A Role for the Judiciary in Reforming Executive Compensation: The Implications of Securities and Exchange Commission v. Bank of America Corp.

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NOTE

A ROLE FOR THE JUDICIARY IN REFORMING EXECUTIVE COMPENSATION: THE IMPLICATIONS OF SECURITIES AND EXCHANGE COMMISSION V. BANK OF AMERICA CORP.

Matthew Farrell†

INTRODUCTION ............................................ 170
BACKGROUND ............................................... 172
I. EXECUTIVE-COMPENSATION PLANS ................... 172
   A. The Regulatory Environment ...................... 172
   B. How Corporations Develop and Implement
      Executive-Compensation Plans ..................... 173
   C. Components of Executive Compensation .......... 174
   D. Trends in Executive Compensation ................. 174
II. DOES AN EXECUTIVE-COMPENSATION "PROBLEM" EXIST? 175
   A. Arguments That No Executive-Compensation
      Problem Exists ........................................ 176
   B. Arguments That Corporations Should Address Any
      Problem Themselves ................................... 177
   C. Arguments That an Executive-Compensation
      Problem Exists ......................................... 178
III. RECENT ATTEMPTS TO ADDRESS THE EXECUTIVE-
     COMPENSATION PROBLEM ................................ 180
    A. Reforms of 1992 ....................................... 181
    C. SEC Disclosure Regulations of 2006 ............... 182
    D. Legislation of 2009 .................................. 182
IV. DERIVATIVE ACTIONS BY SHAREHOLDERS TO ADDRESS
    THE EXECUTIVE-COMPENSATION PROBLEM ............ 184
    A. Facts of SEC v. Bank of America Corp. .......... 189
    B. Reasoning of SEC v. Bank of America Corp. .... 190

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169
VII. IMPLICATIONS OF SEC v. BANK OF AMERICA CORP. AND COURTS’ POLICING OF SEC ENFORCEMENT

A. Applying Judge Rakoff’s Reasoning to Executive-Compensation Disclosures
B. How Courts Can Police SEC Enforcement of Executive-Compensation Disclosures
C. Risks of Judge Rakoff’s Approach
D. Advantages of Judge Rakoff’s Approach

CONCLUSION

INTRODUCTION

Few areas of corporate governance have received as much attention as executive compensation. In the nineteenth century, robber barons were criticized and mocked, and in the early twentieth century, newspapers frequently disparaged top executives. These criticisms have continued into the late twentieth and early twenty-first centuries and intensified as politicians, activists, writers, and filmmakers have explored various aspects of executive compensation. The central conflict that executive-compensation plans must address is essentially an evolution of the agency conundrum. As ownership and management separated in our economic system, people entered into agency relationships, with corporate executives managing a corporation on behalf of shareholders. The interests of the shareholders and executives differ, however, as an executive is generally interested in his or her personal gain rather than in maximizing shareholders’ income and wealth. In theory, a well-constructed executive-compensation plan will align the interests of those managing the corporation with the interests of shareholders, who own the corporation. Despite the efforts of many individuals, this conflict of interests continues and pervades the process of crafting executive-compensation plans. In this Note, I argue that courts can address this problem by policing the Securities and Exchange Commission (SEC) in its regulation of corporate disclosures regarding executive compensation. Although the SEC currently requires that corporations present all pertinent executive-compensation information in a manner that is concise and under-

2 See id. at 47, 48-51; ENRON: THE SMARTEST GUYS IN THE ROOM (Magnolia Pictures 2005).
4 See id.
standable, the SEC’s enforcement of these rules, which courts have been hesitant to impede, often penalizes shareholders—the victims of executive-compensation problems—by requiring that the corporation pay the penalty.

In addressing this issue, I first describe the process of how most public companies develop executive-compensation plans and policies. In this overview, I explain that economic compensation is a polycentric issue that is shaped by federal and state laws, administrative agencies, and private organizations and actors. Second, I discuss recent trends in executive compensation (particularly the dramatic increase in levels of compensation in absolute and relative terms) as well as the important features of modern executive-compensation plans. Third, I address the contentious issue of whether there is a “problem” with the current system of executive compensation. In this discussion, I present the arguments of those who argue that no such problem exists or that the problem is insignificant, those who argue that the problem is one that corporations should address themselves, and those who argue that there is a significant problem that public actors must address.

After explaining why I conclude that there is a problem with executive-compensation practices, I describe legislative attempts beginning in 1992 to address this problem. This description includes legislation introduced in the summer of 2009 that would significantly affect the current executive-compensation regime. I then discuss and explain the shortcomings of another method for reforming executive-compensation practices—derivative suits by shareholders. Next, I describe Judge Jed Rakoff’s decision in SEC v. Bank of America Corp. Although this decision may appear to have little significance for executive-compensation practices, I will explain why Judge Rakoff’s approach in denying a settlement between the SEC and Bank of America (which involved misleading disclosures to shareholders regarding executive bonuses following Bank of America’s merger with Merrill

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7 See Kay & Van Putten, supra note 1, at 1-3; Omari Scott Simmons, Taking the Blue Pill: The Imponderable Impact of Executive Compensation Reform, 62 SMU L. REV. 299, 306 (2009).
8 See Nathan Knutt, Note, Executive Compensation Regulation: Corporate America, Heal Thyself, 47 ARIZ. L. REV. 493, 495 (2005).
9 See generally Bebchuk & Fried, supra note 3, at 4-36, 122-23, 180 (arguing that the corporate governance structure creates executive-compensation problems).
Lynch)\textsuperscript{11} can potentially ameliorate current problems with executive compensation. Specifically, I argue that improved enforcement by the SEC could dramatically improve executive-compensation practices and address many of the problems that scholars and commentators identify. To ensure that the SEC improves its enforcement of executive-compensation disclosures, I argue that courts should follow the lead of Judge Rakoff and require that the SEC thoroughly investigate companies and identify individuals responsible for failing to disclose accurate information. If the SEC and courts guarantee that investors will receive all pertinent information, investors will then be able to address any remaining problems themselves. I conclude by describing why this approach is superior to several other proposals.

BACKGROUND

I

EXECUTIVE-COMPENSATION PLANS

A. The Regulatory Environment

Rules and regulations from a variety of sources govern executive compensation at public companies. Public companies must follow state (usually Delaware) and federal laws, rules and regulations from the SEC and other government agencies (such as the Internal Revenue Service), and rules that self-regulatory organizations (such as the Financial Industry Regulatory Authority (FINRA), which merged the regulatory arms of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD))\textsuperscript{12} now require for listing securities.\textsuperscript{13} Each state has laws governing corporations, and the laws of the state in which a corporation is incorporated bind the corporation.\textsuperscript{14} Delaware law governs most corporations, and, as a result, Delaware has developed a highly specialized and highly regarded judiciary that can react quickly to new developments.\textsuperscript{15} Because of these institutional advantages, corporations generally prefer to incorporate and remain in Delaware.\textsuperscript{16} Self-regulatory organizations, including the NYSE, NASD, and FINRA, have adopted many rules that affect executive compensation in some manner. Perhaps most importantly, both the NYSE and NASD adopted rules, which the SEC ap-

\textsuperscript{12} See Jennifer J. Johnson, Private Placements: A Regulatory Black Hole, 35 Del. J. Corp. L. 151, 156 n.29 (2010).
\textsuperscript{13} Simmons, \textit{supra} note 7, at 923.
\textsuperscript{15} Mark J. Roe, Delaware's Competition, 117 Harv. L. Rev. 588, 594 (2003).
\textsuperscript{16} See id. at 590.
proved, requiring that the board of directors of every listed corporation have a majority of its directors be "independent." Additionally, every corporation has a charter (or articles of incorporation) and bylaws that together list the duties, roles, and rights of shareholders, executives, and directors. These rules and regulations provide the framework in which corporations develop their executive-compensation plans.

B. How Corporations Develop and Implement Executive-Compensation Plans

American corporations resemble "representative democracies." Although shareholders play a limited role, they do elect the board of directors and are allowed to vote on significant matters, like a proposed change to the corporate charter. The directors of a corporation create compensation packages for the executives on behalf of the corporation's shareholders. Although differences among boards exist, boards tend to act similarly when crafting executive-compensation plans.

