INVERTING COMMON CORPORATE GOVERNANCE MYTHS

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I. Introduction

Before I discuss some common corporate governance myths, I would first like to set the context. The United States is in the midst of an epic financial crisis. That is no myth. Home prices have fallen drastically, the level of new home sales is the lowest it has been in a generation, both imports and exports are cliff-diving, and, most troubling of all, unemployment is at levels not seen since the Great Depression. Surely something must be done, but what? When a complex system such as an economy fails, finding causes is easy—they are everywhere you look—but understanding them is difficult. This is due in part to four common cognitive distortions we are all prone to make in times of crisis.

First, people tend to act first and think later.⁴ After all, this is a crisis, so there is no time for contemplation. Something must be done now, even if we have not figured out what to do yet.

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- ¹ See David Leonhardt, Do I Hear a Housing Rebound? Not Yet, N.Y. TIMES, Apr. 22, 2009, at B1.
- ² Patrice Hill, Economy 'Fell off a Cliff' at the End of '08, This Quarter Could Be Worse, WASH. TIMES, Jan. 31, 2009, at A1.
- ³ Janell Ross & Heidi Hall, *Many Men Struggle with New Family Role*, THE TENNESSEAN, Aug. 2, 2009, at B1.
- ⁴ See, e.g., Jawaharlal Nehru Quotes, http://www.brainyquote.com/quotes/quotes/j/jawaharlal133828.html (last visited Mar. 18, 2010) ("A leader or a man of action in a crisis almost always acts subconsciously and then thinks of the reasons for his action."); Steve Pollick, Look to Ottawa Hills to Deal with Deer Glut, Sept. 13, 2009, http://www.toledoblade.com/apps/pbcs.dll/article?AID=/20090913/COLUMNIST22/909139996

("That's the way politics work[] in this fair land—long-term, critical thinking and (continued)

Second, in times of crisis we reflexively find ready explanations in our pre-existing biases. If you are a lifelong dyed-in-the-wool Democrat, chances are your initial explanation for the crisis was that it was caused by Republican deregulation. Likewise, if you are a lifelong dyed-in-the-wool Republican, chances are your initial explanation for the crisis was that it was caused by Democratic regulation. These biased explanations feel right to us, and without time for true contemplation they are often all we have to rely on when decisions need to be made.

Third, we tend to personalize the abstract and complex.⁶ Our modern economy is so vast it eludes comprehension.⁷ When a crisis hits, we reflexively try to reduce it down to the simplest white/black hats level. Just put Ken Lay and Jeff Skilling⁸ in handcuffs, and we think our problems will be solved. If only it were that easy.

Fourth, we have an innate need to simplify, even when our problems are complex. This is related to the prior point, but it is a bit different. Here, I am concerned that given a choice between a simple explanation and a complex explanation, our minds are wired to favor the simple explanation. Often this is a useful cognitive filter, but sometimes it gets us in trouble. At times, we need to resist our urge to simplify and instead "complexify." We need to turn inherently appealing simple solutions on

subsequent straightforward action are ignored till too late, and we are stuck with knee-jerk reactions to crises.").

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⁵ See Gregory Mitchell, Case Studies, Counterfactuals, and Causal Explanations, 152 U. PA. L. REV. 1517, 1563–64 (2004). See Top 10 Crooked CEOs: Kenneth Lay & Jeffrey Skilling, TIME, June 9, 2009, http://www.time.com/time/specials/packages/article/0,28804, 1903155 1903156 1903186,00.html, for additional discussion of the Enron scandal.

⁶ See, e.g., Michael McCann et. al., Java Jive: Genealogy of a Judicial Icon, 56 U. MIAMI L. REV. 113, 115–16 (2001) (mentioning social science analyses, which "emphasize how the media dramatize, personalize, fragmentize, and normalize narratives of events and relationships, thus reconstructing complex social relations and policy issues in simplistic, systematically skewed ways"); Neal R. Feigenson, Accidents as Melodrama, 43 N.Y.L. Sch. L. Rev. 741, 741 (1999) (noting how jurors using common sense often personalize, simplify, and moralize complex questions).

⁷ See John A. Paulos, Complexity and Intelligent Design: How 'Spontaneous Order' Applies to Economics and Evolution, ABC NEWS, Sept. 4, 2005, http://abcnews.go.com/Technology/WhosCounting/story?id=1077586.

⁸ See Top 10 Crooked CEOs, supra note 5.

 $^{^9}$ See John H. Holland, Hidden Order: How Adaptation Builds Complexity 10–12 (1995).

their heads, unwind neat conclusions, and resist our easy answers. But this rarely happens, which probably explains why "complexify" is not a word.

When confronting a crisis, these common cognitive distortions make it harder for us to put the pieces together and suggest that we should be very wary of our initial conclusions.

With that in mind, let us turn back to our crisis. Many view corporate governance failures as a key cause of the current crisis. This is hardly surprising because corporate governance has been a hot button issue for years. Concerns over prior corporate governance failures have led to many recent reforms at public companies. Some of the most widely adopted reforms are majority independent boards, non-executive board chairs, majority vote requirements for director elections, shareholder approval of equity compensation plans, and much more detailed compensation disclosures. Other reforms seem to be on their way toward universality: "poison pills" are waning, board declassification is on the rise, and the Securities and Exchange Commission (SEC) seems poised to finally adopt some form of direct proxy access for shareholders.

