompanying reforms, this Subpart briefly describes them. As a whole, the package of reforms is intended to increase the independence, accountability, and transparency of the pay-setting process by creating an environment in which: (1) independent directors approve executive compensation with the advice of impartial compensation consultants; (2) directors are held accountable to shareholders for those decisions due to shareholders' say-on-pay votes; (3) executives are held accountable to shareholders by being subject to clawbacks if the company's financial reporting is noncompliant; and (4) the relationships between pay and performance, and between CEO pay and worker pay become more transparent due to required public disclosure.

Dodd-Frank includes six specific reforms to achieve these goals.

Say-on-Pay. All public companies must provide shareholders with a so-called "say-on-pay" vote to approve the compensation of its named executive officers at least once every three years.[53] However, this shareholder vote is only an advisory, nonbinding vote on compensation that companies have already awarded to executives, and it "may not be construed—(1) as overruling a decision by such issuer or board of directors; [or] (2) to create or imply any change to the fiduciary duties of such issuer or board of directors."[54]

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52. Exceptions may apply to some U.S. public companies, such as foreign issuers. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 952(a) (2010).

53. *Id.* § 951(a)(1); *see also*, 17 C.F.R. § 229.402(a)(3)(i)–(iv) (2013) (defining "named executive officers" of a company to include (1) the principal executive officer, (2) the principal financial officer, (3) "the three most highly compensated executive officers other than [the principal executive officer and the principal financial officer]," and (4) up to two other executive officers who would have been included as named executive officers if their employment had not terminated before the end of the year).

54. Dodd-Frank Act § 951(c). In addition, at least once every six years, shareholders will determine whether the say-on-pay vote will occur every one, two, or three years. *Id.* § 951(a)(2). Say-on-pay was the key executive compensation reform in Dodd-Frank, and it has been discussed extensively in the academic literature. *See, e.g.*, Thomas et al., *supra* note 6. The adoption of say-on-pay in the United States followed the adoption of say-on-pay for shareholders of financial institutions that received funds from the Troubled Asset Relief Program, and the earlier adoption of say-on-pay in other countries (such as the United Kingdom in 2003, the Netherlands in 2004, Australia in 2005, Sweden in 2006, and Norway and Denmark in 2007). *See* Jeremy Ryan Delman, Note, *Structuring Say-*

Say on Golden Parachutes. Shareholders of public companies can also vote on "golden parachutes" (such as deal bonuses or accelerated vesting of stock options) provided to named executive officers in connection with a change in control of the company, if not already included in the general say-on-pay vote.[55]

Pay Versus Performance Disclosure. Each public company must disclose in its annual proxy statement the relationship between executive compensation actually paid and the financial performance of the company, taking into account any change in the value of the shares of stock and dividends of the company, and any distributions.[56]

Internal Pay Equity Disclosure. Each public company must also disclose: (1) the median annual total compensation of all its employees other than the CEO, (2) the annual total compensation of the CEO, and (3) the ratio of the amount in clause (1) to clause (2).[57]

Clawbacks. If a public company is required to prepare an accounting restatement due to material noncompliance with any financial reporting requirement, then the company will recover any excess amounts of incentive-based compensation received by any current or former executive officer during the three years before the restatement.[58]

Compensation Consultants. Compensation committees may only select a compensation consultant, legal counsel, or other advisor after taking into account factors identified by the SEC that affect the independence of such advisors.[59] Interestingly, personal relationships *must* be explicitly included in the independence determination for consultants, but need not be included in the independence determination for compensation committee members.[60]

Before analyzing the adequacy of these reforms, this Article explores insights that organizational behavior theory provides about the pay-setting process.

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on-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation, 2010 COLUM. BUS. L. REV. 583, 591–97.

55. Dodd-Frank Act § 951(b). *See generally* Kyoko Takahashi Lin, Bernice Grant, Ron Aizen & Jamila Diggs, *Will Mandatory Shareholder Approval of Golden Parachutes Dull Their Luster?*, 4 DEAL LAW., no. 4, July-Aug. 2010.

56. Dodd-Frank Act § 953.

57. *Id.* § 953(b)(1)(A)–(C).

58. *Id.* § 954.

59. *Id.* § 952(b)(1). However, compensation committees are not actually required to *hire* an independent consultant; they only need to do the independence analysis, but are then free to select a consultant of their choice. *See id.* The factors affecting advisors' independence include the provision of other services to the company by the advisor, the amount of fees received from the company by the advisor as a percentage of total revenue of the advisor, the policies and procedures of the advisor that are designed to prevent conflicts of interest, any business or personal relationship of the consultant with a compensation committee member or an executive offer, and any company stock owned by the advisor. N.Y. STOCK EXCH., *supra* note 44, § 303A.05(c).

60. Dodd-Frank Act § 952(b)(2)(D).

II. Organizational Behavior Literature

As discussed in Subpart I.A, financial economists have conducted studies that produced inconsistent results regarding executive compensation. This Part explores the traditional model for directors' determination of management compensation—the optimal contracting theory—and discusses the psychological aspects of boardroom dynamics that reveal shortcomings of that model and lead directors to favor executive interests over shareholder interests. These boardroom dynamics form the basis of this Article's recommendations in Part III.

A. Optimal Contracting Theory

It is well-known in corporate law that the separation between management and ownership of corporations creates an agency problem that, theoretically, is addressed by having the shareholders appoint a board of directors that has the power to direct the affairs of the corporation and supervise management.[61] Under the optimal contracting theory, directors are expected to bargain with management at arm's length in order to set management's compensation, with the exclusive goal of serving shareholders' interests.[62] This theory assumes that the board is not "captured" or controlled by the interests of management; it is instead sufficiently independent from management to bargain with management at arms' length.[63] Due to the separation of ownership and control of public companies, the board of directors, which is appointed by the shareholders to run the company, should design an optimal and efficient pay structure that aligns the interests of the CEO and the shareholders.[64]

However, the empirical evidence in support of this result is mixed.[65] Financial economists have performed studies that test the arm's length bargaining model, and their tests have yielded conflicting results.[66] As explored further below, some empirical studies show that psychological factors, unaccounted for under optimal contracting theory, affect the relationship between the board and the CEO, playing a critical role in determining executive compensation.[67] Indeed, the managerial power theory appears to be more realistic than the optimal contracting theory.

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61. *See generally* Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property (1932).

62. *See* Lucian Bebchuk & Jesse Fried, Pay Without Performance 15–18 (2004); *see also* Omari Scott Simmons, *Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform*, 62 SMU L. Rev. 299, 315–17 (2009).

63. *See* Simmons, *supra* note 62, at 315.

64. *See* Bebchuk & Fried, *supra* note 62, at 17–18.

65. Charles A. O'Reilly III & Brian G. M. Main, *Economic and Psychological Perspectives on CEO Compensation: A Review and Synthesis*, 19 Indus. & Corp. Change 675, 679 (2010).

66. Bebchuk & Fried, *supra* note 62, at 18.

67. *E.g.*, O'Reilly & Main, *supra* note 65, at 675.

B. Managerial Power Theory

In contrast to the optimal contracting model, some scholars have conducted empirical studies that support the managerial power theory.[68] These empirical studies suggest that managerial power and influence might be a better lens through which to view the process of setting executive compensation than the principal-agent/arm's length bargaining model due to the captured nature of the board.[69] As explained above, a board that has been "captured" by management serves the interests of management rather than shareholders.

Many scholars, most prominently Lucian Bebchuk and Jesse Fried, have explored the effect of managerial power on the effectiveness of the compensation committee of the board of directors. In their well-known 2006 book *Pay Without Performance: The Unfulfilled Promise of Executive Compensation*, Bebchuk and Fried argue that the pay-setting process in public companies does not reflect arm's length bargaining between executives and the boards who represent shareholders; boards have failed in their role as guardians of shareholder interests.[70] The managerial power theory posits that directors are subject to influence from management that enables management to extract "rents"—extra value beyond what management would obtain under arm's length bargaining—during the pay-setting process.[71]

On the other hand, some scholars disagree with the managerial power theory. For example, Stephen Bainbridge argues that empirical evidence does not support the managerial power model.[72] He notes "that there are relatively modest differences in pay practices between firms that have a controlling shareholder and those with dispersed share ownership,"[73] even though one would not expect a controlling shareholder to permit management to extract rents at its expense. "As such, the observation that the allegedly questionable compensation practices occur both in companies with dispersed ownership and those with concentrated

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68. Bebchuk & Fried, *supra* note 62, at 63 (citing Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q. J. Econ. 901 (2001); Olivier Jean Blanchard et al., *What Do Firms Do with Cash Windfalls?*, 36 J. Fin. Econ. 337 (1994); David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. Fin. 449 (1997)). *See generally* Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. Chi. L. Rev. 751 (2002).

69. O'Reilly & Main, *supra* note 65, at 675; *see* Michael B. Dorff, *Does One Hand Wash the Other? Testing the Managerial Power and Optimal Contracting Theories of Executive Compensation*, 30 J. Corp. L. 255, 255 (2005) (describing the results of an experimental model of the executive compensation process that indicate that the managerial power theory is correct that CEOs' power over directors results in excessive compensation).

70. Bebchuk & Fried, *supra* note 62, at x, 61.

71. *Id.* at 61.

72. Stephen M. Bainbridge, *Is 'Say on Pay' Justified?*, Regulation, Spring 2009, at 42, 44.

73. *Id.*

ownership may suggest that those practices are attributable to phenomena other than managerial control."[74]

Other scholars have noted that "the six-fold increase of CEO pay between 1980 and 2003 can be fully attributed to the six-fold increase in market capitalization of large U.S. companies."[75] That is to say, the increase in CEO pay during that period was aligned with the increase in value of shareholders' stock, which suggests that executive compensation was appropriately designed to serve shareholder interests.

Although Bebchuk and Fried have written extensively in this area, other scholars have contributed to the literature as well, particularly regarding the director independence issue.[76] "[T]he results of empirical studies examining the influence of independent directors on [a] board's decision-making process are inconclusive."[77] For example, one scholar notes that "there is no evidence to suggest that appointing a wholly independent compensation committee will ensure better risk management" perhaps partially because "the definition of 'independence' is elusive; cognitive biases limit directors' ability to act or make decisions in a manner consistent with a theoretical perception of independence."[78] Other scholars recommend that boards "change the structural, social and psychological environment of the board so that directors (even those who fulfill the requirements of independence) no longer see themselves as effectively employees of the CEO."[79]

C. Psychological Theories

The managerial influence discussed above is arguably caused by various psychological and sociological factors that incentivize directors to approve generous compensation packages for the management team of

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74. *Id.*

75. *Id.* (citing Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q.J. Econ. 49, 49 (2008)).

76. *See, e.g.*, Randall S. Thomas & Harwell Wells, *Executive Compensation in the Courts: Board Capture, Optimal Contracting, and Officers' Fiduciary Duties*, 95 Minn. L. Rev. 846, 848 (2011) ("Board Capture provides an underlying justification for overhauling the entire system and its supporters have pressed for sweeping changes to the current system.").

77. Kristin N. Johnson, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, 45 U. Mich. J.L. Reform 55, 99 (2011) (citing Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 Bus. Law. 921, 924–26 (1999); Eliezer M. Fich & Lawrence J. White, *CEO Compensation and Turnover: The Effects of Mutually Interlocked Boards*, 38 Wake Forest L. Rev. 935, 936 (2003); Idalene F. Kesner et al., *Board Composition and the Commission of Illegal Acts: An Investigation of Fortune 500 Companies*, 29 Acad. Mgmt. J. 789, 794–96 (1986)).

