1

The Financialization of Corporate Governance

*Roberta S. Karmel**

1.1 INTRODUCTION

There is a robust debate in progress between proponents of shareholder primacy, or the theory that corporations should be run for the benefit of shareholders, and proponents of stakeholder governance, or the theory that corporations should be run for additional constituencies also. Members of the academic community,[1] the business world,[2] and law firms[3] are all participants in the conversation. This is a long-standing controversy, going back to the competing views of Professors Dodd and Berle in the 1930s.[4] Corporate purpose seems to be questioned whenever loss of faith in the business community leads to clamors for reform. In the midst of the COVID-19 pandemic, there also is a loss of faith in political leadership. Our social, economic, and political problems have been laid bare by the pandemic, and so thinkers about corporate governance are renewing questions about corporate purpose and fiduciary duty.

In the 1930s these questions led to the passage of the federal securities laws and the creation of the Securities and Exchange Commission (SEC).[5] The cornerstone of federal securities law is investor protection for purchasers and sellers of securities and shareholders of public companies, based primarily on full disclosure. State law, by contrast, is focused on the fiduciary duties of care and loyalty by directors to shareholders. In the 1970s dissatisfaction with big business led to reform of boards of directors based on the principle that directors should be independent from management, a reform that became embodied in the Sarbanes–Oxley Act of 2002.[6]

* Distinguished Research Professor of Law, Brooklyn Law School. The author thanks Vice-Chancellor J. Travis Laster and Professors Onnig H. Dombalagian, Arthur Laby, and Jacob Russell for their helpful comments. The author gratefully acknowledges the research assistance of Brooklyn Law School students Bianca D'Agostaro and Jordan Khorshad and thanks Dean Michael Cahill for a summer research grant that assisted in the preparation of this article.

[1] Colin Mayer, Prosperity (2018); Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 Cornell L. Rev. 91 (2020).

[2] *Statement on the Purpose of a Corporation*, Bus. Roundtable (Aug. 2019), https://opportunity.businessroundtable.org/wp-content/uploads/2019/08/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf.

[3] *See and compare* Martin Lipton, *It's Time to Adopt the New Paradigm*, Harv. L. Sch. F. on Corp. Governance (Feb. 11, 2019), https://corpgov.law.harvard.edu/2019/02/11/its-time-to-adopt-the-new-paradigm/ *with* Peter A. Atkins et al., *An Alternative Paradigm to "On the Purpose of the Corporation,"* Harv. L. Sch. F. on Corp. Governance (June 4, 2020), https://corpgov.law.harvard.edu/2020/06/04/an-alternative-paradigm-to-on-the-purpose-of-the-corporation/.

[4] *See infra* notes 10–12.

[5] The SEC was created by the Securities Exchange Act of 1934, 15 U.S.C. § 78 et seq (2018).

[6] Pub. L. No. 107–204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 28, and 29 U.S.C.).

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An important difference between debates about corporate purpose and the development of the principles of investor protection and directorial fiduciary duties in the past is that the composition of the shareholder base of public companies has changed drastically. In the 1930s and even through the 1970s, the majority of shareholders in public companies were individuals. Because these shareholders were widely dispersed, director primacy ruled. Stakeholder concerns were tolerated partly because of the countervailing power of unions and defined benefit plans relied upon for retirement. Today, public companies are owned and traded by institutional investors.[7] Further, hedge funds and other activist investors, in league with pension funds and other institutions, have caused a financialization of corporate governance.[8] Stock market prices rather than long-term earnings are the focus of corporate managers and directors.

Most individual shareholders no longer own stocks directly, but rather own stocks indirectly through institutional money managers. These individuals have no say in the strategies or direction of public companies. Further, as employees, consumers, and citizens, many are unhappy with the results of the financialization of corporate governance. They are interested in jobs, better products made in the United States, and actions to address the threats of climate change, not the short-term profits of giant corporations.[9] I believe this is at least part of the impulse behind the corporate purpose or stakeholder movement.