¹⁰ See John C. Bogle, A Crisis of Ethic Proportions, WALL St. J., Apr. 21, 2009, at A19; Alan S. Binder, When Greed Is Not Good, WALL St. J., Jan. 12, 2010, at A19.

¹¹ See, e.g., Frank Rich, State of Enron, N.Y. TIMES, Feb. 2, 2002, at A19 (discussing corporate governance and the Enron scandal); Henry Kaufman, *The Economic Forces Behind the Collapse: History Lessons We Failed to Learn*, N.Y. TIMES, Oct. 25, 1987, § 3, at 3 (discussing corporate governance in relation to the "historic drop in the stock market" in 1987).

¹² See Dave Beal, Across the Board Changes Neglect by Rubber-Stamping Boards Has Been a Key Factor in the Shift of Sentiment About Business. New Rules Have Been Quickly Put into Place to Restore Public Confidence, Increase Board Independence and Make Governance Less Passive, St. Paul Pioneer Press, Aug. 11, 2002, at D1.

¹³ See Dan Neel, SEC Tightens Grip on Fund Behavior, INVESTMENT MGMT. WKLY., Jan. 19, 2004, at 4; Kevin Harlin, New Direction for Firms in Wake of Corporate Scandals, Companies Look for Right Ingredients to Make Healthy Board of Directors, TIMES UNION ALBANY, Apr. 20, 2003, at C1; Christopher Caggiano, Taking Stock: As Shareholders Demand New Limits to CEO Compensation, Boards Radically Reconsider How They Pay Top Executives, CORP. COUNSEL, May 1, 2004, at 104; Claudia H. Deutsch, A Brighter Spotlight, Yet the Pay Rises, N.Y. TIMES, Apr. 6, 2008, § 3, at 1.

¹⁴ See Gretchen Michals, A Chewable Poison Pill, DIRECTORSHIP, June 1, 2008, at 14; Anne Stuart, Talk Therapy: How Best to Handle Shareholder Resolutions? Keep Them off the Proxy in the First Place, CORP. COUNSEL, Sept. 1, 2005, at 128; Sara Hansard, SEC Reviewing Director Election Process, Schapiro Says Commission Will also Consider Rules to Give Shareholders Greater Access to the Corporate Proxy, INVESTMENT NEWS, Nov. 9, 2009, at 12.

legislative actions to address the crisis include corporate governance reforms, and compensation practices at some of our largest banks are now overseen by the non-euphoniously-entitled SIGTARP.¹⁵

My goal here is not to assess whether, and to what extent, corporate governance failures caused the current crisis. Instead, I examine some of the common assumptions underlying the corporate governance narrative. In doing so, I suggest that some of our most cherished beliefs are actually products of our cognitive distortions and may be more mythical than real.

II. NEW WAYS OF THINKING ABOUT OLD MYTHS

"Myth" is a strong word. I am using it in the sense of "an explanation for a phenomenon we do not really understand." As in:

Phenomenon	Myth
Thunder	The gods are angry
Crop failure	The gods need a sacrifice
Destruction of financial system	The gods demand a board risk management committee

I realize I am being deliberately provocative in using a strong word like "myth." But how much fun would it be to hear a talk or read an article entitled "What You Think is True is True"? That would give you two minutes of interest and fifty-eight minutes of tedium. Instead, by suggesting that what you think is true may be mythical, I hope to trigger your skepticism, engage your attention, and invert that ratio.

The spirit of my inquiry is motivated by the founder of my law firm, Charles T. Munger, who is fond of saying, "Invert, always invert!" Once

¹⁵ See U.S. Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), http://www.sigtarp.gov (last visited March 31, 2010) (stating the SIGTARP is responsible for conducting, supervising, and coordinating "audits and investigations of the purchase, management and sale of assets under the Troubled Asset Relief Program (TARP)").

¹⁶ See Richard M. Rockwood, *The Focus Investing Series Part 3: The Munger Network of Mental Models*, http://www.focusinvestor.com/FocusSeriesPart3.pdf (stating Mr. Munger advocates thinking similar to Carl Jacobi the noted mathematician who was fond of saying "Invert, always invert").

when giving a commencement speech, instead of telling the graduates how to succeed so they would know what to do, Mr. Munger told them how to fail so they would know what *not* to do.

In that spirit, I will now invert five common corporate governance assumptions (or myths).

1. Stop Excessive Risk Taking

The rallying cry of 2009 was to stop excessive risk taking.¹⁷ The narrative is a familiar one: faulty compensation arrangements incentivized executives to take on too much risky business.¹⁸ With "heads I win, tails you lose" deals, these managers gamed the system and ended up destroying it. To solve this problem, risks need to be reduced, such as by designing compensation plans that do not reward excessive risk taking and by establishing board-level risk management committees.

That is the standard narrative. Let us invert it and see how it feels. Under the inverted view, risk is no longer a four-letter word. Risk can even be desirable. As any bookie (or business school professor) will tell you, you cannot accumulate if you do not speculate. In many instances, not taking a risk may be the biggest risk of all. If you stand still, you can get trampled.