Generally, a board will form a specialized compensation committee to make decisions regarding executive compensation. The NYSE requires its listed companies to have compensation committees composed of only independent directors. The compensation committee then relies on hired consultants and experts to provide it with information on common practices and data that allow the committee to craft an executive-compensation plan. Compensation committees usually retain lawyers and hold frequent meetings to evaluate executives. After the compensation committee develops a compensation plan, the entire board of directors reviews the plan and officially decides how to compensate the company's executives. Investors then

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17 See Bebchuk & Fried, supra note 3, at 24. Generally, directors are "independent" if "they are not current or former employees of the firm and are not affiliated with the firm other than through their directorship." Id.
18 See Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 893, 837, 844-45 (2005) (discussing the roles of corporate actors and how various corporate codes treat bylaws); Braunstein, supra note 14, at 750 (discussing articles of incorporation as well as the roles of shareholders and directors).
19 Bebchuk, supra note 18, at 837.
21 See Bebchuk & Fried, supra note 3, at 18.
22 See id. at 74-75.
24 Bebchuk & Fried, supra note 3, at 24.
25 See id. at 38-39, 70.
27 See Bebchuk & Fried, supra note 3, at 24; Simmons, supra note 7, at 310.
rely on accurate and complete disclosure of the compensation plan, along with other related information, to assess the company.28

C. Components of Executive Compensation

The exact details of executive-compensation regimes and practices vary tremendously among companies.29 Nevertheless, many similarities are also present. First, for example, executive pay packages are usually quite large, with the chief executive officers (CEOs) of many companies earning more than one hundred times what the average company employee earns.30 Executive compensation usually includes a fixed base salary, a bonus scheme (usually consisting of stock options and other incentive plans), perquisites (including pension plans, company cars, use of company aircraft, and other "perks"), and conditional promises of severance payments.31 Some executives, usually CEOs, also receive significant signing bonuses or upfront payments, which a board may justify as necessary to attract highly qualified candidates.32

D. Trends in Executive Compensation

The most significant trend in executive compensation is, simply stated, the recent and dramatic increase in executive compensation. Between 1992 and 2000, the average compensation (controlled for inflation) of CEOs of Standard & Poor's 500 companies increased from $3.5 million to $14.7 million.33 The compensation that top executives earned also increased relative to other company employees. In 1991, the CEO of a large company earned, on average, 140 times what the average employee earned; by 2003, an average CEO at a large company earned 500 times what the average employee earned.34 This increase in compensation is so large that neither growth in firm size, nor improvements in company performance, nor changes in industry practice explain it.35

A second major trend in executive compensation is the rise of equity-based compensation,36 which began as an effort to link executive compensation to performance.37 Nevertheless, if boards of direc-

29 Kay & Van Putten, supra note 1, at 141.
30 See Bebchuk & Fried, supra note 3, at 1.
31 Simmons, supra note 7, at 312–13.
33 Id. at 1.
34 Id.
36 Id. at 283, 289.
37 Bebchuk & Fried, supra note 3, at 157; Kay & Van Putten, supra note 1, at 2.
tors that craft these equity-incentive plans do not use indexing (comparing the change in the company's stock price to an index composed of other companies, which would identify relative performance) to calculate compensation, this practice may frequently lead to executives receiving "windfalls" unrelated to their performance.\footnote{38 See Bebchuk & Fried, supra note 3, at 140–41; Bebchuk & Grinstein, supra note 35, at 300.}

Along with this increase in compensation, however, there has been a trend toward greater transparency and disclosure of executive-compensation practices.\footnote{39 See Charles M. Yablon, Is the Market for CEOs Rational?, 4 N.Y.U. J.L. & Bus. 89, 105 (2007) (reviewing Bebchuk & Fried, supra note 3).} Charles Yablon argues that the increase in disclosure actually contributed to the increase in compensation, as boards and compensation committees often believe that their executives are "above-average" and thus use the disclosed information to set compensation levels for their own executives above the average.\footnote{40 Id. at 112.} Still, the increased transparency of executive-compensation practices does not necessarily explain this ratcheting effect. Furthermore, because advisors and consultants often provide corporate boards and compensation committees with data about a company's peers, including their executive-compensation practices, boards and compensation committees would still likely set their executives' pay above the average even without public disclosure requirements.\footnote{41 See Bebchuk & Fried, supra note 3, at 71–72.} Although the trends in rising executive compensation are apparent, not all agree that these trends present a problem.

II

DOES AN EXECUTIVE-COMPENSATION "PROBLEM" EXIST?

Despite the increases in total and relative compensation that executives receive, significant debate exists over whether this constitutes a "problem." Some believe that American executive-compensation practices are "well-executed," provide high pay for excellent performance and low pay for poor performance, and have contributed to immense economic growth that has benefited millions.\footnote{42 Kay & van Putten, supra note 1, at 1.} Others argue that the American "pay-for-performance model" is immoral, rewards greedy executives for company performance that is unrelated to an executive's performance, allows executives to essentially set their own compensation and enrich themselves at the expense of shareholders, and causes significant economic harm.\footnote{43 See id.} Although arguments for both views exist (and the truth is probably somewhere in the middle),
I conclude that there is a problem with the American model of executive compensation.

A. Arguments That No Executive-Compensation Problem Exists

Ira Kay and Steven Van Putten assert that no significant problems exist with current executive-compensation practices. Kay and Van Putten marshal substantial amounts of data and conclude that CEOs who perform well generally receive high and increasing amounts of compensation because of the small, competitive market for top executives. Recruiting talented executives certainly requires protecting them from various risks, and those commentators who are satisfied with current executive-compensation practices note that executives in public companies do not have the authority or ability to control the board of directors, which arguably decreases the risk of executives siphoning money from the corporation as salary. Kay and Van Putten also argue that this compensation system is an integral component of the American corporate model—the same model that has created the most productive economy in the world.

Others who study executive-compensation practices conclude that, despite some problems with the practices, these problems are rather small and any attempt to change how executives are compensated may actually worsen the situation. For instance, one study found that the top five executives at American companies receive, on average, between two and three percent of the value that the company generates, leading to the conclusion that gains from altering executive-compensation practices "would be swamped by the resulting decline in productivity, profitability . . . and the overall value of the corporation." Individuals arguing that executive-compensation problems are insubstantial also claim that diverting resources to address actual or perceived flaws distracts from more serious socioeconomic issues.

Nevertheless, even Kay and Van Putten admit that some executive-compensation problems deserve attention. They argue that executive-compensation practices would improve if companies reduced

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44 See id. at 1–2. According to Kay and Van Putten, "like most mythologies, the current conception of executive compensation distorts or exaggerates actual events. The mythology has too easily found larger-than-life examples of personal gain and sumptuous lifestyles with no link to superior corporate performance." Id. at 2.

45 Id. at 2–3, 41; Simmons, supra note 7, at 314.

46 Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 838 (7th Cir. 1999); see KAY & VAN PUTTEN, supra note 1, at 143.

47 KAY & VAN PUTTEN, supra note 1, at 10, 181.

48 See Simmons, supra note 7, at 299–300, 303 ("[C]orporate lawmaker self-interest and opportunism . . . can be a source of rent extraction, inefficiency, and welfare loss.").

49 KAY & VAN PUTTEN, supra note 1, at 4.

50 See Simmons, supra note 7, at 305–06, 364.
A ROLE FOR THE JUDICIARY

severance packages, emphasized real stock ownership by executives, and followed exemplary corporate governance practices throughout the process of developing their compensation plans. Kay and Van Putten also admit that excessive use of stock options can harm corporations by failing to adequately incentivize executives to perform well. They also believe that greater disclosure of executive-compensation practices—particularly with regard to deferred compensation, retirement plans, and severance—is important.