There are serious problems with both the shareholder primacy and stakeholder governance theories. They are both more theoretical and ideological than grounded in existing law. In my opinion a better way to change the financialization of corporate governance is to consider the protection of the individual stockholder and beneficiaries of retirement funds. Some have suggested imposing fiduciary duties on institutional investors to those minority stockholders and to their corporations. This would need to be accomplished through a change of state and federal law fiduciary duty principles. Further, a reorientation of the SEC from policies adopted to accommodate institutional investors to policies aimed at protecting individuals could be made. The most important reform, in my opinion, would be a reexamination of executive compensation from a societal, not just a shareholder, perspective. Changes in the tax laws should also be considered.

Section 1.2 of this chapter will outline shareholder primacy and stakeholder governance theories. Section 1.3 will examine executive compensation and the financialization of corporate governance, and how state law and the federal securities laws have protected institutional investors to the detriment of individual investors and the public. Section 1.4 will discuss proposals for fiduciary duties by institutional investors to individual investors and the corporations in which they invest and a reexamination of the prudent investor principle. Section 1.5 will outline recommended changes in state and federal laws to accomplish better protection of individual investors, as shareholders and as beneficiaries of retirement funds. Since this chapter is necessarily limited, I can only set forth a framework for these ideas, but I hope to expand upon them in future work.

1.2 SHAREHOLDER VERSUS STAKEHOLDER GOVERNANCE

In the early 1930s, Professors Berle and Dodd argued over whether control of large public corporations should be for the benefit of shareholders or for society at large.[10] According to

[7] David J. Berger, *Reconsidering Stockholder Primacy in an Era of Corporate Purpose*, 74 Bus. Law. 659, 662 (2019).

[8] Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 Yale L.J. 1870 (2017) [hereinafter "Strine, *Who Bleeds*"].

[9] *Id.*

[10] Adolf A. Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 Harv. L. Rev. 1365, 1368 (1932); E. Merrick Dodd, Jr., *Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?* 2 U. Chi. L. Rev. 194, 203–04 (1935).

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Dodd, corporations were autocratic merchant states and because they derived their power from government, they had to be brought under government control for the benefit of society.[11] Berle, by contrast, believed that control of corporate managers should be returned to shareholders through enforcement of fiduciary duties.[12]

Although Berle's views prevailed when the federal securities laws were passed in 1933[13] and 1934, the Dodd perspective was revived in the 1970s by Ralph Nader, who argued that controls that historically had legitimized corporate power had broken down and that giant, multinational corporations had become unaccountable private governments. Nader recommended federal chartering of corporations in order to restructure the board of directors; redefine the board's relationship with management, employees, and shareholders; and regulate corporate disclosure and conduct.[14] Professor William Cary, former chairman of the SEC, also recommended a federal corporation law, but like Berle, Cary was more concerned about making corporate officers and directors accountable to shareholders than about making corporations accountable to society generally.[15]

The panacea recommended by the SEC and the American Law Institute Corporate Governance Project[16] for the loss of faith in big business was a board of independent directors. The New York Stock Exchange was pressured to encourage boards to have independent directors on audit, compensation, and nominating committees, but otherwise the generally free-market approach of the federal government after 1980 did not focus on corporate governance reform.[17] After the collapse of the Internet bull market rally of the 1990s, and in particular the fraudulent accounting and collapse of Enron and WorldCom,[18] Congress passed the Sarbanes–Oxley Act of 2002 mandating boards and committees of majority independent directors at SEC-regulated public companies.

The shareholder primacy norm was articulated by a Chicago school economist, Milton Friedman, in 1970.[19] Although this model had some critics, it was widely accepted by academics and it gained sufficient respectability that by 1997 the Business Roundtable declared that the "principal objective of a business enterprise is to generate economic returns to its owners."[20] Yet, there was always a question as to whether the shareholder "owners" were long-term or short-term holders of stock. This question was central to the outcome of hostile tender offers and was answered in part by the Delaware courts and in part by anti-takeover statutes passed in the states, especially stakeholder and control share statutes.[21]

[11] E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?* 45 Harv. L. Rev. 1145, 1156 (1932).