From the perspective of the inverted view, the recent calamity looks more like a crisis of excessive timidity than a crisis of excess risk-taking. After the tech bubble burst in 2000,²⁰ there was a flight to safety. Investors discarded the promise of ".com" for the safety of "AAA."²¹

¹⁷ See, e.g., Mark Hulbert, *Did Bankers' Pay Add to This Mess?*, N.Y. TIMES, Sept. 27, 2009, § 3, at 6 (discussing recent academic findings indicating that bank CEOs were incentivized by their compensation structures to engage in excessive risk-taking, but disputing the role excessive risk-taking played in the autumn 2008 credit crisis).

¹⁸ See Lucian A. Bebchuk & Holger Spamann, Regulating Bankers' Pay, 98 GEO. L.J. 247, 249 (2010).

¹⁹ See Gambling in America 110 (Herbert L. Marx ed., 1952).

²⁰ Matt Krantz, Market Bubble Burst 10 Years Ago, USA TODAY, Mar. 25, 2010, at 1B.

²¹ See, e.g., Chatfeild-Roberts Back in the Tech but Warns of Deflation in US, MONEY MARKETING, Dec. 3, 2009, at 18 (noting Chatfeild-Roberts moved back into technology stocks from corporate bonds for the first time since the .com bubble burst in 2000); see also Viral V. Acharya et al., A Prologue: Bird's Eye View, The Financial Crisis of 2007–2009: Causes and Remedies, in RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM 1, 16–17 (Viral V. Acharya & Matthew Richardson eds., 2009), available at http://www.cepr.org/meets/wkcn/1/1716/papers/prol.pdf (discussing how after the tech bubble burst the quantity of bonds issued increased: "There is a large jump [in new issues] (continued)

Let me illustrate this point with one example among thousands. In 2006, investors purchased a AAA-rated bond priced to yield 5.5% annually.²² This was at a time when U.S. Treasury bonds with a similar duration were yielding 4.6%,²³ so this bond offered only a modest premium over the then-prevailing risk-free rate. What could be safer?

Let us look a little deeper into this bond. First, this bond was issued by a trust.²⁴ This trust issued \$825 million in bonds.²⁵ Seventy percent of the bonds issued by this trust were rated AAA,²⁶ and 90% of this trust's bonds received at least an investment grade rating.²⁷ Therefore, this trust must have been a safe vehicle for investment. Or was it?

You probably know where I am going with this. The trust's only assets were, no surprise, mortgage loans, ²⁸ so the safety and security of its bonds were entirely dependent on the safety and security of its mortgage loans. How safe and secure were those mortgage loans? According to data provided in the prospectus, the trust used to sell these bonds, these mortgages were made to borrowers with credit scores well below the

starting in 2004, with an average of 43.8 percent over the next four years compared to 27.8 percent over the prior 11 years").

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²² See Federal Reserve Board, Statistics: Releases and Historical Data, Annual Interest Rates for AAA-Rated Bonds, http://www.federalreserve.gov/releases/h15/data/Annual/H15 AAA NA.txt.

²³ See Federal Reserve Board, Statistics: Releases and Historical Data, Monthly Interest Rates for State & Local Bonds, http://www.federalreserve.gov/releases/h15/data/Monthly/H15_SL_Y20.txt; United States Dep't of the Treasury, Yield Curve Rates, *Interest Rates Statistics for Bonds in 2006*, http://www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield_historical_2006.shtml (showing that twenty-year bonds had an interest rate payout of 4.6% during January of 2006).

²⁴ See Trust by First Franklin Mortgage Loan Trust 2006–FFA, Free Writing Prospectus, S–1 (Sept. 13, 2006), available at http://www.sec.gov/Archives/edgar/data/808851/000114420406043845/v055669 fwp.htm.

²⁵ See generally Trust by First Franklin Mortgage, *supra* note 24; DBRS, *First Franklin Mortgage Trust 2006-FFA*, http://www.dominonbond.org/research/216343/first-franklin-mortgage-loan-trust-2006-ffa/october-2007-performance-analytics-report.pdf (last visited Apr. 5, 2010).

²⁶ See Trust by First Franklin Mortgage, supra note 24, at S-1; DBRS, supra note 25.

²⁷ See Trust by First Franklin Mortgage, supra note 24, at S–1; DBRS, supra note 25 (showing the remaining 10% bonds that are rated lower than BBB-).

²⁸ See Trust by First Franklin Mortgage, supra note 24, at S-46 (listing, among other assets, mortgage loans and other mortgage-related assets).

median (662 vs. the median of 723),²⁹ these mortgages had an average loan-to-value of 99.5% (meaning most borrowers were not making any meaningful down payments),³⁰ and the borrowers were paying interest rates on their mortgages of 10.5% (twice the "risk-free" rate).³¹ Here is the kicker: all of these mortgage loans were second mortgages.³² In effect, this trust was collateralized entirely by what amounted to borrowed down payments for subprime borrowers, the riskiest slice of the mortgage pie.

The people who bought these bonds were not crazed thrill-seekers drunk on the adrenaline of an excessive risk high. Far from it: these were prudent risk-averse investors looking for nothing more than a safe way to earn a little more on their money than the U.S. Treasury was paying: 5.5% instead of 4.6%.³³ That is all they wanted.