B. Arguments That Corporations Should Address Any Problem Themselves

Some argue that problems with executive compensation do exist but that corporations should be responsible for solutions, with no role for legislatures, the SEC, other regulatory agencies, or self-regulatory organizations. For example, shareholders could amend the company’s bylaws or charter (depending on the laws of a jurisdiction and the process that a company has adopted for amending its governance documents) to create shareholder-advocate positions for supervising executive-compensation practices. This approach, however, assumes that executives and board directors have not altered the rules for amending the governance documents to entrench themselves and limit the ability of shareholders to enact changes. Some scholars argue that shareholders can overcome these limits by selling shares in companies that have unfavorable practices and then investing in those with more favorable practices. This argument assumes that variation will exist among firms; however, as described below, variation is unlikely because companies with similar structures will often confront the same conflicts. Also, many investors are unable to sell their shares any time they wish. Thus, if an executive-compensation problem exists, corporations appear to be unable to solve it themselves.

51 Kay & Van Putten, supra note 1, at 5–6.
52 See id. at 6.
53 Id.
54 See, e.g., Knutt, supra note 8, at 495.
56 See Bebchuk & Fried, supra note 3, at 211 (discussing the entrenching effect of staggered boards); Bebchuk, supra note 18, at 843–45 (discussing the limited ability of shareholders to enact changes).
58 See Kay & Van Putten, supra note 1, at 88 (discussing different methods of compensating executives).
59 See id.
C. Arguments That an Executive-Compensation Problem Exists

Overall, there does appear to be a significant problem with executive compensation. Even those who do not believe that significant executive-compensation problems exist will admit that "executive compensation played a role in the decline in performance at some companies" in the past.\(^{60}\) For instance, the excessive use of options at some companies created an intense focus on the short term and even led some executives to engage in fraud to boost the value of their equity compensation.\(^{61}\) More importantly, though, empirical studies generally do not find a strong and persistent correlation between the cash compensation of executives (salary and bonuses) and company performance.\(^{62}\)

One common criticism of executive compensation is the "populism" critique. This critique, based on notions of "fairness" and "morality," abhors that a few individuals make incredible amounts of money.\(^{63}\) According to this approach, the problem is not the process that leads to executive-compensation decisions but the outcome itself.\(^{64}\) Some even argue that "anyone who makes that kind of money must be doing something either illegal or immoral."\(^{65}\) Individuals making this argument typically focus on the massive discrepancies between the compensation of top American executives and that of average American workers, foreign executives, lawyers, bankers, and other professionals.\(^{66}\) Nevertheless, this position relies on subjective notions of what is "fair," which is difficult to quantify and apply, limiting the utility of including it in discussions of reforming executive compensation.

Additionally, paying an executive a large amount of money may be completely rational. For example, if hiring a hypothetical executive would increase the value of a hypothetical company by $10 billion, then paying this executive $1 billion, which seems excessive and "unfair," not only makes sense but may even constitute underpayment from the executive's perspective, as he or she would not receive the entire value that he or she created. Therefore, because of the limita-

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\(^{60}\) See Kay & Van Putten, supra note 1, at 51.

\(^{61}\) See id.

\(^{62}\) Bebchuk & Fried, supra note 3, at 122–23. A small correlation exists between compensation and corporate performance in the 1980s, but no such correlation exists in either the 1970s or the 1990s. Id.

\(^{63}\) See id. at 8.


\(^{66}\) Id. at 797–800.
tions of the populist critique, a preferable approach is to focus on the flaws of the executive-compensation process (rather than its outcomes) and evaluate the seriousness of the problems in terms of the unrecognized shareholder benefits.

The stronger and more common critique of executive-compensation practices is the management-capture or management-power theory. This theory treats board members as imperfect shareholder agents who do not bargain with executives at "arm's-length" when determining executive-compensation packages, and, thus enter into contracts that favor executives over shareholders. Advocates of the management-capture theory argue that directors have both financial and nonfinancial reasons to favor executives. Numerous financial scandals support this idea by highlighting instances of boards being overly deferential to their executives, including the scandals at Adelphia, Enron, Tyco, and WorldCom.

Several reasons account for the failure of boards and compensation committees to develop executive-compensation plans that are efficient in maximizing shareholder value. First, executives have considerable influence on who will be on the company's slate of candidates for board elections, with those who appear on the company's slate almost certain to be elected or reelected as directors. Accordingly, challenging executives' compensation is not likely to either help a director retain his or her board position or obtain positions on other boards. Second, directors who frequently interact with executives—or who are (or were) executives themselves—will likely develop beliefs that support high compensation levels for executives, as such beliefs will help the director avoid the discomfort of arguing that the compensation that executives receive is undeserved. Third, executives can use their power and access to information to influence the board.

An additional reason that boards fail to develop efficient compensation arrangements is their ability to "camouflage" executive-compensation arrangements. The idea of camouflage is that the recognition of compensation practices that are overly favorable to executives provides a check on excessive compensation, which gives ex-
executives (and even directors) an incentive to obscure how a company actually compensates its executives.75 If a significant number of individuals recognize the flaws of a company’s executive-compensation regime, there will be both market costs, as individuals may be less likely to invest in the company, and social costs, as individuals may view the executives and directors as “greedy” and form negative views of the executives and directors.76 Thus, perception appears to be a greater constraint than reality.77

This notion of camouflage helps to explain why improving disclosures is the key to improving executive-compensation practices. If companies are forced to disclose all pertinent information related to executive compensation in a concise and understandable form, the ability of executives to obtain undeserved compensation will be constrained.78 Several different measures could help to accomplish this goal, including statutory regulations, rule changes by self-regulating organizations, and alterations of corporate bylaws or articles of incorporation.79 As discussed below, there have been several recent attempts at reform, but the approach of Judge Rakoff presents an efficient and relatively simple way to improve executive-compensation practices.

III
RECENT ATTEMPTS TO ADDRESS THE EXECUTIVE-COMPENSATION PROBLEM

Legislators and regulators frequently link executive-compensation issues with broader economic difficulties.80 Accordingly, every few years there is a spurt of proposals and legislation that address executive compensation.81 Recent efforts to reform executive compensation include changes in 1992 (which some refer to as “the year of

75 Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, Managerial Power and Rent Extraction in the Design of Executive Compensation, 69 U. CHI L. Rev. 751, 756, 789 (2002) (“Accordingly, under the managerial power approach, managers will prefer compensation structures and processes that enable the extraction of rents to be camouflaged as optimal contracting. . . . [O]utrage costs and constraints and the resulting camouflage motive might explain why firms rely so heavily on compensation surveys and consultants.”).
76 See Bebchuk & Fried, supra note 3, at 66–67; Bebchuk et al., supra note 75, at 770–71.
77 See Bebchuk & Fried, supra note 3, at 67.
78 Bebchuk et al., supra note 75, at 788 (“[W]hether significant outrage costs can be expected to arise would depend on the extent to which rent extraction is clearly apparent to outsiders, not just (or even mainly) upon how much rents are extracted.”).
79 For a brief overview of different possible approaches, see Martin, supra note 28, at 528–29.
80 See Simmons, supra note 7, at 306.
the pay protest\textsuperscript{82}), the Sarbanes–Oxley Act of 2002,\textsuperscript{83} the rules regarding executive-compensation disclosures that the SEC instituted in 2006,\textsuperscript{84} and congressional legislation proposed in 2009.\textsuperscript{85} The most promising reform in terms of actually improving executive-compensation practices is the SEC’s 2006 disclosure rules. Combining these disclosure rules with the enforcement practices that Judge Rakoff’s decision in \textit{SEC v. Bank of America Corp.} suggests, which would require that courts follow Judge Rakoff’s approach when reviewing SEC enforcement actions, will noticeably improve executive-compensation practices.