78. *Id.* (citing Bhagat & Black, *supra* note 77, at 923; Lisa Fairfax, *The Uneasy Case for the Inside Director*, 96 Iowa L. Rev. 127 (2010)).

79. O'Reilly & Main, *supra* note 65, at 675 (citing Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What the Problems Are, and How to Fix Them* 9 (Eur. Corp. Governance Inst., Finance Working Paper No. 44/2004, 2004)).

the company on whose board the directors serve. As explained by Bebchuk and Fried:

> Directors have had various economic incentives to support, or at least go along with, arrangements favorable to the company's top executives. Various social and psychological factors—collegiality, team spirit, a natural desire to avoid conflict within the board team, and sometimes friendship and loyalty—have also pulled board members in that direction. . . . A substantial body of evidence does indeed indicate that pay has been higher, and less sensitive to performance, when executives have more power.[80]

Of particular interest, Bebchuk and Fried believed that the rule implemented by the NYSE in 2003, that required compensation committee members to be independent, would weaken, but not eliminate, the factors that lead directors to favor executives at the expense of shareholders.[81]

Norms of reciprocity, groupthink, polarization, social cascades, and herding are some of the psychological factors that can lead boards to approve excessive levels of executive compensation. These factors are described further below.

1. Norms of Reciprocity

Scholars have found that the following factors play a key role in the establishment of high levels of CEO pay: indebtedness, deference to authority, social forces, social status, and peer group comparison.[82] In particular, studies have found that a compensation committee chair is more likely to approve a large compensation package for the CEO if the chair (1) was appointed to the board during the tenure of the current CEO rather than her predecessor; (2) makes more money than the CEO; and/or (3) is of a lower socioeconomic status than the CEO.[83]

These studies reveal that norms of reciprocity that affect all social interactions are present in boards as well. For example, compensation committee chairs presumably approve higher CEO pay if they were appointed during the CEO's tenure because they feel indebted to the CEO for being appointed to her board. Although directors are technically appointed by the nominating committee, which must be composed entirely of independent directors under NYSE listing requirements, CEOs still have significant influence on the nomination process.[84] Indeed, "[f]ar from

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80. BEBCHUK & FRIED, *supra* note 62, at 4–5.

81. *Id.* at 43. However, the new independence requirement imposed by Dodd-Frank is supplemental to this preexisting independence requirement. *See supra* Subpart I.B.

82. Bebchuk et al., *supra* note 68, at 783–95.

83. O'Reilly & Main, *supra* note 65, at 687–703.

84. BEBCHUK & FRIED, *supra* note 62, at 26 (citing Brian G. M. Main et al., *The CEO, the Board of Directors and Executive Compensation: Economics & Psychological Perspectives*, 4 INDUS. & CORP.

being selected by shareholders, directors frequently are selected for consideration by the CEO. Although the slate of directors is put forward by the nominating committee, the names on the slate are generally suggested by the CEO."[85]

Directors are also likely to identify with the CEO because many directors are CEOs of other public companies; as such, they are less likely to view high levels of CEO compensation as exorbitant.[86] CEOs who serve as directors of other companies have self-interested incentives to approve high compensation for the CEOs of the companies on whose board they serve because CEO pay is set using peer group comparisons.[87] In addition, directors have incentives to approve high levels of pay in order to remain in the good graces of the CEO and retain their board seat. Directors enjoy significant fees for serving on the board and board committees. The median values of such fees were approximately $200,000 for board service and $7500 for committee service as of 2009.[88] As of 2012, the median fee for outside directors of the biggest companies was $244,637 according to the National Association of Corporate Directors.[89]

Although these figures might not be large enough to motivate some wealthy directors, directorships often generate additional directorships, such that many directors serve on multiple boards and generate board fees from multiple companies simultaneously.[90] Moreover, directors receive significant prestige—and sometimes perquisites—for serving on boards, and membership can generate business and social connections.[91]

As explained above, norms of reciprocity may motivate corporate directors to approve high amounts of executive compensation. Moreover, studies show that reciprocity is more likely to occur when groups are

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CHANGE 293 (1995); Cynthia A. Montgomery & Rhonda Kaufman, *The Board's Missing Link*, 81 HARV. BUS. REV. 86, 89 (2003)).

85. Erica Beecher-Monas, *The Risks of Reward: The Role of Executive Compensation in Financial Crisis*, 6 VA. L. & BUS. REV. 101, 119 (2011).

86. *Id.* at 120 (citing Michael B. Dorff, *Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 Buff. L. REV. 811, 845 n.145 (2003) ("CEOs of other companies constitute some 63% of outside directors"); KORN/FERRY INT'L, 30TH ANNUAL BOARD OF DIRECTORS STUDY 10 (2003) (finding that eighty-three percent of boards included a CEO or chief operating officer of another firm in 2002)).

87. *Id.* at 121.

88. Theresa Tovar & Robert Newbury, *Has Director Pay Found Its Floor?*, EXECUTIVE COMPENSATION BULL. (Towers Watson), Aug. 2010, at 3, 6.

89. Joann S. Lublin, *The 40-Year Club: America's Longest Serving Directors*, WALL ST. J. (July 16, 2013, 7:45 PM), http://online.wsj.com/article/SB10001424127887323664204578607924055967366.html.

90. *See, e.g.*, Steven M. Davidoff, *Corporate Boards Should Add Diversity to the Mix*, N.Y. TIMES DEALBOOK (Mar. 8, 2011, 5:41 PM), http://dealbook.nytimes.com/2011/03/08/corporate-boards-should-add-diversity-to-the-mix (noting one executive that held over thirty board positions).

91. BEBCHUK & FRIED, *supra* note 62, at 25. *But see* Davidoff, *supra* note 90 (noting that director positions have "become less of a perquisite or a way to build client relationships and more of a job" due to increased time obligations of approximately 225 hours per year).

small and homogeneous and continue to interact over time.[92] Corporate boards tend to be small and homogenous, as is discussed further below. Additionally, directors often interact indefinitely over time (provided they are reelected to the board) because most directors are not subject to term limits.[93] In fact, over one-third of independent directors of Russell 3000 companies have served a decade or longer, and twenty-eight of them (albeit less than one percent) have served for at least forty years.[94] It is difficult for independent directors to remain truly independent in thought when they serve on the same board for decades.[95] Accordingly, the Council of Institutional Investors—a governance advocate—plans to encourage shareholders and boards to question the independence of directors with very long tenures, and proxy advisors are beginning to consider new policies that would deem outside directors non-independent if they have served on the board for long terms.[96]

2. *Groupthink, Polarization, Social Cascades, and Herding*

a. Groupthink

Groupthink is another psychological factor that can impact corporate boards. Indeed, one scholar articulated a Group Dynamics Theory to encapsulate his argument that "the problems with CEO compensation in public corporations may be caused at least in part by the decision-making flaws rooted in group dynamics," such as groupthink.[97]

Groupthink is the tendency of cohesive and homogenous groups to adopt homogenous views and faulty decisionmaking due to failure to consider alternatives.[98] Groupthink is more likely to occur when a cohesive group has structural organizational faults and/or a provocative situational context such as high stress, difficult decisions to be made, recent group failures, or difficult moral dilemmas[99]—these are arguably common factors in the pay-setting process. Irving Janis identified eight symptoms of groupthink: (1) illusions of invulnerability; (2) unquestioned belief in the morality of the group; (3) rationalization for dismissing warnings;

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92. O'Reilly & Main, *supra* note 65, at 685.

93. *See, e.g.*, Lublin, *supra* note 89 (discussing directors that have served over forty years).

94. *Id.*

95. *Id.*

96. *Id.*; Bob Romanchek & Jeff Keckley, *Director Independence: A Focus on Board Tenure*, DIRECTORSHIP (Jan. 13, 2014), http://www.directorship.com/director-independence-a-focus-on-board-tenure.

97. Michael B. Dorff, *The Group Dynamics Theory of Executive Compensation*, 28 CARDOZO L. REV. 2025, 2029 (2007).

98. *See id.* at 2035–42 (discussing groupthink extensively).

99. Andrew Howard, *Groupthink and Corporate Governance Reform: Changing the Formal and Informal Decisionmaking Processes of Corporate Boards*, 20 S. CAL. INTERDISC. L.J. 425, 427 (2011) (citing IRVING L. JANIS, GROUPTHINK 176–77 (2d ed. 1982)).

(4) stereotypes of group opponents as weak, evil, biased, spiteful, impotent, or stupid; (5) self-censorship of ideas that deviate from the consensus; (6) illusions of unanimity among group members; (7) direct pressure to conform applied to members who question the group; and (8) mind guards who shield the group from dissenting information.[100]

Corporate boards tend to be homogenous, which predisposes them to groupthink. Because board members are often selected from a small pool, they often have similar educational, professional, and other affiliations and relationships before they join the board.[101] Moreover, normally independent directors might share strong social ties with the CEO, such as belonging to the same social clubs, civic organizations, or simply being friends.[102] This can have troubling results for independent directors charged with monitoring executives because having a social relationship "disposes one to interpret favorably another's intentions and actions."[103]

Moreover, independence can even be strained by shared connections that do not rise to the level of strong social ties. Affinity caused by shared backgrounds, for example, has been shown to affect director decisionmaking.[104] Byoung-Hyoun Hwang and Seoyoung Kim conducted an interesting empirical study of Fortune 100 companies from 1996 to 2005 and found that common backgrounds between CEOs and their nominally independent directors resulted in higher CEO pay.[105] Specifically, they found that having a "socially independent board," in which a majority of directors are both conventionally *and* socially independent, has a statistically significant effect in reducing CEO compensation: "the average drop in total compensation [was] $3.3 million, while average total compensation for the sample [was] $12.8 million."[106] A nominally independent director was considered "socially dependent" if she had two or more social ties with the

100. *Id.* at 431–34.

101. Johnson, *supra* note 77, at 104 (citing Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 810 n.60 (2001)); *see* Dorff, *supra* note 97, at 2045 ("Public company directors are generally either CEOs of other public companies or firm lawyers, investment bankers, former politicians, or prominent academics.").

102. Frederick Tung, *The Puzzle of Independent Directors: New Learning*, 91 B.U. L. REV. 1175, 1179 (2011).

103. *Id.* (quoting Brian Uzzi, *The Sources and Consequences of Embeddedness for the Economic Performance of Organizations: The Network Effect*, 61 AM. SOC. REV. 674, 678 (1996)).

104. *Id.* at 1180 (citing Byoung-Hyoun Hwang & Seoyoung Kim, *It Pays to Have Friends*, 93 J. FIN. ECON. 138, 139 (2009)).

105. *Id.* at 1180–82.