How could things have gone so wrong for these investors and so many others like them? Clearly, a big part of their problem was risk avoidance. Rather than avoiding risk, they should have embraced it. Risk is a fact of life. It is everywhere. There is no safe haven. Regardless of whether that is reality, that is how investors should think. When an investment is viewed as risky, investors are wary, they do their homework, kick the tires, model worst case scenarios, and ask "how much is it worth it to me to take this risk?" When an investment is viewed as safe, investors do not think twice; they send the check. This false sense of security is more dangerous than the risk they think they are avoiding. It is exactly the sort of

²⁹ See id. at S-14; Kenneth R. Harney, New Mortgages Worry Regulators, WASH. POST, June 10, 2006, at F01 (reporting a 723 median credit score for year 2006).

³⁰ See Trust by First Franklin Mortgage, supra note 24, at S-14.

³¹ See id. (documenting, under the aggregate mortgage loan summary, the weighted average mortgage rate of 10.457%); Risk–Free Rate of Return, http://www.investopedia.com/terms/r/risk-freerate.asp (last visited Mar. 28, 2010) (defining the "risk-free rate of return" as "[t]he theoretical rate of return of an investment with zero risk, . . . represent[ing] the interest an investor would expect from an absolutely risk-free investment over a specified period of time" and that "the interest rate on a three–month U.S. Treasury bill is often used"); U.S. Treasury–Daily Treasury Yield Curves, http://www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield_historical_2006.shtml (last visited Mar. 28, 2010) (listing rates for three-month U.S. Treasury bills ranging from 4.60% on March 1, 2006 to 4.63% on March 31, 2006).

³² See Trust by First Franklin Mortgage, supra note 24, at S-46.

³³ U.S. Treasury–Daily Treasury Yield Curves, http://www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield_historical_2006.shtml (last visited Mar. 26, 2010) (listing rates for U.S. Treasury bills ranging from 4.00% to 5.10%).

gullibility that lulled us into the current financial mess and is the same trait that swindlers such as Madoff exploit so effectively.³⁴

So a key lesson from this crisis is not that we should avoid excessive risk taking because such risk avoidance tends to lull us into risk denial. Instead, we should avoid excessive timidity. Investors should assume every investment is risky, do their homework, and price it accordingly, then hopefully they can reap the rewards.

In corporate governance terms, the focus on risk is doubly troubling. By telling managers to avoid excessive risks, I fear we are only exacerbating a conflict that already exists between management and investors. Firm-specific risk is perceived very differently by managers and investors. Investors can easily manage their firm-specific risk by diversifying their portfolio of investments among many companies. Therefore, investors often prefer companies that have a higher risk profile. Managers, on the other hand, cannot easily manage their firm-specific risk by diversifying their portfolio of jobs. At any time, they are stuck at one job at one company and cannot diversify away that risk. A company's managers usually have a lot more to lose than the company's investors when their company fails, 37 so a company's managers can often be thought of as more risk-averse than the company's owners.

If the rallying cry of corporate governance is "avoid excessive risk taking," I expect it will be the managers who will lead the charge and the investors who end up disappointed. (Not exactly what most corporate governance reformers have in mind.) Instead, if this rallying cry is inverted to "stop excessive timidity," we may have a credo more likely to please investors.

³⁴ See Frank B. Cross, Law and Trust, 93 GEO. L.J. 1457, 1527–30 (2004) ("Hucksters of all sorts... take advantage of trust[s] in order to profit at the expense of the trusting."); Michael Moore, Builders & Titans: Bernie Madoff, TIME, Apr. 30, 2009, http://www.time.com/time/specials/packages/article/0,28804,1894410_1893837_1894189,00.html (recognizing Bernie Madoff as a man who ran a Ponzi scheme for at least twenty years on thousands of clients including business leaders, celebrities, character, and even some of his own relatives).

³⁵ See Christine Dugas, Time to Dust Off That 401(K) Plan, USA TODAY, June 27, 2003, at 3B.

³⁶ See id.; John C. Coffee, Jr., Shareholders Versus Managers: The Strain in the Corporate Web, 85 MICH. L. REV. 1, 19 (1987).

³⁷ Mark J. Loewenstein, *Making America Competitive*, 18 DEL. J. CORP. L. 453, 470–71 (1993).

2. Managers Must Think Like Owners

No corporate governance principle is more foundational than "managers must think like owners." This bedrock concept goes all the way back to the classic principal/agent conflict identified by Berle and Means in 1932.³⁸ With ownership and control separated in large modern corporations,³⁹ the interests of the owners and those of the managers are bound to conflict. Because it is the separation of ownership and control that creates this conflict,⁴⁰ the thinking seems to be that we should bring ownership and control closer together by compensating managers in the form of stock. By making managers owners, they will think like owners. The agent will become the principal, thereby minimizing the conflict.

That is the traditional view, and it appears to be a very neat solution. But let us invert it and see what we get. Instead of expecting managers to think like owners, consider what would happen if we expected managers to think like *managers*.

Under this alternative view, a manager's job would be to manage the company, and the owner's job would be to manage the manager. When managers are expected to think like owners, we are really expecting managers to manage themselves. While wearing these two conflicting hats, is it not surprising that managers often think like owners only to the extent it benefits them as managers? It seems more realistic to recognize the conflict and deal with it instead of denying it.

With managers thinking like managers, a company's owners will have to think—and act—like owners. No longer passively outsourcing the ownership function to managers, in this inverted world the owners would actually have to manage the managers. It is a lot easier to just give the managers stock, call them owners, and expect them to act accordingly.