A. Reforms of 1992

In 1992, executive compensation emerged as an issue in the presidential election.\textsuperscript{86} Bill Clinton, for instance, pledged to reform executive compensation.\textsuperscript{87} Additionally, members of Congress introduced numerous bills aimed at reforming executive compensation, including one that would give shareholders the right to propose executive-compensation policies.\textsuperscript{88} Perhaps most importantly, however, the SEC promulgated disclosure rules that required companies to present executive-compensation information in a series of tables and a committee report.\textsuperscript{89} The SEC amended these rules in 2006 in an attempt to make executive-compensation information easier to understand.\textsuperscript{90}

B. The Sarbanes–Oxley Act of 2002

In 2002, in response to numerous corporate scandals, Congress passed the Sarbanes–Oxley Act.\textsuperscript{91} Although intended to address a number of “problems” with American corporations, the Act mostly focused on companies’ auditing practices.\textsuperscript{92} Sarbanes–Oxley federalized numerous areas of corporate law, including provisions for

\textsuperscript{82} \textit{Id.} at 148.
\textsuperscript{84} See Martin, \textit{supra} note 81, at 149-50.
\textsuperscript{85} See discussion \textit{infra} Part III.D.
\textsuperscript{88} Murphy, \textit{supra} note 86, at 713-14, 728.
\textsuperscript{89} See \textit{id.} at 731; see also Martin, \textit{supra} note 28, at 492. Lucian Bebchuk and Jesse Fried note that these required disclosures decreased the ability of directors and executives to camouflage executive compensation. \textit{Bebchuk \& Fried, supra} note 3, at 67-68.
\textsuperscript{90} See Martin, \textit{supra} note 81, at 150.
\textsuperscript{92} See \textit{Brown}, \textit{supra} note 5, at 6-7; see also Knutt, \textit{supra} note 8, at 509 ("The majority of Sarbanes–Oxley is not dedicated to executive compensation issues . . . ").
forfeiting executive pay, prohibiting loans from companies to executives, and mandating separation of accounting and auditing services. Sarbanes–Oxley also makes executives certify certain information disclosures and, if the disclosed information later proves to be inaccurate and the executives knew of the inaccuracies, the executives are legally liable.

C. SEC Disclosure Regulations of 2006

On January 27, 2006, the SEC proposed amending its rules regulating the disclosure of executive-compensation information; when the public comment period ended in April 2006, the SEC had received over 20,000 comments—the most for any proposed rule in the SEC's seventy-year history. Under the new rules, a company must disclose the compensation that its CEO, Chief Financial Officer (CFO), and three other highest-paid officers received during the fiscal year. The goal of these rules was to increase transparency by providing investors with a more complete and clearer image of the compensation of certain executives, not to dictate levels of compensation. Rather than list the information that a company must disclose, the SEC disclosure rules are “principles based,” meaning that they require a company to report all forms of compensation unless the rules specifically exempt it. The SEC also requires that companies provide a “Compensation Discussion and Analysis” (CD&A), which must be written in “plain English” and must describe the company's compensation objectives, policies, and decision-making processes, as well as the role that executives played in crafting the CD&A. In brief, a company must now explain how much compensation its top executives receive and why.

D. Legislation of 2009

In 2007 and 2008, as the SEC's new rules were going into effect, the United States experienced a significant economic decline that was part of a broader global financial crisis. In 2008, Henry Paulson, the Secretary of the Treasury, confronted a number of failures of

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93 See Knutt, supra note 8, at 510; Simmons, supra note 7, at 328.
94 See Brown, supra note 5, at 25.
95 Borges, supra note 5, at 8–9.
96 Id. at 23; Brown, supra note 5, at 30.
97 See Brown, supra note 5, at 3, 18.
98 Borges, supra note 5, at 2, 34.
99 See id. at 45–47, 79.
100 Id. at 46; Brown, supra note 5, at 3.
financial corporations and worked on drafting a bailout of the American banking industry.\textsuperscript{102} Even before these events culminated in congressional action that provided hundreds of billions of dollars in aid to firms having financial difficulties, a significant portion of the public debate regarding the causes of the economic crisis involved claims that executives were too highly paid.\textsuperscript{103}

In the midst of this public debate, members of Congress introduced a number of bills designed to reform corporate governance and overhaul executive compensation. Two important bills aimed at this purpose are the Excessive Pay Shareholder Approval Act\textsuperscript{104} (Excessive Pay Act), sponsored by Senator Richard Durbin, and the Shareholder Bill of Rights Act of 2009\textsuperscript{105} (Bill of Rights Act), sponsored by Senators Charles Schumer and Maria Cantwell. The Excessive Pay Act would require that a supermajority (sixty percent) of shareholders vote to approve "excessive compensation," which the bill defines as compensation that is greater than one hundred times the compensation that the average employee receives.\textsuperscript{106} The Excessive Pay Act would also require that proxy materials disclose the compensation that the lowest-paid employee received, the average amount of compensation all employees received, and the total amount of compensation paid to employees making more than one hundred times that average.\textsuperscript{107} After Senator Durbin introduced the Excessive Pay Act on May 7, 2009, the Senate referred it to the Senate Committee on Banking, Housing, and Urban Affairs;\textsuperscript{108} the committee has not taken any action on the act.

Senators Schumer and Cantwell introduced the Bill of Rights Act on May 19, 2009.\textsuperscript{109} The Bill of Rights Act would require that all publicly traded companies permit shareholders to vote on a nonbinding resolution either approving or disapproving executive-compensation plans.\textsuperscript{110} The Bill of Rights Act would also: require that boards be declassified (that is, federal law would prohibit staggered boards whereby shareholders elect only a portion of directors each year, helping incumbent directors and executives entrench themselves); mandate the creation of corporate "risk committees" (composed entirely

\textsuperscript{102} Id. at 676.
\textsuperscript{103} Id. at 672.
\textsuperscript{104} S. 1006, 111th Cong. (2009).
\textsuperscript{105} S. 1074, 111th Cong. (2009).
\textsuperscript{106} S. 1006; see David A. Katz & Laura A. McIntosh, Populists' Wish Lists Offer Legislative Parade of Horribles, N.Y. L.J., July 23, 2009, at 5.
\textsuperscript{107} S. 1006.
\textsuperscript{108} Id.
\textsuperscript{109} S. 1074.
\textsuperscript{110} S. 1074. For a strong criticism of the Shareholder Bill of Rights Act of 2009, see Martin Lipton, Jay W. Lorsch & Theodore N. Mirvis, Opinion, Schumer's Shareholder Bill Misses the Mark, WALL ST. J., May 12, 2009, at A15.
of independent directors who would evaluate a company’s risk-management practices); and permit shareholders to include their nominations for board seats in a company’s proxy materials.\(^ {111}\) The Senate referred the Bill of Rights Act to the Senate Committee on Banking, Housing, and Urban Affairs.\(^ {112}\) Neither the Senate nor the committee has taken any action. Thus, the recent legislative efforts do not appear very promising. Still, other means for addressing executive-compensation problems remain.

### IV

**DERIVATIVE ACTIONS BY SHAREHOLDERS TO ADDRESS THE EXECUTIVE-COMPENSATION PROBLEM**

Before discussing Judge Rakoff’s decision and reasoning in *SEC v. Bank of America Corp.* and how this approach, if combined with the SEC regulations enacted in 1992 and 2006, could effectively address current executive-compensation problems, it is worthwhile to discuss one other possible method of resolving executive-compensation problems: shareholder derivative actions. As discussed below, this approach is not likely to succeed and has several flaws that make it undesirable.

Historically, shareholders have often used derivative actions to challenge executive-compensation practices.\(^ {113}\) Generally, to prevail in a derivative suit challenging executive compensation, a shareholder suing on behalf of the company must demonstrate either that the directors who crafted the executive-compensation plan were engaged in unacceptable self-dealing or that the executive compensation is so egregious that it constitutes “waste,” which generally requires that the shareholder prove that a rational person would not have approved the compensation.\(^ {114}\) An early case that established a role for such shareholder suits is *Rogers v. Hill*.\(^ {115}\) In *Rogers*, the plaintiffs—shareholders of the American Tobacco Company—sought to recover bonuses that American Tobacco paid to its top executives.\(^ {116}\) The Supreme Court

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\(^ {111}\) S. 1074; see Lipton et al., *supra* note 110. Eliminating staggered corporate boards would likely increase shareholder power. The concept of the “market for corporate control” is based on the idea that a poorly run firm will have a low share price, which will make it vulnerable to takeovers by those who recognize the potential gains from a more effectively run company. *Bebchuk & Fried*, *supra* note 3, at 55. Staggered boards prevent hostile acquirers from gaining control for more than one year, and many would-be hostile acquirers will not attempt to acquire a company with a staggered board due to the extended time commitment. *See id.*

\(^ {112}\) S. 1074.


\(^ {114}\) Hawkins, *supra* note 55, at 455.

\(^ {115}\) 289 U.S. 582 (1933).