106. *Id.* at 1182 (citing Hwang & Kim, *supra* note 104, at 146). However, Hwang and Kim's study has some limitations—for example, they did not control for the more commonly identified social influences that have been shown to affect CEO pay. *Id.* at 1184. The study also seems to focus on the social ties of the *overall* board rather than just the compensation committee. *See id.*

company's CEO, such as "mutual alma mater, military service, regional origin, academic discipline, [or] industry."[107] Thus, "Hwang and Kim's study offers important empirical evidence confirming our suspicions that existing definitions of independence may not capture all the potential influences that may affect directors' impartiality."[108]

The homogeneity of corporate boards is also attributable to a lack of gender and racial diversity.[109] Many scholars have argued that increasing diversity might strengthen corporate boards. For example, Lisa Fairfax indicates that "[m]ost social and psychological data on group dynamics suggest that having a diverse group of directors will facilitate a board's decision-making function because that data reveals that heterogeneous groups tend to make higher quality decisions."[110]

Furthermore, age similarity has been shown to enhance social influence. For example, one study found that CEO compensation is higher if the CEO and compensation committee members are closer in age.[111] As such, a board with greater age diversity might be less subject to social influence by the CEO.

Groupthink occurs because people make decisions based on their perspective, which is shaped and limited by their personal backgrounds.[112] Adding directors with diverse backgrounds can facilitate the consideration of other viewpoints.[113] However, while diversity can reduce groupthink, and most directors support board diversity, corporate board diversity has not increased much over the years, and some directors question its value.[114]

107. *Id.* at 1181–82 (citing Hwang & Kim, *supra* note 104, at 140–42 (explaining how these social ties produce enhanced interaction, shared experiences, and common interests)).

108. *Id.* at 1185.

109. For example, a recent study found that white men hold nearly seventy percent of Fortune 100 board seats, women (of all races) hold twenty percent, and minorities (of both genders) hold sixteen percent (though they comprise thirty-seven percent of the population). Martha C. White, *Top Boardrooms: No-Go Areas for Women, Minorities*, NBCNEWS.COM (Aug. 16, 2013 4:51 PM), http://www.nbcnews.com/business/top-boardrooms-no-go-areas-women-minorities-6C10936005 (referencing ALLIANCE FOR BD. DIVERSITY, MISSING PIECES: WOMEN AND MINORITIES ON *Fortune* 500 BOARDS (2010)).

110. Lisa M. Fairfax, *The Bottom Line on Board Diversity: A Cost-Benefit Analysis of the Business Rationales for Diversity on Corporate Boards*, 2005 WIS. L. REV. 795, 831.

111. Tung, *supra* note 102, at 1179 (citing Main et al., *supra* note 84, at 319–20).

112. *Id.*

113. Davidoff, *supra* note 90 (arguing that greater diversity on corporate boards is needed, and noting that "[a]dding two or three board members with more diverse backgrounds could spur more critical thinking — a type of introspection that was absent before the crisis").

114. Kimberly D. Krawiec et al., *The Danger of Difference: Tension in Directors' Views of Corporate Board Diversity*, 2013 U. ILL. L. REV. 919, 920–22; *see* David A. Carter et al., *The Gender and Ethnic Diversity of U.S. Boards and Board Committees and Firm Financial Performance*, 18 CORP. GOVERNANCE 396, 396 (2010) (finding that "[w]e do not find a significant relationship between the gender or ethnic diversity of the board, or important board committees, and financial performance for a sample of major US corporations").

b. Polarization

Homogenous groups are also prone to polarization—taking extreme positions.[115] This, of course, presents particular concerns in the compensation-setting process because:

> even if the individual members of a compensation committee would prefer a more modest pay package, if the group has a predilection toward higher pay levels, that will be the decision. This phenomenon is more acute when the group is homogeneous, as it tends to be at the upper echelon of corporate management, because if group members share a particular bias, polarization may magnify its impact.[116]

c. Social Cascades

Corporate boards can also be affected by social cascades. Social cascades are dynamics in which people follow a leader's actions because they lack sufficient information to form their own opinions about a decision.[117] In the compensation-setting context, social cascades can occur when the compensation committee is unduly swayed by the opinion of the CEO or the compensation consultants who are retained to prepare and present compensation packages.

Indeed, compensation committees in the post-Dodd-Frank environment are particularly susceptible to social cascades. As explained by Fairfax:

> [The recent reforms] increase the possibility that boards will unduly rely on management, advisors, and outside consultants in a manner that could have significant negative repercussions. . . . [A]necdotal and other evidence suggest that when directors believe that they lack the necessary expertise to grapple with particular issues, they tend to rely more heavily on managers and other advisors perceived to have such expertise. From this perspective, it is no surprise that the growing influence of compensation consultants coincides with the increased emphasis on independent directors who often may feel ill equipped to tackle the complexities of compensation matters. Finally, increasing shareholders' power [through say-on-pay votes, proxy access, etc.] also may increase the potential for enhanced reliance on outside consultants such as proxy and advisory firms.[118]

Subpart III.A proposes continuing professional education to remedy this social cascades factor.

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115. Beecher-Monas, *supra* note 85, at 124.

116. *Id.* (citing Daniel J. Isenberg, *Group Polarization: A Critical Review and Meta-Analysis*, 50 J. PERSONALITY & SOC. PSYCHOL. 1141, 1141 (1986)).

117. Dorff, *supra* note 97, at 2042–52 (discussing social cascades extensively).

118. Lisa M. Fairfax, *Government Governance and the Need to Reconcile Government Regulation with Board Fiduciary Duties*, 95 MINN. L. REV. 1692, 1719–20 (2011).

d. Herding

Social cascades and groupthink are closely related to another phenomenon: herding. As discussed above, directors often have personal ties to each other and the CEO. These personal ties can lead to herding, which is the tendency of group members to follow the crowd when making decisions, despite having other information.[119] Furthermore, compensation consultants might propose similar pay packages to multiple companies due to the herding phenomenon.[120]

Part III of this Article now explores ways in which the organizational behavior findings described above can be applied to improve the process of setting executive compensation.

III. Critique of Dodd-Frank and Proposal for Additional Reforms

Parts I and II of this Article show that Dodd-Frank's compensation committee independence requirement does not address certain organizational behavior factors that can impair directors' objectivity. This Part tackles the question of how we can use the organizational behavior findings described above to improve the independent judgment of compensation committees. Ultimately, this analysis shows that (1) the SEC appropriately determined that it was impractical to require consideration of personal relationships in the independence assessment, but (2) additional reforms are needed to counteract the organizational behavior issues that might impair independent action. To that end, this Article recommends two additional reforms, and to provide an international perspective, positions those reforms within the global corporate governance landscape.

As described in Subpart I.C, Dodd-Frank's executive compensation reforms were intended to increase the independence, accountability, and transparency of the pay-setting process. The compensation committee independence requirement, especially when combined with the compensation advisor independence analysis, is intended to diminish conflicts of interest that can occur when the members of the compensation committee and/or their advisors lack independence and objectivity to determine executive compensation in an arm's length fashion.

While the goal of greater independence is sensible, independent judgment and action will not be achieved unless the social dynamics that impact boardrooms and discourage board members from thinking and acting independently are addressed. The problem is that the independence rules ignore social influence and assume "away social norms and social

119. Beecher-Monas, *supra* note 85, at 129.
120. *Id.*

pressures that we know affect behavior."[121] Indeed, "[f]ormal independence without social independence may be insufficient to assure the effectiveness of independent directors."[122] The compensation committee independence reform does not directly address this issue; rather, it focuses only on whether a director has received compensation other than director fees or has affiliations with the company. Moreover, similar factors were already in the preexisting rule as suggested (albeit not mandatory) considerations, so the new rule does not substantially change the independence analysis.

A. Consideration of Personal Relationships

One solution to the organizational behavior issues would be to mandate the consideration of personal relationships in the determination of director independence. As described in Subpart I.B, to qualify as independent, a director may not have any "material relationship" with the listed company.[123] "Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others."[124] However, there is no explicit requirement to consider personal or social relationships—although boards are instructed to "broadly consider all relevant facts and circumstances" that might signal potential conflicts of interest.[125] This presents the question of whether the language in the independence definition is already broad enough to encourage boards to consider personal relationships, or whether something more explicit is needed. Although "familial" relationships are included in the list above, personal relationships are not. Further, the list does not *mandate* that boards consider any of the listed relationships; it only suggests them for possible consideration.

Before adopting the new independence rule in 2013, the SEC issued a proposed rule in 2011 and sought comments on it.[126] Specifically, the SEC asked for comments as to whether the exchanges should be required to include personal or business relationships between a compensation committee member and an executive officer of the company, as mandatory factors for consideration, in addition to the Fees Factor and the Affiliate Factor.[127] Several commentators responded

121. Tung, *supra* note 102, at 1178.

122. *Id.* at 1177 (noting that "socially dependent directors" are nominally independent directors who share a common background with the CEO).

123. N.Y. Stock Exch., *supra* note 44, § 303A.02.

124. *Id.*

125. *Id.*

126. Listing Standards for Compensation Committees, Release Nos. 33-9199, 34-64149, 46 Fed. Reg. 18,966 (Apr. 6, 2011) (codified at 17 C.F.R. pts. 229, 240).

127. *Id.* at 18,971 (The SEC asked: "Should there be additional factors apart from the two proposed factors required to be considered? For example, *should the exchanges be required to include business or personal relationships between a compensation committee member and an executive officer*

affirmatively, and although these comments were not ultimately adopted, they provide helpful insight regarding independence issues.

For example, the National Association of Corporate Directors recommended that in nominating compensation committee members, the "governance/nominating committee and the board should take account of personal friendships, prior business relationships, and even ties created by philanthropic activities between the CEO and the prospective committee member" because these "types of relationships may interfere with the committee member's objectivity in evaluating CEO performance and setting executive pay."[128] Also, the Council of Institutional Investors urged the SEC to consider family linkages, ties to executive officers and relationships with other directors, in addition to the existing standards when defining the independence standards for compensation committee members.[129]

Several commentators also noted that board interlocks, which occur when executives serve on each other's boards, can impair independence.[130] Indeed, as a former CEO commented, "[t]he most effective way to encourage independence of compensation committee members is to prohibit interlocking corporate directorships. 'You scratch my back, I'll scratch yours' is all too common, especially when officers are on one another's boards."[131] Conflicts of interests can also arise if a director is an executive officer of another company whose peer group includes the company on whose board she serves, because her decisions about the compensation of executives at that company might affect her own employee compensation due to the use of peer group comparisons in setting executive pay.[132]

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of the issuer as mandatory factors for consideration? Should the exchanges be required to include board interlocks or employment of a director at a company included in the listed issuer's compensation peer group as mandatory factors for consideration? Would any such requirements unduly restrain a company in setting the composition of its board of directors?" (emphasis added)).

128. Letter from Barbara H. Franklin & Kenneth Daly, Nat'l Ass'n of Corporate Dirs., to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Apr. 29, 2011), *available at* http://www.sec.gov/comments/s7-13-11/s71311-29.pdf (concerning the proposed rules for listing standards for compensation committees and referencing a report from 2003).

129. Letter from Justin Levis, Senior Research Assoc., Council of Institutional Investors, to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Apr. 20, 2011), at 2–3, *available at* http://www.sec.gov/comments/s7-13-11/s71311-12.pdf.

130. *See, e.g.*, Letter from Georg Merkl to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n, (Apr. 1, 2011), at 4–5, *available at* http://www.sec.gov/comments/s7-13-11/s71311-2.pdf; *see also* Levis, *supra* note 129, at 3.

131. Letter from John K. Lundberg, former CEO Crum Forster, to U.S. Sec. & Exch. Comm'n (Mar. 31, 2011), *available at* http://www.sec.gov/comments/s7-13-11/s71311-1.htm.