3. Pay Managers in Stock

With our eagerness to have managers thinking like owners, equity compensation has long been embraced as a key component of good corporate governance.⁴¹ Recent concerns that the financial crisis was abetted by managers exploiting "take the money and run" cash-based

 $^{^{38}}$ See Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 6–7 (1932).

³⁹ See id. at 69.

⁴⁰ See id. at 81, 84-89.

⁴¹ See Charles M. Elson, Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure, 50 SMU L. Rev. 127, 134–35 (1996).

compensation schemes⁴² has only made stock compensation appear even more attractive. Restricted stock with long-term performance-based vesting may now be the single most popular corporate governance tool.

So let us invert this, substituting cash for stock as our compensation currency of choice, and contemplate what a cash-only compensation system would look like.

You may wonder what a cash-only compensation system would do to incentives. With equity, a manager's main incentive is to increase the stock price. The problem is the stock price depends on a lot of variables, many of which are out of the manager's control. At best, the stock price is just an indirect and distorted reflection of what the manager actually did. At worst, the stock price will have nothing to do with the manager's efforts, as was seen when market bubbles rewarded incompetent managers and market crashes punished competent managers. These managers might as well have been paid with lottery tickets.

A cash-only compensation system requires owners to set incentives the old-fashioned way: figure out what they want their managers to accomplish and pay them based on what they actually accomplish. This is not easy to do well. It requires a good understanding of the business, where it is going, what needs fixing, which achievements are probable, possible, and nearly impossible, and how much it is worth to the company to accomplish these goals. This is the sort of finely-tuned understanding we would expect a knowledgeable board of directors to have. But many boards lack this understanding, and others are not sufficiently independent of their

⁴² See, e.g., Jim Puzzanghera, Don't Expand My Authority, 'Pay Czar' Says, L.A. TIMES, Oct. 29, 2009, at B3 (noting cash compensation for the top five executives and twenty highest-paid employees at Bank of America Corp., Citigroup Inc., American International Group Inc., General Motors Co., Chrysler, and the two automakers' financing units was decreased "to reduce incentives for the type of short-term risk-taking that many believe was at the heart of the financial crisis").

⁴³ See Jesse M. Fried. Hands-Off Options, 61 VAND. L. REV. 453, 457 (2008).

⁴⁴ See R.J. Bannister & Ravin Jesuthasan, Is Your Company Ready for Value Based Management?, J. Bus. Strategy, Mar. 1, 1997, at 12.

⁴⁵ See Sandra Guy, New Day for CEO Compensation, CHI. SUN TIMES, Aug. 26, 2002, at 49 (referencing a return to an old fashioned ethic—cash compensation); Mike Farrell, CEO Pay Raises Mixed in Cable Despite Stock Price, Layoffs, \$23M for Viacom's Dauman, MULTICHANNEL NEWS, Apr. 27, 2009, at 3 (referring to cash compensation as "mostly tied to performance goals"); Ross Bevan, Designing Executive Compensation Programs, CMTY. BANKER, June 30, 2001, at 56 (recognizing cash compensation can be fully performance based).

managers to implement it. It is a lot of work. It is much easier to shower managers with equity and let the stock market sort it out.

Imagine if a CEO paid the managers of his subsidiaries this way. Instead of figuring out what the managers needed to accomplish and how much that would be worth, and then closely monitoring their performance throughout the year and adjusting as needed, a CEO could just hand them shares in their subsidiary and leave them alone, figuring they would act like owners and everything would work out. I doubt anyone would view that CEO as managing effectively. So why is it okay to manage our CEOs that way?

Equity brings complexity. Complexity brings compensation consultants. That alone should be enough to scare people away from But even worse, equity brings obfuscation. When setting performance targets, we have a pretty good idea what a dollar will be worth. We never know what equity will be worth. This equity uncertainty causes obfuscation inflation and leads to crazy results. Boards often undervalue the equity they grant. When we see news of a CEO pulling down a nine-figure payday, 46 I will bet when the performance targets were set no one actually thought they would be paying out nine figures for a year's work. No, the directors thought they would be allocating a mix of X options, Y restricted shares, and Z performance units based on some ostensibly scientific formula that, once run through the requisite black box, would magically spit out the right value. Who knew it would all add up like that? If the directors had been dealing exclusively in dollars, they would have known, and they would never have agreed to such a gigantic payday.

Similarly, I feel for the managers who have a great year when the stock market happens to be having a bad year. With equity compensation, all their hard work is wiped out by the vagaries of the market. That makes no sense. If the manager did valuable work and accomplished what the owners asked, the owners should pay for what they received.

But should we pay in equity because it is tax-advantaged? Any tax advantage of equity only matters if it exceeds equity's other costs. I expect those other costs—distorted incentives, unintended payouts, shareholder dilution—are substantial but rarely factored into the analysis. In any event,

⁴⁶ See, e.g., David Goldman, *The Top 10 Highest Paid CEOs Are* ..., Aug. 14, 2009, http://money.cnn.com/2009/08/14/news/companies/highest_paid_ceos/index.htm (listing the top ten highest paid CEOs for 2008 who made between \$702,440,573 and \$71,795,744).

tax is subordinate. The goal is to build a sensible incentive structure, not a tax-avoidance scheme.