\(^ {116}\) *See id.* at 583, 590; Knutt, *supra* note 8, at 493–94.
determined that, even though American Tobacco properly enacted its executive-compensation plan, courts could still review its compensation scheme to determine whether the compensation scheme was unreasonable or constituted corporate waste.\textsuperscript{117}

Although Rogers established that courts can review executive-compensation practices via derivative suits, shareholders rarely succeed in such challenges.\textsuperscript{118} Courts are hesitant to tell companies how much they should pay their executives because of the general belief that "judges are not competent to decide what business executives are worth."\textsuperscript{119} Thus, to prevail, the shareholder-plaintiffs must meet an extremely high burden.\textsuperscript{120} Under Delaware law, for instance, if a company's board of directors (1) has no personal interest in its executive-compensation recommendations, (2) sufficiently investigates and discusses compensation proposals, and (3) relies on the advice of outside consultants, its decisions will be protected by the "business judgment rule," which is extremely deferential to board decisions.\textsuperscript{121}

The most recent significant decision involving shareholder derivative actions challenging executive compensation is Brehm v. Eisner (In re The Walt Disney Co. Derivative Litigation).\textsuperscript{122} The case involved the brief tenure of Michael Ovitz as the President of Disney.\textsuperscript{123} In 1995, Ovitz entered into an agreement with Disney to serve for five years; in December 1996, just fourteen months after he started, Disney terminated Ovitz without cause, thereby triggering the severance-package provision of the agreement that required Disney pay Ovitz approximately $130 million.\textsuperscript{124} In 1997, several Disney shareholders brought derivative actions against Ovitz and Disney's directors in the Delaware Court of Chancery.\textsuperscript{125} The Court of Chancery ruled that, although Ovitz received $130 million for fourteen months of work, this payment did not satisfy the "high hurdle required to establish waste," as the high pay was meant to entice Ovitz to leave his previous company and work for Disney.\textsuperscript{126} The Court of Chancery found that, despite some flaws in the board's and compensation committee's procedures,

\begin{footnotes}
\item[117] See Rogers, 289 U.S. at 591-92; Knutt, supra note 8, at 493-94.
\item[118] See Bebchuk et al., supra note 75, at 779.
\item[119] Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 838 (7th Cir. 1999).
\item[120] See Bebchuk et al., supra note 75, at 780; Simmons, supra note 7, at 311 n.40.
\item[122] 906 A.2d 27 (Del. 2006).
\item[123] Martin, supra note 28, at 497.
\item[124] In re The Walt Disney Co., 906 A.2d at 35; Martin, supra note 28, at 497.
\item[125] See In re The Walt Disney Co., 906 A.2d at 35 ("The plaintiffs claimed that the $130 million severance payout was the product of fiduciary duty and contractual breaches by Ovitz, and breaches of fiduciary duty by the Disney defendants, and a waste of assets.").
\item[126] Id. at 75.
\end{footnotes}
the process did not violate the directors' duty of care. The Delaware Supreme Court affirmed, though it did note that fiduciary duties, good faith requirements, and corporate waste theories apply to executive-compensation practices. Still, the case shows that, generally, courts will review a board's procedures, not the size of its executive-compensation packages.

Given the hostility of courts to derivative actions, this approach is simply not likely to reform problematic executive-compensation practices. Even if courts were amenable to shareholder derivative actions, relying on individual shareholders to challenge executive-compensation practices would cause a significant problem. A rational shareholder is unlikely to incur massive litigation costs if all shareholders, including those who are passive, will share any recovery. Thus, a different approach is necessary to address executive-compensation problems.

ANALYSIS

V
SEC ENFORCEMENT PRACTICES

Rather than legislative changes or private legal action, government enforcement of existing executive-compensation rules can address current executive-compensation issues. In this Part, I argue that an effective way to ameliorate executive-compensation problems is for courts to police the SEC in its enforcement of SEC disclosure rules.

An alternative to private suits challenging executive compensation is government enforcement of executive-compensation rules and regulations. Throughout the twentieth century, the American administrative state grew significantly, with this "headless fourth branch of government" shaping and implementing the regulatory scheme that largely governs executive compensation. The most important government agency in terms of regulating executive compensation is the SEC. Since its creation in the early twentieth century, the SEC has focused on ensuring that companies disclose accurate information to markets and investors. Although the SEC does not review the substance of executive compensation, it promotes transparency by making shareholders aware of and thus more likely to address improper executive compensation, in turn reducing the ability of executives to

127 Id. at 56.
128 Martin, supra note 28, at 488–89.
129 See id.
130 See Burghart, supra note 101, at 702; see also id. at 674.
obtain compensation packages that favor themselves over shareholders.132

In recent years, the SEC has proceeded against numerous companies that failed to disclose information regarding executive compensation. For example, in 2004, prior to the 2006 rule changes, the SEC attempted to enforce then-existing disclosure requirements against General Electric (GE) for “failing to fully and adequately describe the ‘terms and conditions’ of its retirement agreement with its former CEO Jack Welch.”133 The SEC also filed a complaint against, and eventually settled with, Tyson Foods for Tyson’s failure to adequately disclose the value of the perquisites that its chairman received.134

In its enforcement actions against public companies, the SEC attempts to deter corporate misbehavior without harming innocent shareholders.135 Nevertheless, the SEC settles a vast majority of its cases.136 When the SEC settles a case involving executive-compensation disclosures, it generally settles with the company rather than with particular board members, executives, or consultants.137 Thus, the settlement payment comes from the corporation, which belongs to the shareholders, with the underlying rationale being that shareholders will be more vigilant and can take appropriate action.138 Taking action against the corporation itself is also easier in terms of the burden that the SEC must satisfy to prevail.139 John Coffee argues that the emphasis on settlements has created a culture of dysfunction at the SEC and makes the SEC appear more powerful than it actually is.140

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132 See id. at 523.
133 See KAY & VAN PUTTEN, supra note 1, at 52.
134 See id.
137 See Reply Memorandum of Plaintiff, supra note 135, at 2–3 (discussing the SEC’s penalties policy, which may require a corporation—but not individuals—to pay a penalty).
138 See id. at 13, 16.
139 For example, some sections of the Exchange Act, such as Section 14(a) and Rule 14a–9, have no scienter requirement. See Memorandum of Plaintiff Securities & Exchange Commission in Support of Entry of the Proposed Consent Judgment at 19, Bank of Am. Corp., 653 F. Supp. 2d 507 (No. 09-CV-6829) [hereinaafter Memorandum of Plaintiff]. If, however, the SEC brought enforcement actions against individuals in a 10(b) proceeding (a provision for charging an individual with fraud), the SEC could succeed only if it could prove that the individuals did not believe, in good faith, that the information was not inaccurate or misleading. See id. at 24–25.
140 Coffee, supra note 136, at 1. Still, Coffee notes that the combination of the SEC’s policies of settling most cases and carefully choosing issues to litigate provides general deterrence at a relatively low cost. Id.
Courts have historically been extremely deferential to the SEC's determination of whether a settlement is in the public interest. Additionally, courts have routinely protected the executive-compensation decisions that informed directors make in good faith and without self-interest. This protection has led some commentators to conclude that courts are unable (or unwilling) to address the problems associated with executive compensation. Nevertheless, the SEC's 2006 disclosure rules are unlikely to affect executive-compensation practices unless these rules are vigorously enforced. Every time the SEC or Congress implements new rules to increase transparency in executive compensation, corporations create new ways to avoid disclosing this information. The SEC's new regulations seem able to avoid this problem by making disclosure the default position, but the SEC still must ensure that companies disclose all required information accurately. Accordingly, the SEC must actively enforce these new rules, and this enforcement will necessarily involve the courts. Commentators have argued that “[p]ublic officials and governance reformers . . . should work to ensure that compensation arrangements are and remain transparent.” A case that demonstrates how courts can effectively police SEC enforcement to ensure that the SEC effectively addresses executive-compensation problems is SEC v. Bank of America Corp.

VI

SEC v. BANK OF AMERICA CORP.