132. Merkl, *supra* note 130, at 5. *See* Letter from Gerald W. McEntee, Am. Fed'n of State, Cnty. & Mun. Emps., to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Apr. 29, 2011), at 2–3, *available at* http://www.sec.gov/comments/s7-13-11/s71311-31.pdf; *see* Meredith Miller, Chief Corp. Governance Officer, UAW Retiree Med. Benefits Trust, to Elizabeth Murphy, Sec'y, U.S. Sec. & Exch. Comm'n

In the litigation context, courts have also voiced similar concern that directors who meet the independence requirements are still subject to managerial influence. For example, the Delaware Chancery Court has suggested in some litigation matters that social, civic, and personal connections (such as shared university attendance or golf club membership) should be considered in assessing the independence of directors.[133] In *In re Oracle Corp. Derivative Litigation*, the Delaware Chancery Court refused to abide by a decision of the special litigation committee of independent directors because their ties to Stanford University due to shared university attendance, donation, or employment, created reasonable doubt as to the directors' impartiality.[134]

In a more recent case involving Barnes & Noble, the Delaware Chancery Court suggested that friendship, frequent socialization, and golf playing could impair the independence of putatively independent directors.[135] These Delaware decisions reflect a judicial acknowledgment that the determination of true independence might require consideration of personal ties in addition to the existing independence standards.[136] On the other hand, some commentators believe that the listing standards should not adopt per se prohibitions on specific relationships because the listing standards are sufficiently broad to permit appropriate consideration of all factors that affect independence.[137]

Moreover, it does not seem feasible to prohibit independent directors from having personal ties to executives, given the pervasiveness of personal relationships between board members and executives and

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(Apr. 27, 2011), at 1–3, *available at* http://www.sec.gov/comments/s7-13-11/s71311-15.pdf (providing comments similar to those of McEntee); *supra* text accompanying note 84.

133. Richard E. Wood, Kirkpatrick & Lockhart Nicholson Graham LLP, Compensation Committee Structure, Function and Best Practices 7–10, 13 (2004) (citing Biondi v. Scrushy, 820 A.2d 1148 (Del. Ch. 2003); *In re* Oracle Corp. Derivative Litig., 824 A.2d 917 (Del. Ch. 2003)). *But see* Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040 (Del. 2004).

134. *In re Oracle Corp.*, 824 A.2d at 920.

135. Steven M. Davidoff, *How Independent Are Barnes & Noble Directors?*, N.Y. Times DealBook (Oct. 25, 2010, 2:28 PM), http://dealbook.nytimes.com/2010/10/25/how-independent-are-barnes-noble-directors. However, Judge Strine eventually dismissed the case against the directors who allegedly unfairly sided with the chairman. Phil Milford & Jef Feeley, *Barnes & Noble Wins Dismissal of 4 Directors from Lawsuit*, Bloomberg (Mar. 27, 2012, 1:22 PM), http://www.bloomberg.com/news/2012-03-27/barnes-noble-wins-dismissal-of-4-directors-from-lawsuit.html. The chairman of Barnes & Noble settled the remaining claim. *See* Phil Milford & Jef Feeley, *Barnes & Noble Chief Said to Settle Suit for $29 Million*, Businessweek (June 14, 2012), http://www.businessweek.com/news/2012-06-13/barnes-and-noble-chief-said-to-settle-suit-for-29-million.

136. Davidoff, *supra* note 135.

137. *See, e.g.*, Letter from Davis Polk & Wardwell LLP to Elizabeth M. Murphy, Sec'y, U.S. Sec. & Exch. Comm'n (Apr. 28, 2011), at 2–3, *available at* http://www.sec.gov/comments/s7-13-11/s71311-18.pdf (noting "we do not believe that there should be any inference that the existing listing standards do not already adequately address the considerations of all of the facts and circumstances surrounding a director's relationship with the issuer, or the issuer's management, that may affect compensation committee member independence and are consistent with the objectives of the Dodd-Frank Act and the proposed rulemaking").

obvious difficulties in measuring, monitoring, and evaluating such ties. For example, how would one evaluate the many social ties that directors and executives have from attending the same Masters of Business Administration programs, places of worship, and/or country clubs? Clearly, it would be impractical to disallow all such ties. Further, personal relationships can take on many forms, and it would be difficult to define and determine which relationships are more problematic than others from an independence standpoint. Indeed, as explained by Tung:

> Rather than driving us to rethink independence requirements, Hwang and Kim's findings may instead cast doubt that a workable definition of independence exists that could possibly capture the variety of shared experiences that might dampen conventionally independent directors' monitoring incentives. Any such attempt at rulemaking would be unavoidably over-and underinclusive.[138]

In short, "social incentives are messy; they are difficult to measure or analyze rigorously. Perhaps that explains why social influences on nominally independent directors have only recently begun to draw scholarly attention."[139] In addition, although diversity caused by hiring directors with fewer social ties could be helpful in stimulating alternative viewpoints, it could also undermine trust on boards and lessen directors' effectiveness.[140]

Tung argues that although the appropriate policy response to Hwang and Kim's study is unclear, "we may need to rely on the fine-grained ex post analysis of judges, as exemplified by Vice Chancellor Strine in *Oracle*" because "shared experiences and other social influences may be too numerous and subtle for comprehensive ex ante enumeration."[141] However, this Article suggests an ex ante approach that would reduce the need for judges to detect and undo, on an ex post basis, the effect of the proverbial "golden handcuffs" that bind nominally independent directors to CEOs. Also, the recommendations proposed herein will mitigate the impact of personal relationships on board dynamics in a manner that is more practical than injecting personal relationships into the independence assessment.

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138. Tung, *supra* note 102, at 1185. Tung further notes that although then-current definitions of director independence could perhaps be improved, "Hwang and Kim's interesting findings may not translate easily to crafting stricter definitions of independence." *Id.* For more information on Hwang and Kim's findings, see *supra* Subpart II.C.2.

139. Tung, *supra* note 102, at 1178.

140. Fairfax, *supra* note 110, at 833 (citing Margaret M. Blair & Lynn A. Stout, *Trust, Trust Worthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1796–99 (2001) (discussing the importance of trust in corporate decisionmaking)).

141. Tung, *supra* note 102, at 1185.

B. Comparative Law Considerations

From a comparative law standpoint, the United States is the originator of the concept of independent directors, and is still its most enthusiastic supporter.[142] Director independence in the European Union typically follows the U.S. model of not considering social ties.[143] Director independence typically encompasses only financial and familial independence from controlling shareholders and top corporate officers.[144] Even if the director has "social ties to the controller," she will be considered independent as long as she has "no close family or financial ties, such as an employment position or a consulting relationship."[145] However, such independence is often token, especially in countries such as Germany and France, which have supervisory boards that are comprised of shareholder representatives and employee representatives, as each of such groups represents the interests of the group that appointed it.[146]

C. Recommendations

In light of all the above considerations, this Article advocates a creative approach to augmenting the independence of compensation committee members, while avoiding the concerns noted above. The Article proposes two reforms: (1) a requirement for compensation committee members to have continuing professional education regarding compensation issues and (2) a rotation system that encourages the compensation committee (or at least the chair thereof) to rotate off the committee after a certain number of years. The remainder of this Article addresses these two recommendations in turn.

These reforms are similar to the requirements under Sarbanes-Oxley that require (1) financial literacy of all members—and financial expertise of at least one member—of the audit committee and (2) the lead and concurring partners of the accounting firm that conducts a company's audit to rotate off the client engagement every five years.[147]

1. *Continuing Professional Education*

The first recommendation is that compensation committee members should be required to have continuing professional education to ensure that they are knowledgeable and up to date regarding best practices in executive compensation, as well as the complex business, legal, tax, and

142. Reinier Kraakman et al., The Anatomy of Corporate Law 65 (2d ed. 2009).
143. *Id.* at 95.
144. *Id.* at 182 (noting that unlike the United States, corporations in several E.U. countries such as Italy and France typically have large blockholders, such as the state or families).
145. *Id.* at 95.
146. *Id.* at 64–65.
147. Corporate Governance, 17 C.F.R. § 229.407 (2013).

accounting considerations that affect executive compensation decisions. These rules are complex and evolving. Knowledge of fundamental principles and best practices can help improve decisionmaking. Requiring professional education will help to ensure that compensation committees are fully equipped to make appropriate decisions regarding executive compensation packages, and are not overly influenced by possible pressure from compensation consultants or the CEO. This is especially important for the director who has the difficult role of compensation committee chair.

This recommendation is timely: a recent in-depth examination of compensation committee processes of twenty large U.S. public companies revealed that this consideration of expertise and independence is one of the five main considerations for compensation committees.[148] The study revealed that "[w]hile many boards consider director expertise and independence in determining who will serve on the compensation committee, many of the interviewees had previous professional or personal ties to management before joining the board. Thus, in reality, actual independence was sometimes not emphasized."[149] One of the implications of this finding was that "compensation committee members need the right background and mind-set to understand executive compensation issues at a deep level, including the fairness of committee decisions in the eyes of shareholders and managers."[150] Directors of public companies "tend to be highly intelligent, educated, sophisticated, and busy" but might lack knowledge about specific compensation practices.[151] Moreover, the study "revealed that compensation committee members felt a profound tension between the demands of management and those of shareholders. One interviewee noted that the compensation committee 'is the only board committee where you sit on the opposite side of the table from management.'"[152]

a. *Support for Continuing Education and Relationship to Organizational Behavior Theory*

Several practitioners have discussed in practitioner journals the general need for compensation committee members to be knowledgeable. This Article takes the next step of proposing mandatory education,

148. Dana R. Hermanson et al., *What Are Compensation Committee Members Thinking About?*, DIRECTORSHIP (Jan. 24, 2013, 8:48 PM), http://www.directorship.com/what-are-compensation-committee-members-thinking-about.

149. *Id.*

150. *Id.*

151. Dorff, *supra* note 97, at 2045 (emphasis omitted) ("[Directors] have little incentive to spend time working through the details of a complex compensation package, much less to dream up alternatives to the traditional forms of compensation. They are far more likely to defer to the status quo, assuming that the sophisticated boards that have made this decision before them have acted correctly.").

152. Hermanson et al., *supra* note 148.

coupled with a rotation program, and it grounds such recommendations within a scholarly and theoretical framework. As explained by two executive compensation practitioners:

> Unlike audit committee members, there is no requirement for compensation committee members to have any particular expertise. However, it is beneficial for compensation committee members and top executives to be educated about compensation issues. The first area of education should be the company's own plans and policies. General education about executive compensation can come from a variety of sources, including director institutes, compensation consultants and legal counsel.[153]

Another executive compensation practitioner summarized similar views regarding education of compensation committee members as follows:

> A compensation committee can make "informed" decisions only if the committee members have adequate background and knowledge with respect to the matters under the committee's consideration. While outside advisors can be relied upon for their technical expertise, committee members, who bear the decisionmaking responsibility, must be sufficiently conversant with compensation concepts, techniques and requirements to be able to determine for themselves the merits of all proposed actions. There are many resources available for director education in general and compensation committee education in particular. For example, the Conference Board created a directors' institute to provide corporate governance education for directors serving on the boards of U.S. corporations. This program provides professional educational programs for corporate board members, dealing with a wide range of important board issues, including compensation. Also, both the NYSE and Nasdaq have announced programs to provide education for directors of listed companies.[154]

Providing continuing professional education to compensation committee members will help reduce the effects of several of the organizational behavior factors identified in Subpart II.C. For example, it will help directors avoid the social cascades dynamic whereby directors blindly follow the recommendations of the compensation committee's consultant, legal advisor, or chairperson because they lack sufficient information to make their own judgments about difficult decisions.[155] Education would decrease the tendency of groups to defer to one member who is perceived as being better informed, and counteract

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153. Steven D. Kittrell & James P. McElligott Jr., *Avoid the Disney Trap*, *in* FOCUS ON EXECUTIVE COMPENSATION 9–10 (2005).