Additionally, cash-compensated managers should not be required to invest in company stock either. The manager is already heavily invested in the company just by being its manager. It is only prudent for managers to diversify their holdings away from the company that employs them. No one should be forced to put all of their eggs in one basket. Forcing our managers to do this probably self-selects for risk-seekers, so it should not surprise us when we get managers who are more prone to make irrational, all-or-nothing bets. Which manager is more likely to throw the dice with the company assets: the manager with everything he owns in company stock or the manager who invests his personal assets in index funds?

Equity is too often the currency of choice for executive compensation. ⁴⁷ Last I checked, cash was still legal tender for all debts, public and private—even executive compensation.

4. Independent Boards Curb CEO Pay

You may be thinking: cash or stock, it is all too much. How do we curb this explosive growth in CEO pay? A popular answer over the past decade has been to increase board independence: require majority independent boards with fully independent compensation committees. Separating the directors from the CEO would, it was hoped, keep the CEO's pay in check. 49

How well has this worked? Two economists recently culled compensation data from SEC reports going all the way back to 1936.⁵⁰ They found that for the first forty years of the 1936–2005 period—up to the mid-1970s—CEO compensation initially dropped and then held steady.⁵¹ During the greatest business expansion in history, executive

⁵⁰ See Carola Frydman & Raven E. Saks, Executive Compensation: A New View from a Long-Term Perspective 1 (Finance and Economic Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Working Paper No. 2007–35, 2007), available at http://ssrn.com/abstract=972399.

⁴⁷ See Mark A. Clawson & Thomas C. Klein, *Indexed Stock Options: A Proposal for Compensation Commensurate with Performance*, 3 STAN. J.L. BUS. & FIN. 31, 40 (1997).

⁴⁸ See Ryan Miske, Note, Can't Cap Corporate Greed: Unintended Consequences of Trying to Control Executive Compensation Through the Tax Code, 88 MINN. L. REV. 1673, 1693 (2004).

⁴⁹ See id. at 1694.

⁵¹ See id. at 47 (presenting the median value of CEO total compensation between 1936 and 2005).

compensation barely increased.⁵² It was only around 1980 that CEO pay started to increase rapidly before leveling off and actually dropping after 2000.⁵³

For this article's purposes, what is most interesting about this is that executive compensation seems to have been tamest at a time when boards were least independent (1950s–1970s) and wildest at a time when boards were becoming more independent (1980s–present).⁵⁴ Correlation is not causation, but in the spirit of inversion, it should be asked why executive compensation might be more likely to increase when boards are more independent. I can think of three reasons.

First, there is a normal human tendency to accept more from others than from ourselves.⁵⁵ If we are asked to write down what we think we are worth, most of us will be influenced by modesty (even if only false modesty) or a desire to not appear greedy and write down a lower number than we think we really deserve.⁵⁶ On the other hand, if someone offers to pay us more than we think we are worth, chances are we will accept it. When a large amount is paid to us, we feel more shame if we were personally involved in establishing that amount than if someone else did it

⁵² See id. at 2 ("The remarkable stability in the level of executive compensation from the end of World War II to the mid-1970s is surprising in light of the robust economic activity and considerable growth of firms during most of this period.").

⁵³ See id. at 47 (presenting the median value of CEO total compensation between 1936 and 2005).

⁵⁴ See id. at 3 ("[B]oth the level of pay and the use of options were lower from the 1950s to the 1970s than in more recent years, even though corporate governance was arguably weaker in the earlier period.").

⁵⁵ Cf. DAVID JOPLING, SELF-KNOWLEDGE AND THE SELF 45–47 (2000) (arguing that self-concepts are not essentially faithful representations of the self). See G. F. Schueler, Why Modesty Is a Virtue, 107 ETHICS 467, 467–68 (1997) (describing a modest person as someone who thinks of his or her accomplishments and skills as low of a relevant scale); Julia Driver, Modesty and Ignorance, 109 ETHICS 827, 827–28 (1999) (explaining modesty involves a person underestimating self-worth in some respect).

⁵⁶ See Schueler, supra note 55, at 467–68; Driver, supra note 55, at 827–28; JOPLING, supra note 55, at 45–47; cf. Jiayuanyu & Kevin R. Murphy, Modesty Bias in Self-Ratings of Performance: A Test of the Cultural Relativity Hypothesis, 46 PERS. PSYCHOL. 357 (2006) (noting that self-ratings of performance are usually higher than ratings by supervisors), available at http://www3.interscience.wiley.com/journal/119295544/abstract?CRETRY=1&SRETRY=; Lloyd S. Baird, Self and Superior Ratings of Performance: As Related to Self-esteem and Satisfaction with Supervision, 20 ACAD. OF MGMT. J. 291, 291–300 (1977) (describing differences between self-ratings and superiors' ratings of employees).

for us.⁵⁷ Of course, there are sociopaths among us who would gladly write down the biggest possible number without any concern for what others would think of them. These are people who cannot be trusted alone with the cookie jar. Modern corporate governance, with its emphasis on independent boards and independent compensation committees, seems to be primarily concerned with keeping the hands of sociopathic CEOs out of the cookie jar.⁵⁸ But in distancing *all* CEOs from their compensation decisions, even those who are not sociopaths, we are minimizing the beneficial role that shame can play and perversely paving the way for otherwise normal people to accept sociopathic numbers.