On first impression, Judge Rakoff's decision in SEC v. Bank of America Corp. does not appear to have a connection to executive-compensation regulation. In SEC v. Bank of America Corp., the SEC alleged that Bank of America misled investors about the billions of dollars Bank of America paid to former Merrill Lynch employees after Bank of America acquired Merrill Lynch. The SEC and Bank of America proposed a settlement, but Judge Rakoff denied it. Judge Rakoff is

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142 See Katz & McIntosh, supra note 106, at 4.
143 See Bebchuk & Fried, supra note 3, at 45–46.
144 Martin, supra note 81, at 153.
145 Bebchuk & Fried, supra note 3, at 193.
147 Id. at 508.
known as a maverick, and he previously inserted himself into corporate governance matters at WorldCom and has required the release of private documents in previous settlements. After discussing the facts of SEC v. Bank of America Corp. and Judge Rakoff’s innovative approach below, I then explain how his reasoning can help improve the SEC’s enforcement of executive-compensation regulations.

A. Facts of SEC v. Bank of America Corp.

In September 2008, Bank of America and Merrill Lynch negotiated a merger. The parties negotiated the principal terms of this transaction on September 13 and 14, and a major topic of discussion was whether to pay significant 2008 bonuses to Merrill Lynch employees and corporate officers in accordance with its discretionary bonus program. Bank of America, which was essentially acquiring Merrill Lynch, agreed to allow Merrill Lynch to pay its employees and officers bonuses of up to $5.8 billion, with the only additional restraint being that Merrill Lynch had to consult Bank of America before making any final decisions about the form of the bonuses. Bank of America and Merrill Lynch executed a merger agreement on September 15, 2008, publicly announcing the merger that morning. On November 3, 2008, Bank of America and Merrill Lynch solicited shareholder support for the merger with a joint proxy statement.

According to the SEC, Bank of America indicated that Merrill Lynch agreed not to pay discretionary bonuses to its employees and officers without Bank of America’s consent (implying that bonuses were unlikely), even though Bank of America had agreed that Merrill Lynch could pay substantial bonuses. Several weeks after the merger, the value of shares of Bank of America dropped substantially, as Merrill Lynch’s losses in 2008 were greater than anticipated.

The SEC subsequently charged Bank of America with making materially false and misleading statements in the joint proxy statement. Bank of America argued that the shareholders had not been misled, that the proxy statement did not contain false or misleading statements, that the disclosures were consistent with common merger-

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151 Id.
152 Id. at 5.
154 Complaint, supra note 150, at 1–2.
155 See id. at 2.
156 Orey, supra note 11, at 1–2.
157 See Complaint, supra note 150, at 1; see also Ellis, supra note 148.
disclosure practices, and that shareholders could have found relevant information from a variety of sources (particularly the media). Nevertheless, the same day that the SEC brought these charges, the SEC and Bank of America proposed a settlement, which they submitted to a federal district court for approval. This settlement would have enjoined Bank of America from making false statements in proxy solicitations and required Bank of America to pay a $33 million penalty to the SEC. Bank of America, which neither denied nor admitted the charges, still asserted that the proxy statement, if analyzed closely and carefully, was not misleading, and that any misstatements were immaterial because shareholders had access to the information from other readily available sources.

B. Reasoning of SEC v. Bank of America Corp.

Judge Rakoff, sitting in the United States District Court for the Southern District of New York, heard oral argument on the proposed settlement on August 10, 2009, and he received numerous written submissions in August and September. Judge Rakoff refused to approve the settlement, concluding that, even under the most deferential standard of review, the settlement was "neither fair, nor reasonable, nor adequate." He stated that the notion that the shareholders of Bank of America, who may have been misled in approving a merger with a nearly bankrupt company, would have to lose an additional $33 million to be motivated to better monitor and assess the company's executives was "absurd." Judge Rakoff noted that the practice of forcing a company that violates securities laws to pay a penalty essentially means that the victims of the violation pay an additional penalty, which seems inappropriate. Furthermore, because

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160 Id. at 508; Memorandum of Plaintiff, supra note 139, at 1.

161 See Bank of Am. Corp., 653 F. Supp. 2d at 509; Memorandum of Law on Behalf of Bank of America Corp., supra note 141, at 1.


163 Id. at 509.

164 See id.

165 Id. at 508, 512.
the company was responsible for the penalty, paying it would not deter those truly responsible for misleading the shareholders. 166

Judge Rakoff was concerned that the SEC did not pursue charges against those truly responsible for the violation—particularly the executives of Bank of America and the lawyers who allegedly prepared the misleading statements. 167 He also asked why the SEC did not insist that Bank of America waive the attorney-client privilege if it wished to argue that it merely relied on counsel. 168 In the past, Judge Rakoff has drawn on his experience as prosecutor to note unfortunate changes in enforcement practices. According to Rakoff, when he was a prosecutor in a securities-fraud unit many years ago, law enforcement put greater accountability on executives, usually filing charges against the people responsible for violations rather than against whole companies. 169 Rakoff decided that the settlement proposal “was a contrivance designed to provide the [SEC] with the façade of enforcement” while giving the executives at Bank of America “a quick resolution of an embarrassing inquiry . . . at the expense of the sole alleged victims, the shareholders.” 170

VII
IMPLICATIONS OF SEC v. BANK OF AMERICA CORP. AND COURTS’ POLICING OF SEC ENFORCEMENT

Judge Rakoff’s approach in rejecting the settlement is different from the approach that judges have taken in many similar cases, 171 and its adoption by other judges would have numerous ramifications. In terms of executive-compensation practices, the ramifications have the potential to be especially significant. In SEC v. Bank of America Corp., the SEC did not prosecute Bank of America because it paid bonuses to former Merrill Lynch employees; rather, the SEC alleged that Bank of America failed to disclose the bonus arrangements to its shareholders. 172 As noted above, the key mechanism for protecting shareholders from unfair executive-compensation practices is transparency, and a leading cause of unfair and inefficient compensation

166 See id. at 512.
167 See id. at 511.
169 Story, supra note 149. Even SEC policies state that the SEC should bring charges against responsible individuals where possible. Bank of Am. Corp., 653 F. Supp. 2d at 510; Reply Memorandum of Plaintiff, supra note 135, at 3 (“Of course, the [SEC] will vigorously pursue individual charges where supported by the evidence and the law. The [SEC] is firmly committed to pursuing charges and the full scope of relief against individuals in such circumstances.”).
172 See Memorandum of Plaintiff, supra note 139, at 3.
practices is the ability of boards of directors and executives to "camouflage" executive compensation. The 2006 SEC disclosure rules, however, establish the broad principle that a corporation must disclose all executive-compensation information, with only a few specific exemptions. Accordingly, imagining future SEC enforcement actions that resemble the situation in SEC v. Bank of America Corp. is not difficult. To be sure, the SEC must be willing to challenge the sufficiency of executive-compensation disclosures, which is admittedly uncertain, but nothing indicates that the SEC will be reluctant to enforce its new rules, particularly as executive compensation receives increasing political and media attention. If courts adopt Judge Rakoff's approach and require that the SEC focus on those responsible for disclosure failures and camouflaging compensation regimes, shareholders will be better protected, reducing or even eliminating many of the executive-compensation problems identified above.

A. Applying Judge Rakoff's Reasoning to Executive-Compensation Disclosures

Admittedly, SEC v. Bank of America Corp. only tangentially relates to executive compensation. Still, the central focus in the case was the allegation that Bank of America failed to accurately disclose the bonus arrangements to which it agreed. Similarly, a frequently discussed problem with executive compensation is the lack of accurate disclosures. Thus, Judge Rakoff's requiring that the SEC break out of its past practices in regulating proxy disclosures has the potential to profoundly affect the SEC's regulation of executive-compensation disclosures.

As noted above, the SEC's 2006 rules, which amended the 1992 rules concerning executive compensation, require that a company disclose all forms of executive compensation not specifically exempted. To address current executive-compensation problems, however, the SEC must also enforce the rules in a manner that is consistent with the principles of the rules and regulations, meaning that it must review the executive-compensation disclosures that companies make, investigate to determine if they are accurate, and bring charges if a company fails to fully and accurately disclose its executive-compensation practices (and the reasons for these practices) in a comprehensible manner.