154. WOOD, *supra* note 133, at 14; *see* Press Release, N.Y. Stock Exch., NYSE Euronext Announces Plan to Launch Board Education Program (Mar. 9, 2011), *available at* http://www.nyse.com/press/1299669253730.html (noting that "[o]ur goal is to prepare company boards for the current governance environment in which investor groups and others have been successfully calling for more accountability and transparency in the boardroom," using "conferences, events, publications, and online resources").

155. *See supra* Subpart II.C.2.

groupthink and herding.[156] Educating directors will empower them to formulate and ask tough questions about all compensation proposals and advice presented by their advisors, and to revise those proposals as appropriate.

Although it is certainly appropriate and necessary for directors to seek advice and counsel, they will be better able to "come to the table" prepared to ask the right questions of their advisors if they have the requisite training and continuing education. Ultimately, although compensation committee members can receive excellent guidance from legal counsel and compensation consultants, the committee members are responsible for approving executive compensation packages.

Some compensation committee members might understandably not want to invest time and resources in professional education. They are very busy, and the number of hours that directors are expected to spend on board service has risen to an average of 225 hours per year.[157] However, director education is becoming increasingly popular. In fact, a recent survey of public companies indicates that "[a]pproximately two companies out of 10 require their board members to attend some type of continuing education programs to remain abreast of regulatory and compliance developments."[158] Moreover, such education might help to insulate directors from liability because being well-informed before making business decisions is a requirement for reliance on the business judgment rule.[159]

Furthermore, several changes in the governance landscape make continuing education a wise investment of time for directors. For example, compensation decisions have come under increased scrutiny due to public outrage over high amounts of pay and the embarrassment of negative say-on-pay votes. Further, directors risk losing their board seats due to "withhold campaigns" (i.e., shareholder attempts to withhold votes needed to reelect directors) if the compensation packages they approve receive negative say-on-pay votes from a majority of the company's shareholders. The majority of companies had positive say-on-pay votes in 2012 with substantial shareholder support, and only 2.6% (fifty-seven companies) in the Russell 3000 failed.[160] The results for 2013 were very similar.[161] However, there have been several highly

156. *Id.*

157. *See* Davidoff, *supra* note 90.

158. Matteo Tonello, *The 2013 Director Compensation and Board Practices Report*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. BLOG (Feb. 26, 2013, 9:21 AM), http://blogs.law.harvard.edu/corpgov/2013/02/26/the-2013-director-compensation-and-board-practices-report.

159. Lewis H. Lazarus & Brett M. McCartney, *Standards of Review in Conflict Transactions on Motions to Dismiss: Lessons Learned in the Past Decade*, 36 DEL. J. CORP. L. 967, 972–73 (2011).

160. SEMLER BROSSY, 2012 SAY ON PAY RESULTS: RUSSELL 3000 SHAREHOLDER VOTING 1 (2012).

161. SEMLER BROSSY, 2013 SAY ON PAY RESULTS: RUSSELL 3000 SAY ON PAY RESULTS 1 (2014) (noting that fifty-seven of 2250 companies failed).

publicized instances in which shareholders have issued failing say-on-pay votes. For example, Oracle failed its say-on-pay vote with only forty-one percent shareholder approval in 2012, and only forty-three percent approval in 2013.[162] And shareholders are voting more negatively in the United States than in the United Kingdom, where they have historically been more reluctant to cast negative say-on-pay votes.[163]

Moreover, shareholders have filed shareholder derivative lawsuits against several of the companies in the United States that received negative say-on-pay votes. The lawsuits, which are against the companies as well as their directors and compensation consultants, allege corporate waste, unjust enrichment, breach of fiduciary duties, and other charges, due to the compensation arrangements that the directors approved. However, plaintiffs have faced significant obstacles in recent executive compensation lawsuits; indeed the cases typically do not progress beyond the demand stage.[164] This is partially because Dodd-Frank expressly provides that the say-on-pay vote "may not be construed—(1) as overruling a decision of such issuer or board of directors; [or] (2) to create or imply any change to the fiduciary duties of such issuer or board of directors"—as mentioned in Part I.C.[165]

In addition to equipping directors to deal with increased shareholder oversight, continuing education also has the added benefit of increasing director primacy.[166] Some scholars have argued that say-on-pay and other reforms inappropriately shift the locus of decision-making authority from directors to activist shareholders in a way that "seems likely to disrupt the very mechanism that makes the public corporation practicable; namely, the vesting of 'authoritative control' in the board of

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162. *Id.*; *see* Semler Brossy, *Update: Oracle Fails Say on Pay with 41% Support*, SAY ON PAY (Nov. 15, 2012), http://www.semlerbrossy.com/sop/update-oracle-fails-say-on-pay-with-41-support.

163. *See, e.g.*, Thomas et al., *supra* note 6, at 1230 (citing Jeffrey N. Gordon, *"Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In*, 46 HARV. J. ON LEGIS. 323, 341 (2009) (explaining that "shareholders invariably approve the Directors Remuneration Report, with perhaps eight turndowns across thousands of votes over a six-year experience")).

164. *See, e.g.*, Kyoko Takahashi Lin & Lawrence Portnoy, *Say-on-Pay Litigation Update*, DAVISPOLK BRIEFING: GOVERNANCE (Sep. 5, 2012), http://www.davispolk.com/briefing/corporategovernance/61662 ("These cases, decided by federal courts applying Delaware law, contribute to a line of cases holding that a failed shareholder say-on-pay vote alone does not rebut the business judgment rule presumption afforded to a board['s] decisions, including in the realm of executive compensation.").

165. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 951(c) (2010). *But see* Thomas & Wells, *supra* note 76, at 849 ("[R]ecent Delaware court decisions have given new life to *officers*' fiduciary duties, not only by establishing that officers are bound by the same fiduciary duties as are directors, but by finding that officers' fiduciary duty of loyalty has special application when those officers are negotiating their own compensation agreements.") (emphasis added).

166. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550 (2003) (noting that the director primacy theory asserts that "[n]either shareholders nor managers control corporations—boards of directors do").

directors."[167] Empowering directors with continuing education will help shift the locus of decisionmaking authority back to the directors. In addition, companies must now disclose the "experience, qualifications, attributes or skills" of all board nominees and directors every year.[168] Yet, Dodd-Frank imposes additional responsibilities on directors without regard to whether directors have the expertise to carry out the duties.[169] The education requirement proposed in this Article will help companies satisfy the director expertise disclosure requirement.

Moreover, both executive compensation law and accounting rules have become more sophisticated and complex in the past decade due to increased regulation.[170] For example, in the case of executive compensation laws, complicated tax rules such as section 409A of the Internal Revenue Code (which deals with deferred compensation),[171] and extensive SEC disclosure rules under Item 402 of Regulation S-K[172] have made executive compensation a more technically challenging field than it was a decade ago. Although compensation committee members would certainly not be expected to have the same level of knowledge as their legal advisors and compensation consultants, they could attend continuing education sessions to stay abreast of compensation issues. For example, they could attend trainings on nuances such as (1) the levels and types of executive compensation that are considered "market;" (2) poor pay practices (such as single-trigger change in control bonus provisions) that might result in negative say-on-pay votes; (3) the pros and cons, from human resources, legal, and accounting standpoints, of granting various equity awards such as stock options, restricted stock, and/or restricted stock units; and (4) the tax implications of awarding various equity awards or deferred compensation.

Furthermore, the proposed continuing education recommendation is similar to a post-Enron American Bar Association (the "ABA") recommendation that has not been sufficiently explored by scholars. However, the ABA recommendation is merely a best practices suggestion, whereas this Article advocates a mandatory education program. In 2002,

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167. Bainbridge, *supra* note 72, at 46 (noting that in public companies, meaningful shareholder involvement is difficult due to collective action problems: disperse "[s]hareholders have neither the information nor the incentives to make sound decisions on either operational or policy questions"). However, institutional shareholders such as unions and public employee pension funds find say-on-pay appealing, and their interests often vary from average shareholders. *Id.* at 47.

168. Fairfax, *supra* note 118, at 1715.

169. *Id.* at 1718.

170. The Author has practiced law as an executive compensation lawyer for most of the past decade, and formerly worked as a Certified Public Accountant.

171. I.R.C. § 409A (2012).

172. Standard Instructions for Filing Forms Under Securities Act of 1933, Securities Exchange Act of 1934 and Energy Policy and Conservation Act of 1975—Regulation S-K, 17 C.F.R. § 229.402 (2012) [hereinafter Regulation S-K].

the Enron bankruptcy prompted the ABA to appoint a Task Force on Corporate Responsibility to examine systemic corporate governance issues.[173] The Task Force's Preliminary Report suggested certain reforms that should be imposed on public companies on a mandatory basis, and other principles that boards should adopt as a matter of best practices of corporate governance.[174] One of the best practices that the task force advocated was that public companies should:

> Institute and maintain a training and education program for all directors, and particularly independent directors, in regard to (a) their legal and ethical responsibilities as directors, (b) the financial condition, the principal operating risks and the performance factors materially important to the business of the corporation and (c) *the operation, significance and effects of compensation incentive programs* and related party transactions.[175]

b. Comparative Law Considerations

In addition to being consistent with the ABA's recommendation for U.S. public companies, the proposed continuing education recommendation is consistent with international corporate governance trends. In recent years, several European countries have adopted requirements or recommendations that their remuneration committees (the term often used in Europe for compensation committees) have compensation knowledge or experience. In 2009, the European Commission issued a recommendation on remuneration policy that included a proposal (the "EC Recommendation") that "[a]t least one of the members of the remuneration committee should have knowledge of and experience in the field of remuneration policy."[176] Although European Commission Recommendations are not binding on Member States of the European Union, some Member States have decided to follow the EC Recommendation.[177] Six (twenty-two percent) of the twenty-seven Member States have endorsed the EC Recommendation, twenty (seventy-four percent) have not endorsed it (or did so to a lesser extent than originally proposed), and one (four percent) did not provide data.[178] The six Member States that endorsed the EC Recommendation

173. James H. Cheek, III et al., *Preliminary Report Of The American Bar Association Task Force On Corporate Responsibility*, 54 MERCER L. REV. 789, 790 (2003).

174. *Id.* at 805.

175. *Id.* (emphasis added).

176. Commission Recommendation (EC) No. 385/2009, 2009 O.J. (L 120) 28, 31.

177. *Report on the Application by Member States of the EU of the Commission 2009/385/EC Recommendation (2009 Recommendation on Directors' Remuneration) complementing Recommendations 2004/913/EC and 2005/162/EC as Regards the Regime for the Remuneration of Directors of Listed Companies*, at 6, COM (2010) 285 final (May 2, 2010).