Second, independent directors may be more likely to offer sociopathic numbers to CEOs. Not having any skin in the game, they are spending other people's money and can be expected to take as much care with it as politicians do with taxpayers' money. Their independence also means they are distant from the company, often not knowing enough about it to fashion the sort of carefully-crafted, company-specific performance metrics that are required for a rational compensation program.⁵⁹ Instead, they are prone to fall back on crude but easy compensation tools, such as equity compensation⁶⁰ and benchmarking, assisted by compensation consultants and fueled by the plethora of compensation data now provided

⁵⁷ Cf. Sandeep Gopalan, Shame Sanctions and Excessive CEO Pay, 32 DEL. J. CORP. L. 757, 789 (2007) (arguing that shame can play an integral role in reducing excessive CEO pay and that publicizing "egregiously high CEO pay" will give CEOs an incentive to not be as greedy because "they will not want to appear as greedy").

⁵⁸ See Miske, supra note 48, at 1693; 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, 854 (2003) ("A rational CEO may care more about his or her own compensation than about any other corporate decision. It is hard to imagine any other area in which the CEO's interests are so directly at stake.").

⁵⁹ See Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 772 (2002) ("[E]ven if directors have the inclination and incentive to negotiate for CEO compensation that maximizes shareholder value, they will usually lack the information to do so effectively.").

⁶⁰ See id. at 772–73 ("[D]irectors will rely heavily, if not almost exclusively, on the information and proposal provided by the compensation consultant."); Dorff, *supra* note 58, at 855 ("Board members therefore have numerous tools at their disposal with which they can satisfy CEO's compensation demands while rationalizing both to themselves and to the shareholders the resulting overlarge payments.").

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courtesy of the SEC.⁶¹ The resulting Lake Wobegon effect ensures that executive compensation ratchets ever upward.⁶²

Third, in the old days before board independence, when CEO pay barely rose at all, 63 it was very common for a company's ex-CEO to serve on the board.⁶⁴ But in the recent zeal to purge boards of anyone who has had any connection with company, the ex-CEO has often been the first to go. 65 If the goal was to keep executive compensation within rational bounds, it was a mistake to discard the ex-CEOs. If crafting rational performance metrics for CEO compensation requires a detailed understanding of both the company and the job, who better to do that than the person who previously held that job at that company? If we are concerned that too many boards have devolved into a cult of personality centered around a celebrity CEO, who better to say the emperor has no clothes than the person who previously held the position? And if we are concerned with stratospheric increases in CEO pay, how would a compensation committee chaired by the ex-CEO react to the notion that the current CEO is worth twice, or ten times, what the prior CEO earned? I expect current CEOs were more than happy to link arms with governance reformers and usher the ex-CEOs off their boards.

So do independent boards curb CEO pay? I suspect they may curb CEO pay, or they may not. What really counts is having an active and knowledgeable board, and a CEO who feels accountable both for achieving his or her goals, and for setting them. And let us not forget the potential value of keeping the ex-CEO around on the board.

If independent boards cannot be relied on to do the job, maybe someone else will: stockholders.

⁶¹ See Sec. & Exch. Comm'n, Executive Compensation and Related Person Disclosure 1 (2006), http://www.sec.gov/rules/final/2006/33-8732a.pdf.

⁶² See Timothy De Lizza, The Incoherency of American Corporate Governance and the Need for Federal Standards, 34 FORDHAM URB. L.J. 1111, 1118 (2007) (describing the Lake Wobegon Syndrome, under which all CEOs are above average because firms benchmark salaries at 65% of their competitors often using "unnamed aspirational peers rather than those firms with whom they realistically compete for talent").

⁶³ See Benjamin E. Hermalin, *Trends in Corporate Governance*, 60 J. Fin. 2351, 2362–63 (2005) (recognizing the trend in greater outside representation on boards and recognizing more board independence corresponds to a trend toward higher pay among firms).

⁶⁴ See James A. Brickley & James S. Linck, What Happens to CEOs After They Retire? New Evidence on Career Concerns, Horizon Problems, and CEO Incentives, 52 J. FIN. ECON. 341, 342–43 (1999).

⁶⁵ See id. at 342–43.

5. "Say on Pay" Is the Way

The "say on pay" movement seeks to give stockholders the right to register their approval or disapproval of a company's overall executive compensation program. ⁶⁶ It started as a subject of the SEC's shareholder proposal rules, ⁶⁷ pushed by stockholder activists at the companies they perceived to have the worst compensation practices. ⁶⁸ In the wake of the recent financial crisis, "say on pay" was mandated for all TARP recipients, ⁶⁹ and now it is being considered by Congress for all public companies. ⁷⁰

The popular conception of "say on pay" is that we will limit compensation by giving stockholders a voice in compensation matters.⁷¹ Let us invert that and contemplate the possibility that "say on pay" will lead to increases in compensation. How could this happen?

"Say on pay" has so far been all about stigma. Initially, shareholder activists identified companies whose combination of high pay and low performance left them vulnerable and targeted them with "say on pay" shareholder proposals. These proposals drew unwanted attention to the targeted companies, putting them on the defensive. Even when the proposals did not pass—and most did not "4—the "say on pay" campaigns

⁶⁶ Steven Syre, *Pushing For a Say on Pay*, BOSTON GLOBE, Feb. 10, 2009, at B5.