173 See supra notes 74–79 and accompanying text.
174 See supra notes 95–100 and accompanying text.
175 Memorandum of Plaintiff, supra note 139, at 3.
176 See, e.g., Bebchuk et al., supra note 75, at 754–58 (discussing how managers may obscure compensation schemes to avoid investor outrage).
177 See Borges, supra note 5, at 2.
If the SEC continues to follow its pre-SEC v. Bank of America Corp. operating practices, the 2006 rules are unlikely to have a significant effect. For example, one can imagine a hypothetical situation resembling SEC v. Bank of America Corp. where the troubling behavior at issue is a company’s failure to comply with the SEC’s executive-compensation disclosure regulations. If the SEC behaved as it did in SEC v. Bank of America Corp. (that is, simply charging the company with violating the 2006 regulations and negotiating a settlement with the company as a penalty), the 2006 rules would be unlikely to have much effect. Of course, a company and its board would rather not pay a penalty, but they might prefer paying a penalty to complying with the executive-compensation disclosure rules. If executives truly do have a significant influence over the board—and it appears they do—78—the ability of executives to earn higher levels of compensation than they would if they accurately disclosed the company’s executive-compensation practices could more than compensate (from the executives’ perspective) for payment of any penalties. Also, as SEC v. Bank of America Corp. demonstrates, the company would pay the penalty,179 so the benefits of noncompliance with SEC regulations would accrue to the executives, while shareholders would bear the burden of noncompliance in the form of the company’s losses.

This problematic approach certainly seems to be a logical outgrowth of the SEC’s settlement culture. Many companies likely would not fully comply with SEC regulations; as a result, the SEC would be able to select a few targets, and—instead of engaging in a lengthy investigation that would uncover why the company failed to disclose its executive-compensation practices—would negotiate with the company to reach a mutually acceptable agreement. Thus, the SEC would appear to be enforcing its rules and regulations while avoiding (and hiding) the true extent of the problem.180 Because the SEC would not hold individuals personally accountable, and because limited resources means that the SEC could not pursue every violator, directors and executives could continue to camouflage executive-compensation packages and practices.

An alternative manner of enforcing the 2006 regulations would follow the outline that Judge Rakoff presents in SEC v. Bank of America Corp.181 First, the SEC would have to investigate whether a company violated the 2006 regulations. Accordingly, the SEC would review the company’s required executive-compensation disclosure to make sure that it accurately reported the compensation of the CEO, CFO, and

178 See supra notes 67–68, 70–73 and accompanying text.
180 See Coffee, supra note 136.
181 See supra notes 148–49, 163–70 and accompanying text.
the three next-highest-paid directors. The SEC would also have to review the CD&A to ensure that the company truthfully disclosed (in plain English) its executive-compensation policies and objectives, as well as the reasoning behind these policies and objectives.

Second, if the SEC found that the company failed to comply with the disclosure requirements, the SEC would investigate further to discover who is responsible for this failure. This approach is superior to merely forcing the company to pay a penalty, as it avoids having the shareholder-victims pay an additional penalty for their victimization. An investigation may not be easy, but it would potentially force those responsible for harming shareholders to bear the full cost of their actions, which would almost certainly improve deterrence. The SEC could focus its investigation on the compensation committee, the entire board, perhaps the executives, and even the consultants (including lawyers) who advised the board.

The final step in this enforcement process would be to bring charges against those responsible for failing to properly disclose executive-compensation information. The SEC could embrace its preference for settlements at this point and negotiate a settlement with the responsible individuals.

In addition to any financial penalties that those responsible for failing to comply with executive-compensation regulations receive, nonlegal sanctions might even be more likely to deter inappropriate behavior in the future. For example, a finding that an individual was responsible for a company's failure to comply with SEC regulations would expose the individual as disingenuous, thereby affecting the individual's future prospects and potentially threatening any position that the individual currently holds. Also, the ensuing guilt and public embarrassment would provide additional punishment that would otherwise not be available if the SEC pursued the company rather than the responsible individuals. Shame can be very useful for both pun-
ish the notion of individual responsibility in executive compensation is already stronger than notions of individual responsibility in the merger context that Judge Rakoff addressed.

Additionally, the SEC will very likely be able to demonstrate that directors, executives, or consultants violated SEC regulations, as a company must disclose its reasons and principles for its executive-compensation practices. This disclosure will also address the management-capture theory and other assertions that executives can easily influence boards and compensation committees. If the company does not disclose the true reasons for its plan, then those who prepared the CD&A, and those who advised them, would be liable.

Accordingly, the SEC could follow Judge Rakoff’s approach and pursue executives and directors at companies that seem to have inadequately disclosed reasons for their executive-compensation practices. For example, the SEC could prosecute a company that set its CEO’s compensation at a certain level because it wanted the CEO to be paid more than the average CEO. If this desire affected the board’s decisions and the CD&A did not discuss this, then the SEC has a strong case against the company, those who prepared the executive-compensation package, those who prepared the CD&A, and perhaps even the consultants who advised the individuals who crafted the compensation package. If executives played a role in shaping executive compensation and this role was not disclosed, then the SEC would have a strong case against those responsible for failing to disclose the executives’ influence. The SEC could also be very effective in requiring companies to accurately disclose how much the company’s top executives

188 Id.
189 See BORGES, supra note 5, at 68 (discussing the implications of 15 U.S.C. § 7243 (2006)).
190 BROWN, supra note 5, at 3–4.
191 Id. at 3.
actually earn—including salary, bonuses, deferred compensation, pensions, perquisites, and any gratuitous payments—which would limit the ability of executives to unfairly hide their actual compensation. The elimination of executive-compensation camouflage would allow investors to more clearly understand how much executives earn, and investors could influence the company by either voicing their “outrage” or by considering this information when voting. SEC enforcement actions in accordance with Judge Rakoff’s reasoning might not eliminate all problems with executive compensation, but they could address many of them.

B. How Courts Can Police SEC Enforcement of Executive-Compensation Disclosures

As previously noted, the SEC enforcement approach that Judge Rakoff’s reasoning in SEC v. Bank of America Corp. suggests differs from the SEC’s current enforcement practices. A major factor that has contributed to the SEC’s focus on settlements is that courts generally defer to the SEC in situations where the SEC recommends a proposed settlement. In the past few years, courts have approved thousands of SEC settlements resembling the SEC–Bank of America settlement. Even Judge Rakoff recognized that courts deferentially review the SEC’s settlement proposals. Still, Judge Rakoff’s decision provides an example of how courts can ensure that the SEC pursues enforcement actions against individuals who are responsible for inadequate disclosure of executive-compensation information.

Some scholars have argued that courts are not capable of addressing the problems of executive compensation. Additionally, as previously noted, many judges are skeptical as to whether courts are capable of policing executive-compensation practices. These beliefs are likely based on fears that courts would be reviewing the substance of executive compensation and whether the amount is “reasonable,” “fair,” or complies with some other vague, subjective concept that would be both difficult to apply consistently and beyond the competence of the average judge.

192 See Bebchuk et al., supra note 75, at 756.
193 See Bebchuk & Fried, supra note 3, at 65–66.
194 See supra note 141 and accompanying text.
195 See Pearlstein, supra note 171; see also Memorandum of Law on Behalf of Bank of America Corp., supra note 141, at 30 (citing examples of settlements involving the SEC that received deferential review).
197 See, e.g., Bebchuk & Fried, supra note 3, at 45.
198 See, e.g., Exacto Spring Corp. v. Comm'r, 196 F.3d 833, 838 (7th Cir. 1999).
Judge Rakoff’s reasoning demonstrates how courts can police executive compensation while avoiding these problems. If courts embraced Judge Rakoff’s ideas, they would not review the compensation that an executive receives; instead, review would involve whether the SEC identified the appropriate parties to prosecute and, perhaps, the extent to which a company’s disclosures were inaccurate. If a court reviewing the SEC’s actions determined that the SEC was trying to achieve a quick settlement while not pursuing thoroughly the alleged failure to accurately and fully disclose executive-compensation information, the court would not permit the SEC to settle. Faced with this possibility, the SEC would almost certainly alter its practices in a way that more effectively addresses executive-compensation problems. Thus, as \textit{SEC v. Bank of America Corp.} indicates, courts can play a role in addressing the current problems of executive compensation.