178. *Report on the Application by Member States of the EU of the Commission 2009/385/EC Recommendation (2009 Recommendation on Directors' Remuneration) Complementing Recommendations 2004/913/EC and 2005/162/EC as Regards the Regime for the Remuneration of*

include Austria, Belgium, Denmark, Lithuania, Portugal and Slovenia.[179] One of those six countries (Belgium) adopted it as a mandatory legislative provision—which is commonly referred to in the European Union as "hard law"—whereas the other five countries adopted a "comply or explain" approach—which is commonly referred to as "soft law."[180] Belgium enacted the law by amending its Belgian Companies Code to implement several corporate governance changes, including a requirement that listed companies have a remuneration committee that (1) is composed of a majority of independent directors *and* (2) has the necessary expertise in the area of remuneration policy.[181]

Even though twenty Member States did not adopt the EC Recommendation, seven of them took alternative approaches that are within the spirit of the EC Recommendation, such as recommending that *all* board members have sufficient qualifications to fulfill their respective duties.[182] And in Germany, the German Share Institute (Deutsches Aktieninstitut, DAI) started a movement in 2010 "for better and continuous education of board members."[183]

In considering the EC Recommendation, some Member States noted that a compensation expertise standard like the one adopted by Belgium would be too difficult to define.[184] Indeed, Belgium does not appear to define expertise in its new law.[185] However, the recommendation in this

Directors of Listed Companies, at 15–16, SEC (2010) 670 (June 2, 2010) [hereinafter *Report on Remuneration*], *available at* http://ec.europa.eu/internal_market/company/docs/directors-remun/sec-2010-670-2_en.pdf.

179. *Id.*

180. *Id.* "Comply or explain" is a "soft law" approach in which companies must either comply or explain why they chose not to comply. All E.U. jurisdictions have a corporate governance code stating that listed companies are not required to follow, but they must annually report whether they comply and explain the reason for any noncompliance. *See* Kraakman et al., *supra* note 142, at 67–69.

181. Elke Janssens et al., *New Belgian Corporate Governance Act on Remuneration in Listed Companies*, NautaDutilh (Apr. 28, 2010), http://www.newsletter-nautadutilh.com/xzine/xzine.html?xzine_id=4468&cid=4&aid=12053.

182. *Report on Remuneration*, *supra* note 178, at 15–16. For example, (1) Spain, Finland, the Netherlands, Poland, and Slovakia generally recommended that each board member have sufficient expertise, experience, and/or qualifications to perform to fulfill her duties, (2) Italy recommended that at least one member of the Remuneration Committee have expertise in finance, and (3) Luxembourg recommended that the Remuneration Committee have access to the necessary skills and means to fulfill the role (which could include compensation consultants). *Id.*

183. Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, 59 Am. J. Comp. L. 1, 27 n.145 (2011). For good governance, a "tailored induction program should be established for all members, and the particular capabilities of individual directors relevant to their service on the board should be disclosed," keeping in mind that with independence comes a lack of firm specific-knowledge. *Id.* at 27.

184. *Report on Remuneration*, *supra* note 178, at 6.

185. Wet tot versterking van het deugdelijk bestuur bij de genoteerde vennootschappen en de autonome overheidsbedrijven en tot wijziging van de regeling inzake het beroepsverbod in de bank- en financiële sector [Law Concerning Corporate Governance] of Apr. 6, 2010, Belgisch Staatsblad [B.S.] [Official Gazette of Belgium], Apr. 23, 2010, *available at* http://www.ejustice.just.fgov.be/mopdf/2010/04/23_1.pdf.

Article does not rise to the level of proposing that any compensation committee members of U.S. public companies become "compensation experts" per se. Rather, the proposal herein is akin to the financial *literacy* requirement imposed on all audit committee members, as opposed to the higher standard of financial *expertise* required for at least one audit committee member.

Clearly, there is some level of support globally to follow the education requirements advocated in this Article. The United States could build on this momentum to adopt a similar standard, either as "hard law," as in Belgium, or "soft law," as in Austria, Denmark, Lithuania, Portugal, and Slovenia. Hard law would be preferable because soft law is generally believed to be less effective for corporate governance purposes. For example, some companies in the European Union claim to comply with soft law, but in reality do not follow the spirit of the soft law, or they simply do not report whether or not they have complied.[186] However, if it proves politically unfeasible to enact these recommendations as hard law in the United States, then soft law would be an appropriate compromise. Ultimately, a global norm will probably emerge for continuing education on compensation committees.

c. Comparison to Audit Context

In the audit context, financial literacy is determined by each company's board in its business judgment,[187] whereas financial expertise is generally based on experience in certain well-defined positions, such as serving as a public accountant, controller, or Chief Financial Officer.[188] In the compensation context, on the other hand, there are no such well-defined positions, so requiring compensation committee members to become "experts" might be problematic.

However, if accreditation bodies in the compensation field were to devise an appropriate certification in the United States, then this might be an appropriate reform in the future. For example, WorldatWork Society of Certified Professionals sponsors a Certified Executive

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186. Kraakman et al., *supra* note 142, at 67–69.

187. N.Y. Stock Exch., *supra* note 44, § 303A.07 ("*Each member of the audit committee must be financially literate, as such qualification is interpreted by the listed company's board in its business judgment*, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the listed company's board interprets such qualification in its business judgment. While the Exchange does not require that a listed company's audit committee include a person who satisfies the definition of audit committee financial expert set out in Item 407(d)(5)(ii) of Regulation S-K, a board may presume that such a person has accounting or related financial management expertise." (emphasis added)).

188. Regulation S-K, 17 C.F.R. § 229.407(d)(5)(ii) (2012). Public companies must disclose that the company's board has determined that the audit committee has at least one financial expert, or explain why it does not have one. *Id.*

Compensation Professional designation and notes that certification signals that one is an expert in the field, and is intended for professionals involved in various aspects of executive compensation strategy or administration, including finance, legal, and tax.[189] Certification involves taking an examination and completing twelve recertification credits every three years.[190] If regulators decide to implement a requirement for compensation committee expertise, then other certification programs could be developed that are tailored more directly to the needs of board members.

2. *Rotations*

In addition to being subject to mandatory continuing education requirements, the compensation committee should have a rotation system. However, due to practical concerns caused by differences in the number of independent directors on various boards, this proposal should be a recommended rather than mandatory measure.

a. *How Rotations Address Organizational Behavior Issues*

Imposing a rotation program would address some of the group dynamic concerns discussed in Subpart II.C. In particular, studies show that reciprocity is more likely to occur when groups continue to interact over time, and when groups are small and homogeneous.[191] In the United States, compensation committees are usually comprised of an average of only three directors, and the entire board typically averages eleven members in total.[192] In addition, the composition of boards tends to lack diversity of gender, race, or other background.[193] This lack of diversity is exacerbated when only a subset of the board is involved.

Directors are not currently required by law to rotate or be subject to term limits or mandatory retirement, so they could remain on the board and the compensation committee indefinitely, assuming that they are reelected. Ironically, when rotation off the compensation committee has occurred in the past, it might have been for perverse reasons. It has been suggested that members of the compensation committee "who won't play

189. *Certified Executive Compensation Professional*, WorldatWork Soc'y of Certified Profs., http://www.worldatworksociety.org/society/certification/html/certification-cecp.jsp (last visited Feb. 4, 2014).

190. *Frequently Asked Questions About Certification*, WorldatWork Soc'y of Certified Profs., http://www.worldatworksociety.org/society/certification/html/certification-faq.jsp (last visited Feb. 4, 2014).

191. O'Reilly & Main, *supra* note 65, at 685.

192. Kraakman et al., *supra* note 142, at 70; *see* Fairfax, *supra* note 118, at 1713–14 ("The average public company board consists of ten directors, a number that has been virtually unchanged for at least a decade.")

193. *See, e.g.*, Fairfax, *supra* note 110, at 800–04; *see also* Julia Werdigier, *Fund Plans to Invest in Companies with Women as Directors*, N.Y. Times, Oct. 27, 2009, at B7.

along [with CEO compensation requests] are rotated out to other committees."[194]

For the reasons described above, compensation committees fit the profile of groups that are prone to reciprocity: they are small and homogenous, and they continue to interact over time.[195] These factors also contribute to groupthink.[196] Although the size of the committee need not change, this Article proposes the adoption of a rotation system to provide a mechanism for "shaking up" static group dynamics, infusing new perspectives, and minimizing reciprocity and groupthink.

There is admittedly a significant risk that directors who rotate onto the compensation committee of a particular company will have already been captured by management of that company if they come from another position on that company's board, as opposed to from a different company's board, which is an alternative proposal discussed below. However, there is still some benefit to having a different set of eyes reviewing and approving the executives' compensation packages because each person will assess the packages from her own personal viewpoint and raise unique questions and concerns. This will alleviate the groupthink issue discussed in Subpart II.C.2.

Further, as Hwang and Kim's study made clear,[197] the extent to which an individual director is likely to approve high amounts of compensation varies based on the extent of her social ties to the CEO. If a board has directors with varying levels of social ties to the CEO, a rotation system will help to distribute the directors such that those with extensive social ties are not always on the compensation committee.

In addition, if the chair of the compensation committee rotates, it will alleviate the social cascades factor whereby people follow a leader's action because they lack information to form their own opinion. Rather than consistently following the idiosyncratic views of a particular person who always serves as the compensation committee chair, the compensation committee will have the opportunity to be led by different individuals.

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194. John G. Steinkamp, *A Case for Federal Transfer Taxation*, 55 Ark. L. Rev. 1, 22–23 (2002) (quoting Sarah Anderson et al., *Executive Excess 2001*, United for a Fair Economy 1, 4 (2001) (describing a Fortune magazine study)) ("The process by which corporate boards generally determine CEO compensation may be largely responsible for the tremendous increases in recent years: 'In this market the same person—the executive—sits on both sides of the bargaining table. The nominal buyer, the corporation, usually makes its purchase through the compensation committee of the board of directors, which traditionally consists of independent (non-management) directors. The compensation committee, in turn, relies on compensation information generated by the corporation itself or by an outside consultant retained by the corporation. In reality, however, the internal information, and even the conclusions of the consultant are under control of the chief executive.' It has been suggested that 'directors who won't play along are rotated out to other committees.' Directors who do 'play along' with CEO compensation requests may breach their duties to shareholders.").

195. *See supra* Subpart II.C.2.

196. *Id.*

197. *Id.*

b. Logistical Issues

Setting practical concerns aside, the best approach for the rotation program would be to impose a term limit for how long a director could serve on the compensation committee. After a set period of time, she would rotate to another board committee. If the limited number of independent directors on a particular board makes this impossible, the next best approach would be to impose a term limit for the compensation committee chair. After a set period of time, she would step down as chair and remain on the committee but allow another committee member to assume the chairperson role.

This dual approach is ideal because of the structural limitations of boards; although public companies are required to have a majority of independent directors,[198] boards vary in the extent to which the number of independent directors exceeds this baseline requirement. The percentage of independent board members has increased in the past decade.[199] In 2012, eighty-four percent of directors on Standard & Poor's 500 boards were independent, and the CEO was the only non-independent director on fifty-nine percent of Standard & Poor's 500 boards.[200] Given these high percentages of independent directors, the preferred rotation system (in which directors can only serve on the compensation committee for a fixed number of years before rotating off it) seems feasible for most public companies.