⁶⁷ See 17 C.F.R. § 240.14a-8 (2007) (noting the SEC's proposals for shareholders).

⁶⁸ See, e.g., Barbara Kiviat, *Giving Investors a Say on CEO Pay*, TIME, April 9, 2008, http://www.time.com/time/business/article/0,8599,1729480,00.html.

⁶⁹ See Shareholder Approval of Executive Compensation of TARP Recipients, 75 FED. REG. 2790 (Jan. 19, 2010) (to be codified 17 C.F.R. pt. 240).

⁷⁰ See H.R. 3269, 111th Cong. (2009).

⁷¹ See Joseph W. Yockey, On the Role and Regulation of Private Negotiations in Governance, 61 S.C. L. REV. 171, 214 (2009).

⁷² See James E. Heard, Executive Compensation: Perspective of the Institutional Investor, 63 U. CIN. L. REV. 749, 749 (1995) (discussing that institutional investors were using their holdings to influence executive compensation by targeting companies with poor performance whose CEOs were receiving large compensation).

⁷³ See Joseph W. Yockey, On the Role and Regulation of Private Negotiations in Governance, 61 S.C. L. REV. 171, 216 (2009) (discussing "say on pay" proposals in the context of private negotiations and that these proposals may result in companies taking a defense posture).

⁷⁴ See Jeffrey N. Gordon, Essay, "Say on Pay": Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In, 46 HARV. J. ON LEGIS. 323, 339–40 (2009) (noting that in 2008 the growth in the number of "say on pay" proposals rose only to 70% and the shareholder support remained only around 42%).

publicized poor pay practices and left the targeted companies stigmatized.⁷⁵

In the beginning, the mere threat of a "say on pay" proposal was a potent weapon for stockholder activists. However, the activists recently overplayed their hand, proposing "say on pay" at numerous companies, many with decent pay practices. 76 With so many proposals floating around, a "say on pay" campaign no longer carried the old stigma. The activists ceded some control over the issue to the other shareholders because with so many proposals pending, the old stigma would now attach to a company only if and when the proposal passed. This was proving difficult for the activists to achieve.

It is possible that the activists may have eventually succeeded in getting more "say on pay" proposals passed, which would have resharpened their weapon. On its face, a "say on pay" proposal sounds so reasonable (a shareholder thinks: "why shouldn't I have a say on pay?") that there was a chance these proposals would start passing in large numbers, even at companies with decent pay practices. Such a cascade of approvals might have boosted the activists' movement. Or, if enough "good corporate citizens" were saddled with "say on pay," perhaps the cascade would have diluted the stigma, even for the bad citizens. The stigma game would shift away from the "say on pay" proposals to each year's "say on pay" votes.

However, now that Congress is intervenin and requiring "say on pay" votes for all TARP recipients (and maybe soon for all public companies).⁷⁷ there will never be a cascade of approvals for the proposals, so we will never know how that would have played out. The stigma game will change. Neither the activists' threat of a "say on pay" proposal, nor the fact that a company is forced to give its shareholders a "say on pay," will carry any stigma. That stigma will instead attach only when shareholders actually say "no" to a company's pay.

If shareholders say "no" all the time, their "no" votes will not carry much of a stigma. Companies with the worst pay practices will be better than they were before because indiscriminate "no" votes will just lump

⁷⁵ See James E. Heard, Executive Compensation: Perspective of the Institutional Investor, 63 U. CIN. L. REV. 749, 749 (1995); Gordon, supra note 74, at 356.

⁷⁶ Abigail Arms, Risk Metrics Group: 2008 Post Season Report, in PREPARATION of ANNUAL DISCLOSURE DOCUMENTS 2008, at 89, 95 (PLI Corporate Law & Practice, Course Handbook Series No. 14393, 2009).

⁷⁷ See TARP Standards for Compensation and Corporate Governance, 74 FED. REG. 28394, 28417 (June 15, 2009) (to be codified at 31 C.F.R. pt. 30).

them together with companies with decent pay practices. They will find safety in numbers. And those companies with decent pay practices will have "no" votes that carry little, if any, stigma, so those companies will be no worse off than before.

If, on the other hand, shareholders say "no" rarely, their "no" votes will stigmatize. When no votes are rare, companies with the highest pay and lowest performance are most likely to get the "no" votes, so these companies will bear the brunt of this stigma. However, these companies will not be much worse off than they were before because these were the same companies initially targeted with "say on pay" proposals. For these companies, it will feel like déjà vu all over again.

Meanwhile, I expect compensation may rise faster than before at the rest of our public companies. With mandatory "say on pay," most companies will have their compensation publicly ratified by their shareholders each year, making it harder to challenge. And, over time, as more and more companies see their compensation approved, it will be that much harder for activists to make a case that executive compensation, whether at those companies or in general, is broken and needs to be fixed.

Thus, I doubt "say on pay" will curb pay in a meaningful way. It is a binary solution to a multi-faceted problem, a simple approach that would benefit from some "complexification."

III. CONCLUSION

After having inverted five common corporate governance myths, you may believe it is my inversions that are the myths, but hopefully we can all agree that looking at these problems from all sides can only deepen our understanding.

I will leave you with a universal truth: good corporate governance is hard. There is no way around that. Resist the easy answers, and invert, always invert!