C. Risks of Judge Rakoff’s Approach

Although \textit{SEC v. Bank of America Corp.} presents a scheme that could address executive-compensation problems, Judge Rakoff’s approach also presents certain risks that could undermine or eliminate the benefits of the approach. In \textit{SEC v. Bank of America Corp.}, Joseph A. Grundfest, a law professor and former SEC commissioner, provided the court with an affidavit explaining why Judge Rakoff should approve the proposed settlement.\textsuperscript{200} Although many reasons that Grundfest provided involve notions of convenience and benefits for the company, he also discussed other possible ramifications of not approving the settlement proposal, including massive litigation costs and distraction from other activities.\textsuperscript{201} If courts require that the SEC conduct costly investigations and focus on individuals, SEC officers and employees would have to divert more resources to these investigations, potentially limiting the SEC’s ability to perform its other regulatory activities. The SEC might also have to pursue fewer cases, as determining responsibility for improperly disclosing executive-com-

\textsuperscript{200} Affidavit of Joseph A. Grundfest, \textit{supra} note 158.

\textsuperscript{201} See id. at 19–20.
penetration information could prove difficult. Additionally, companies, corporate executives, and directors will very likely have some defenses. In *SEC v. Bank of America Corp.*, Bank of America claimed that it had "powerful defenses."\(^{202}\) This prospect is not extremely problematic, however, as companies, executives, and directors with strong, valid defenses should not be coerced into forgoing these defenses and settling simply to avoid a hassle.

Several positions that the SEC took in *SEC v. Bank of America Corp.* could also hinder the ability of the SEC to pursue, in future enforcement actions, individuals who allegedly violate disclosure laws.\(^{203}\) The SEC claimed that the facts of *SEC v. Bank of America Corp.* were not sufficient to pursue culpable executives and directors, as the individuals otherwise responsible relied on consultants and other experts.\(^{204}\) This argument is not particularly troublesome, however, because the SEC could pursue consultants, executives, and officers to determine the extent to which these individuals are culpable. In *SEC v. Bank of America Corp.*, the SEC also argued that it would have the burden of proving that those it charged intended to deceive, defraud, or manipulate information, or that they acted recklessly, and the SEC claimed that these elements are difficult to establish.\(^{205}\) If the SEC is correct, courts might force the SEC to embark on many difficult battles that the SEC will likely lose.

The SEC, however, appears to be exaggerating the problems it would face if forced to follow Judge Rakoff's reasoning in executive-compensation enforcement actions. As noted above, the 2006 regulations of executive-compensation disclosures are well worded, and proving a violation is thus not likely to be difficult. Additionally, as the academic literature concerning executive compensation is vast and sophisticated, the SEC would have a variety of options for presenting reasons why executives and directors made certain executive-compensation decisions. Furthermore, even if the SEC is correct in its claims about the burden that it would have to satisfy in future prosecutions, nothing indicates that it could not prove intent to deceive, defraud, or manipulate information, or that certain executives or directors acted recklessly.

Events that occurred after Judge Rakoff rejected the settlement proposal in *SEC v. Bank of America Corp.* indicate that the SEC can adapt to his approach. For example, Bank of America cooperated with the SEC by providing more information and waiving attor-

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\(^{203}\) See Coffee, *supra* note 136, at 5.


\(^{205}\) See Memorandum of Plaintiff, *supra* note 139, at 24–25.
ne–client privilege.\textsuperscript{206} This indicates that the SEC retained a strong position. If Bank of America believed that the SEC could not satisfy its burden, the company would have had no reason to cooperate. Also, the SEC did not abandon the enforcement action, which indicates that the SEC is not entirely pessimistic about its ability to prevail in similar suits.\textsuperscript{207}

D. Advantages of Judge Rakoff’s Approach

The scheme that Judge Rakoff’s approach suggests has several advantages over other possibilities for addressing executive-compensation problems. For instance, numerous past attempts at legislating transparency have failed to address serious problems with executive-compensation practices, as new laws generally lead to the creation of new instruments for disguising compensation.\textsuperscript{208} Judge Rakoff’s ideas would likely increase transparency by simply enforcing existing regulations in a more efficient and fair manner. As transparency in executive compensation increases, nonlegal sanctions can also become effective tools for addressing executive-compensation problems.\textsuperscript{209} Increasing transparency and focusing on individuals will mean that emotions like guilt, embarrassment, and shame will attach to certain executive-compensation plans and decisions, and these considerations will likely alter the behavior of executives and directors. Using the courts to alter the SEC’s enforcement process will allow the existing regulatory regime to continue, and the result will be the production of accurate and clear information concerning executive compensation.

Additionally, this approach has several advantages over recently proposed legislation, namely the Excessive Pay Act and the Bill of Rights Act.\textsuperscript{210} Perhaps most importantly, since Senators Durbin, Schumer, and Cantwell introduced these bills, the Senate has not acted on them. Thus, relying on new legislation to address executive-compensation problems does not seem to be an effective strategy, as there appears to be a lack of political support for these proposals.\textsuperscript{211} Additionally, if Congress did act, powerful interest groups might influence the legislation, making the rules less effective.\textsuperscript{212} Finally, the proposed bills go beyond what is a much simpler means of addressing the

\textsuperscript{207} See id.
\textsuperscript{208} Martin, supra note 81, at 158.
\textsuperscript{209} See Gopalan, supra note 187, at 760.
\textsuperscript{210} See discussion supra Part III.D.
\textsuperscript{211} See Bebchuk, supra note 18, at 843.
\textsuperscript{212} See id.
problem. For instance, the Bill of Rights Act would make staggered boards illegal, which could have dramatic consequences, including allowing powerful investors to manipulate a company or its managers into pursuing unwise, short-term strategies.213

Judge Rakoff's approach also avoids the problems of relying on shareholder derivative suits to address executive-compensation problems. First, Judge Rakoff's approach would utilize the SEC, which avoids a collective-action problem among shareholders and prevents a victorious shareholder from prevailing at the expense of other shareholders. Also, as previously noted, courts are very likely to dismiss shareholder suits against corporate executives and directors, so derivative actions against executives and directors who fail to accurately and fully disclose executive-compensation information are probably incapable of addressing these problems.214

CONCLUSION

As Coffee notes, putting "the genie back in the bottle" is difficult.215 Although the effect of Judge Rakoff's decision in SEC v. Bank of America Corp. is still uncertain, and although the extent to which other judges will follow his approach is unclear, Judge Rakoff's decision to reject the proposed settlement presents a framework that could be applied to SEC enforcement of existing executive-compensation regulations. There are numerous problems with executive-compensation practices, but using the courts to police the SEC in a manner that will address the problems appears to be a promising solution.

At its core, the expanded agency problem of executive compensation requires that resources be used to monitor and constrain corporate executives and directors. Corporations have created massive amounts of wealth, but that wealth has not always gone to those who are most entitled to it. This is largely due to the shareholder collective-action problem, the ability of executives to influence the directors who determine executive-compensation practices, and the ability of executives and directors to camouflage executive compensation. In the past twenty years, legislation and numerous proposals have surfaced, and the regulatory framework now requires that companies disclose not only what they pay their executives but also why they pay them these amounts. New legislation that would go further has been proposed, but this legislation does not seem necessary or likely to gather sufficient political support for Congress to enact it.

213 Katz & McIntosh, supra note 106.
214 See supra notes 113–29 and accompanying text.
215 Coffee, supra note 136, at 5.
If other courts adopt Judge Rakoff’s approach and apply it to SEC enforcement actions based on failures to comply with rules governing the disclosure of executive-compensation information, executive-compensation practices will likely improve. Although this approach requires that the SEC pursue individuals and companies that have not complied with the disclosure regulations, nothing suggests that the SEC is incapable of pursuing these cases. Judge Rakoff’s reasoning in SEC v. Bank of America Corp. would lead to investors having more information and corporate directors having to provide accurate reasons for their compensation practices, both of which have the potential to eliminate the ability of disingenuous executives and directors to camouflage executive compensation. As this process compels directors to present executive-compensation information, the flaws of the current practices can be addressed, and the extent of any remaining problems is likely to be much clearer, enabling future commentators to build upon this judicially policed disclosure framework.