However, companies that have only a slight majority of independent directors would have difficulty implementing a mandatory rotation program for the members of the compensation committee, especially because (1) the compensation committee, nominating/corporate governance committee,[201] and audit committee must each have only independent directors, and (2) audit committee members must also be financially literate and have one financial expert, such that companies will need their audit committee members to stay on that committee if those directors are the only ones who satisfy those requirements. As such, if a company has only a slight majority of independent directors,

198. N.Y. Stock Exch., *supra* note 44, § 303A.01 cmts ("Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.").

199. Spencer Stuart, 10 Years Later: Sarbanes-Oxley Act Continues to Shape Board Governance (July 30, 2012) (summarizing data compiled as part of a 2012 Spencer Stuart U.S. Board Index). The percentage has increased from seventy-nine percent in 2002 to eighty-four percent in 2012 for Standard & Poor's 500 boards. *Id.*

200. *Id. See* Beecher-Monas, *supra* note 85, at 118 ("Over the last decade, boards have been getting smaller and more independent. Most boards in large corporations now consist primarily of independent directors, that is, directors without direct financial or family ties to the corporation.").

201. N.Y. Stock Exch., *supra* note 44, § 303A.04(a).

there might not be enough independent directors on the board to rotate onto the compensation committee on a regular basis.

But even just having the compensation committee chair rotate could be helpful. This is because the compensation chair position is considered by some experts to be the most difficult role to serve on the entire board of directors because of the inherent tensions and difficulties involved in saying "no" to the CEO.[202]

A rotation period of five years would be appropriate to balance the need to bring in fresh perspectives with the need to retain institutional knowledge and chemistry within the committee.[203] As explained above, imposing a maximum length of time for service as a member or chairperson of the compensation committee would help to alleviate the social forces that can lead compensation committees to approve high levels of executive pay.[204] At the end of a five-year term of service, the compensation committee member or chairperson (depending on the approach adopted by the company) would step down from the role. After a five-year break, during which the chair could serve on another committee, she would be permitted to rejoin the compensation committee.

c. *Other Support for Rotations*

After Sarbanes-Oxley was enacted in 2002, there were a few calls to impose rotations on not only audit firm partners (as discussed below), but also on compensation committee members.[205] However, those recommendations for compensation committee rotations were never implemented. It is not clear why this was the case; the literature does not reflect an extensive or recent discussion of this point. This Article's rotation recommendation for compensation committees, though supported by these earlier recommendations, is more developed and nuanced. It is framed by scholarly literature and appropriate for the current financial environment.

Although compensation committee rotations did not end up being added to Sarbanes-Oxley, the time is finally ripe for this reform. The reform is more appropriate and timely now because the financial crisis that led to Dodd-Frank was largely related to compensation issues,[206] whereas the financial crisis that led to Sarbanes-Oxley (such as the Enron and WorldCom scandals) was primarily related to accounting issues.[207]

Furthermore, a compensation committee rotation program would help to spread the workload among compensation committee members,

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202. James F. Reda et al., Compensation Committee Handbook at xi (2d ed. 2001).
203. *See* Wood, *supra* note 133, at 13–14.
204. *See supra* Subpart II.C.
205. *See, e.g.*, Kittrell & McElligott, *supra* note 153, at 9.
206. *See supra* Subpart I.A.
207. Beecher-Monas, *supra* note 85, at 129.

because they would serve only for a fixed term. Compensation committee members were already meeting more frequently prior to Dodd-Frank and will probably meet even more frequently now, given that Dodd-Frank focuses on the compensation committee and places the committee under increased scrutiny.[208] This can result in a significant workload for a small number of people, as the compensation committee typically only has three members.[209]

As mentioned above, in 2003 the ABA Task Force provided several recommendations to address systemic corporate governance issues in the wake of the Enron bankruptcy. One of the best practices recommended in the Task Force's Preliminary Report was for boards to "[c]onsider whether to establish term limits or policies governing rotation of the chair and membership of the Board of Directors and its Corporate Governance, Audit and Compensation Committees, and the number of board and committee memberships."[210]

In addition, some executive compensation practitioners endorsed periodic rotation of compensation committees shortly after Congress enacted Sarbanes-Oxley.[211] In 2004, for example, an executive compensation practitioner advocated for a periodic review of committee assignments.[212] He noted that although rotation would infuse the committee with fresh perspectives, it would cause the committee to lose members with knowledge of the company's compensation practices.[213] In 2005, two other practitioners noted that "[t]rue independence for a compensation committee may extend beyond the requirements of the stock exchange rules. . . . Periodic rotation of membership can bring new perspectives."[214]

Nonetheless, a recent survey of public companies found that "[a]s the workload and challenges facing board committees increase, member rotation policies remain infrequent."[215] For example, some boards do not favor mandatory rotation of committee assignments or chairpersons as a general matter because the board believes that experience and continuity are more important than rotation; however, they acknowledge that rotation should occur if it is likely to increase committee performance.[216] Further, although rotation is not currently required for any board

208. Fairfax, *supra* note 118, at 1714.
209. *Id.*
210. Cheek, III et al., *supra* note 173, at 805.
211. S*ee, e.g.*, Kittrell & McElligott, *supra* note 153, at 9.
212. Wood, *supra* note 133, at 13–14.
213. *Id*.
214. Kittrell & McElligott, *supra* note 153, at 9.
215. Tonello, *supra* note 158.
216. *E.g.*, *Corporate Governance Principles*, ADP, http://www.adp.com/about-us/corporate-social-responsibility/governance/corporate-governance-principles.aspx (last visited Feb. 4, 2014).

committees, many companies rotate their lead or presiding independent director.[217]

d. Comparative Law Considerations

From a comparative law standpoint, it appears that no other countries mandate a rotation of board committee members. However, there are important corporate governance differences that make rotation less necessary outside the United States. Several countries have a two-tier board structure, either on a mandatory basis (e.g., Germany, China, and the Netherlands), or on an optional basis (e.g., France and Italy).[218] Also, companies in all E.U. jurisdictions can now opt for a corporate form called the *Societas Europaea*, which allows either a one-tier board or a two-tier board.[219] The two-tier structure includes (1) a supervisory board that is *entirely* composed of independent directors (and, in some countries, employee and union representatives) and (2) a management board that is entirely composed of executives.[220]

Because the remuneration committee in such countries is a subgroup of the supervisory board, and no executives sit on the supervisory board, they are more insulated from management influence.[221] In the United States, on the other hand, the majority of the board must be independent, but the CEO and sometimes other officers typically serve on the board, or at least join board meetings on an informal basis.[222] As such, concerns about managerial influence are stronger on U.S. boards.

In addition, although the United States has not adopted regulations linking director independence and board tenure, many countries outside the United States have.[223]

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217. Julie Hembrock Daum & David Kimbell, *Achieving Greater Independence in the Board Room*, Point of View, 2005, at 25, 31, *available at* http://content.spencerstuart.com/sswebsite/pdf/lib/POV_Issue_1_2005.pdf ("While the NACD Blue Ribbon Council recommends not rotating the role of the lead and presiding director, we found rotation to be a common practice, particularly among boards with a presiding director. More than half of the surveyed companies with presiding directors rotate the role versus just one-third of companies with lead directors.").

218. Kraakman et al., *supra* note 142, at 57 n.6 ("For France see Art. L. 225-57 Code de commerce. For Italy see Art. 2409-8 to 2409-15 Civil Code. For the SE, see Art. 38 Council Regulation (EC) No 2157/2001 of 8 Oct. 2001, 2001 O.J. (L 294) 1.").

219. *Id.* at 56–57.

220. *Id.*

221. However, "the extent of the distinction between the board structures is often unclear. Informal leadership coalitions can cross-cut the legal separation between management and supervisory boards [*e.g.*, in German companies with no controlling shareholder, the management board often picks the supervisory board]; while supermajorities of independent directors and an independent chairman can give single-tier boards a quasi-supervisory flavor. . . . [L]abor codetermination in Germany, the most prominent two-tier jurisdiction, weakens the supervisory board as a governance organ devoted exclusively to the interests of the shareholder class." *Id.* at 57–58.

222. *See* Stuart, *supra* note 199; *see also* discussion *supra* Subpart II.C.2.

223. Romanchek and Keckley, *supra* note 96 (noting that "In Hong Kong and Singapore, a company must disclose reasons why it believes a director should still be considered independent after

e. Diversity

If companies adopt a rotation system in the United States, then they should keep diversity of backgrounds in mind. For a mandatory rotation system to be as effective as possible, it will be important for the board to consider having a diverse pool of candidates from varied backgrounds when any new directors are selected to join the board, rather than using a limited pool of candidates based on personal connections. If replacement directors are in the same social circle as, or are friends with, the CEO, the ability of the director to avoid groupthink will, of course, be diminished.[224]

In addition to diversity of personal and professional backgrounds, there is extensive literature regarding the importance of gender and racial diversity in board membership.[225] Moreover, recent SEC rules require disclosure of the role of diversity in selecting board members, and the SEC has voiced concerns about lack of diversity on boards and lack of compliance in companies' reporting of board diversity.[226] The SEC requires disclosure of whether, and if so how, a nominating committee (or the board) considers diversity in identifying nominees for directors.[227] The SEC did not define diversity, but recognized that some companies include only gender, race, and national origin as diversity considerations, whereas other companies have a more expansive view of diversity that includes different viewpoints, professional backgrounds, education, skill, and other individual qualities.[228]

A recent survey of public companies reveals that "[a]ccording to the director nomination policy of large companies, diversity matters as much as business skills. Yet, aside from some level of female representation, corporate boards remain remarkably uniform."[229] In the case of smaller public companies, this could be because "[m]ost smaller companies save board search firm fees and use personal connections to recruit new director nominees."[230]

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serving more than nine years on the board. Similar rules requiring companies to provide 'sufficient and clear' justification are in place for directors serving more than nine years on boards in Ireland, Italy, and the United Kingdom. And in most of Europe, regulations have been passed that automatically deem a director to not be independent after serving more than 12 years on the board").

224. *See* Dorff, *supra* note 97, at 2078 (noting that constructing diverse groups may combat groupthink, but that the empirical data on this is mixed).

225. *See supra* Subpart II.C.2. *See generally* Mijntje Lückerath-Rovers, A Comparison of Gender Diversity in the Corporate Governance Codes of France, Germany, Spain, the Netherlands and the United Kingdom (Apr. 6, 2010) (unpublished manuscript) (on file with Erasmus University Rotterdam, the Netherlands), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1585280.

226. Comm'r Luis A. Aguilar, Sec. & Exch. Comm'n, Keynote Speech by SEC Commissioner: An Update on Diversity and Financial Literacy (Apr. 30, 2011) (transcript available at http://www.sec.gov/news/speech/2011/spch043011laa.htm).

227. 17 C.F.R. §§ 229, 239, 240, 249, 274 (2009).

228. *Id.*

229. Tonello, *supra* note 158.

230. *Id.*

Some might ask why diversity is not enough to solve the problems identified in this Article. Why should boards have to implement education and rotation requirements when they can simply have more women and minorities on the board in order to reduce homogeneity and the risk of groupthink? One response is that if the diverse candidates share the same educational and professional backgrounds and the same social ties as the CEO, they too are still susceptible to managerial influence. Increased diversity is helpful, but not sufficient, in responding to the problem.

Beyond encouraging diversity, it is not practical to legislate that members can have no prior relationships with a CEO, for the reasons discussed above, including the difficulty measuring personal relationships. However, it is advisable for the nature and extent of any such relationships to be considered when appointing nominally independent directors, especially if they will serve on the compensation committee.[231]

f. Comparison to Audit Context

Although listing standards do not currently require rotation of directors or committee members, Congress has embraced rotations as a mechanism to preserve independence in other contexts. Rotation requirements apply to the independent auditors that report to the audit committee. Specifically, section 203 of Sarbanes-Oxley made it "unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer."[232] This rule, enacted after the Enron bankruptcy, was intended to improve the independence of independent auditors.

In addition, the NYSE Listed Company Manual indicates that the audit committee should not only ensure the regular rotation of the lead audit partner as required by law, but also "should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the *audit firm itself*."[233] Further to that suggestion, regulatory agencies in the United States and the European Union recently considered expanding the mandatory rotation requirement to require the audit firm itself—rather than just the audit partners—to rotate.[234] After extensive consideration by scholars and

231. *See* Wood, *supra* note 133, at 10.

232. 15 U.S.C. § 78j-1(j) (2013).

233. N.Y. Stock Exch., *supra* note 44, § 303A.07(b)(iii)(A) (emphasis added).

234. *See, e.g.*, Pub. Co. Accounting Oversight Bd., PCAOB Release No. 2011-006, Concept Release on Auditor Independence and Audit Firm Rotation 2 (2011). "The PCAOB is a nonprofit corporation established by Congress [in connection with Sarbanes-Oxley] to oversee the audits of

practitioners of the pros and cons of that proposal, it was not adopted. Indeed, from a global perspective, rotation of the lead audit partner "is now rather common, while external rotation (of the firm) is highly controversial and rarely mandated."[235] Yet, this recent debate shows that the concept of rotations is still a hot topic in the corporate governance field. Moreover, some of the arguments for and against the proposal are relevant to the question of whether compensation committee members should rotate.

Various experts weighed in on the audit firm rotation proposal. For example, a joint team of accounting/finance professors and practitioners determined that although "[e]nhancing perceived and actual auditor independence is a worthy objective for public policy. . . . [M]andating audit firm rotation would be a bad policy. Indeed, such a change may impair auditor independence, weaken audit expertise and undermine corporate governance."[236]

However, some of the concerns that led to rejection of audit firm rotations are not present in the compensation committee rotation context. Most significantly, experts noted that "a policy of mandatory auditor rotation could undermine accretion of expertise and impair audit quality" because auditors are most vulnerable to missing fraud in new engagements, and accounting quality increases with auditor tenure.[237] Such concerns do not exist in the compensation committee context, though, because the role of the compensation committee is to design and approve executive compensation rather than to detect fraud and perform audits.

Furthermore, experts were also concerned that auditor independence would be undermined because audit firms would engage in "beauty contests" every few years to solicit new business, which would lead to bidding wars, solicitous relationship building, and opinion shopping.[238] Again, that concern does not apply to directors who are merely switching roles on the board. This concern would be more troubling and apropos if one were to propose rotation of the compensation *consultants* that advise compensation committees.

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public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports." *About the PCAOB*, PUB. CO. ACCOUNTING OVERSIGHT BD., http://pcaobus.org/About/Pages/default.aspx (last visited Feb. 4, 2014).

235. Hopt, *supra* note 183, at 63 n.361 (noting that in Austria, rotation of the audit firm "was introduced by law, but then abolished before the law came into force").

236. *See, e.g.*, Tracey C. Ball et al., Audit Firm Rotation: A Joint Academic and Practitioner Perspective 1 (Jan. 3, 2012) (unpublished manuscript), *available at* http://faculty.som.yale.edu/shyamsunder/Research/Accounting%20and%20Control/Presentations%20and%20Working%20Papers/AuditFirmRotation/Audit_Firm_Rotation_%20Dec30_Jamal.pdf (summarizing the findings of a joint team of accounting/finance practitioners and professors).

237. *Id.* at 2 (citing various studies).

238. *Id.*

In addition, a recent academic study found that the concentration of the audit market in only four large international firms would make it difficult for mandatory audit firm rotation to bring about the desired "fresh look."[239] Admittedly, similar concerns exist for rotation of existing board members, if all of the directors have already become subject to managerial influence. However, once again, this concern would be more pertinent if compensation consultants were required to rotate, because the compensation consulting industry, like the audit industry, is dominated by a few major players.[240]

g. Counterarguments and Alternative Proposals

In evaluating the proposals in this Article, critics might argue that there is not much evidence that rotations and expertise actually help boards be more effective. For example, in the auditing context, the expertise and rotation requirements have been in place since 2002, yet corporations have continued to engage in accounting fraud—the 2010 Lehman scandal is a prominent example. Of course, it is possible (but difficult to prove) that such accounting fraud might have reached an even higher level if these reforms had not been in place. Ultimately, it is difficult to prove empirically that rotations and expertise are effective because once the requirements are put in place there is no control group against which to compare companies that implemented the requirements.

Critics might also argue that this recommended approach is too indirect in achieving its goal of augmenting compensation committee independence because it does not directly change the definition of independence; they might question the "fit" between the problem and the proposed reform. Certainly, a reform in which directors are prohibited from having social ties to the CEO would eliminate the issue. However, as discussed above, it is not practical to change the definition of independence in a way that directly addresses the issue of personal relationships.

Another approach with a more direct fit to the problem would be for boards to have so-called "professional independent directors" who serve set terms of perhaps five to seven years on several corporate

239. *Id.* ("Most large clients already receive one service or another from every one of the four firms. If one of these accounting firms audits the client, the other three often provide it a host of advisory services in tax, valuations etc. This perpetual engagement and pre-existing relationships between most large companies and all four major audit firms implies that there is only limited opportunity for mandatory rotation to bring about a 'fresh look.'").

240. *See, e.g.*, Robin Ferracone, *When Familiarity Breeds Complacency: Factors to Consider When Selecting a Compensation Consultant*, FORBES (Feb. 9, 2011, 1:35 PM), http://www.forbes.com/sites/robinferracone/2011/02/09/when-familiarity-breeds-complacency-factors-to-consider-when-selecting-a-compensation-consultant (noting that three of the top five compensation consulting firms are integrated firms that offer a variety of services, primarily to management).

boards, and then rotate to different companies' boards.[241] Some scholars advocate that approach.[242] One advantage of that approach is that because the directors who rotate onto a company's board will come from another company's board, it decreases the concern that such directors have been captured by management of the new company on whose board they serve. However, this approach is generally viewed as a radical and controversial type of corporate director rotation that has gained little support.[243] The recommendations in this Article are a creative yet practical approach to indirectly achieve the goal of enhancing the independent judgment of the compensation committee members. These recommendations are less radical, and thus more likely to be adopted, than the professional independent director approach.

In addition, critics might argue that the two recommendations in this Article work against each other because after equipping themselves with compensation-related knowledge, the compensation committee members would eventually be required to rotate off the compensation committee. However, the committee member will have a five-year period during which to use the knowledge she learns. Using a five-year period decreases concerns that would arise if the rotation cycle were more frequent. Moreover, the rotations could occur on a staggered basis, such that all directors would not rotate off the committee at the same time. This seems like a reasonable compromise because the benefits of periodic and staggered rotation after an extended period of time would outweigh any loss of expertise.

As an alternative, if the rotation proposal recommended in this Article is not implemented, compensation committees should consider adopting the best practice of having alternating members of the committee raise critical questions during board deliberations in a "designated naysayer" capacity.[244] For example, the United Kingdom, in its corporate governance code, encourages non-executive directors to "constructively

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241. *See, e.g.*, William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders: The Rise of the New Corporate Kleptocracy*, 8 STAN. J.L. BUS. & FIN. 69, 107–08 (2002). Such directors would need to meet certain qualification requirements, and "could apply to sit on specific boards but would be assigned by the SEC." *Id.* at 107. They "would be required to report any suspected legal violation to corporate counsel and—absent satisfactory action—to the SEC." *Id.* This arguably would improve corporate governance because "[a]fter all, who would deal drugs if the 'narc' was sitting in the room?" *Id.* at 108.

242. *See, e.g.*, Vikramaditya Khanna & Timothy L. Dickinson, *The Corporate Monitor: The New Corporate Czar?*, 105 MICH. L. REV. 1713, 1741 (2007).

243. *See, e.g.*, Robert C. Pozen, *The Case for Professional Corporate Boards*, BROOKINGS (Dec. 5, 2010), http://www.brookings.edu/research/opinions/2010/12/05-professional-boards-pozen (proposing a professional independent board model but acknowledging that even if various concerns are satisfied, "it will take extraordinary efforts to persuade a company to adopt the new board model").

244. *See* Dorff, *supra* note 97, at 2075 (noting that having half of a group play Devil's Advocate can be helpful for introducing conflict).

challenge" strategy proposals and scrutinize management's performance.[245] This can help stimulate discussion of alternative viewpoints and reduce the risk of groupthink. In several corporate failures, the failure of the board to ask critical questions or to consider alternative viewpoints helped lead to corporate failure.[246] Although the designated naysayer approach might not be as effective as having an entirely different person join the compensation committee or assume the committee chair, it would be somewhat helpful in achieving the spirit of a rotation system.

Conclusion

The compensation committee independence requirement in Dodd-Frank is not sufficient to achieve its goal of making compensation committee members independent of management because it does not take into account relevant insights from organizational behavior literature regarding group dynamics. Those insights indicate that nominally independent directors might still be subject to psychological pressures that lead them to approve excessive amounts of compensation for the management of the company on whose board they serve. Due to the difficulties of incorporating personal relationships into the independence standards, this Article proposes an alternative approach for lessening the extent to which independent directors might become subject to managerial influence. This approach includes two reforms for compensation committees: (1) mandatory continuing professional education and (2) an optional rotation system. Regulators and/or companies should consider implementing these proposals to augment the reforms instituted under Dodd-Frank.

Although say-on-pay has already resulted in several cases in which the majority of shareholders of U.S. public companies cast negative votes on compensation, such votes are of limited effect due to their advisory and ex post nature—they are non-binding votes on compensation decisions that have already been approved by compensation committees. Making structural changes to the compensation committee, as advocated in this Article, is an ex ante approach that can supplement the ex post say-on-pay vote.

The recommendations endorsed in this Article are likely to make the reforms that have already been enacted more effective. While the reforms in Dodd-Frank are appropriate and well-intended, they do not go far enough to address one of the underlying causes of inappropriate executive compensation decisions: social dynamics coupled with long tenure and a lack of compensation expertise within the compensation

245. Fin. Reporting Council, The UK Corporate Governance Code § A.4 (2012).
246. Davidoff, *supra* note 90.

committee. Those factors make it difficult for compensation committee members to say "no" to CEOs.

By empowering *shareholders* to say "no," say-on-pay has begun to empower *compensation committees* to say "no" too because the committee members want to avoid negative say-on-pay votes and the associated negative ramifications. In a similar manner, rotations and continuing education are additional tools that can empower compensation committee members to be more effective directors. Although these tools might at first appear to be burdens on compensation committee members, they can ultimately be helpful tools that empower compensation committee members and enable them to fulfill their duties on the board. Ultimately, the recommendations in this Article, along with the other reforms that have already been implemented under Dodd-Frank, might help to prevent future financial crises.

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