[12] Adolf A. Berle, *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049 (1931); Berle, *supra* note 10, at 1367–68.

[13] Securities Act of 1933, 15 U.S.C. § 77 et seq (2018).

[14] Ralph Nader, Mark Green & Joel Seligman, Taming the Giant Corporation (1976).

[15] William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663 (1974).

[16] American Law Institute, Principles of Corporate Governance and Structure: Analysis and Recommendations (2008).

[17] *See* Roberta S. Karmel, *Realizing the Dream of William O. Douglas: The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 Del. J. Corp. L. 79 (2005).

[18] *See* Iman Anabtawi, *Secret Compensation*, 82 N.C. L. Rev. 835, 840 (2004).

[19] Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times (Sept. 13, 1970), at 32–33.

[20] *Statement on Corporate Governance*, Bus. Roundtable (1997), http://www.ralphgomory.com/wp-content/uploads/2018/05/Business-Roundtable-1997.pdf

[21] Roberta S. Karmel, *Implications of the Stakeholder Model*, 61 Geo. Wash. L. Rev. 1156, 1162–68 (1993).

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The shareholder primacy model was challenged by Lynn Stout in 1999.[22] Others have also questioned its viability.[23] More recently an interest in sustainability or ESG[24] metrics has undermined the shareholder primacy norm. In the United States ESG has become a disclosure obligation,[25] but it has sparked questions about corporate purpose.[26] These questions have led to a renewed debate concerning whether corporations should be managed with a view toward maximizing returns to shareholders or whether other constituencies should be an object of corporate strategies.

Once again, this debate is being waged under the threat of a federal corporation law, the Accountable Capitalism Act,[27] introduced by Senator Elizabeth Warren. This statute would require all US companies with over $1 billion in annual revenue to obtain a federal charter from a new agency, the Office of United States Corporations at the Department of Commerce, which would have the power to revoke the charter for repeated and egregious illegal conduct. The charter would oblige corporations to consider the interests of all corporate stakeholders – including employees, customers, shareholders, and the communities in which the company operates – instead of having an allegiance to shareholders only. Boards would be required to include directors elected by employees; sales of company shares by directors and officers and corporate stock repurchase programs would be limited; shareholder approval would be required for all political contributions.

Although the Accountable Capitalism Act has been attacked as "unconstitutional and socialist,"[28] it is not totally out of sync with the thinking of important players in the business world, the academic world, and others. In January 2018, Larry Fink, CEO of BlackRock, sent a letter to corporate CEOs in which he called for companies to serve a social purpose: "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."[29] The Business Roundtable responded to this challenge in August 2019 with a statement signed by 181 CEO members, saying that they shared "a fundamental commitment to all of our stakeholders" and they committed to the following: "Delivering value to our customers. . . . Investing in our employees. . . . Dealing fairly and ethically with our suppliers. . . . Supporting the communities in which we work. . . . Generating long-term value to shareholders. . . ."[30]

This rejection of strict shareholder primacy and embrace of stakeholder governance harkens back to the stakeholder statutes passed in the 1980s and early 1990s by over half the states, in order to protect against hostile takeovers. Yet, even in states where such statutes were not limited to takeover battles, they had little effect, and Delaware never passed such a statute. Strong opposition to stakeholder governance was voiced by Professor Lucian A. Bebchuk as an excuse to

[22] Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247 (1999). *See also* Lynn Stout, The Shareholder Value Myth (2012).

[23] Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547 (2002); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 Tex. L. Rev. 579, 583 n.17 (1992).

[24] ESG stands for Environmental, Social, and Governance standards.

[25] Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 Geo. L. J. 923 (2019).

[26] *Id.*

[27] S. 3348, 115th Cong. (2018).

[28] Lee Edwards, *The Accountable Capitalist Act: Socialist and Unconstitutional*, The Heritage Foundation (Sept. 24, 2018), https://www.heritage.org/progressivism/commentary/the-accountable-capitalism-act-socialist-and-unconstitutional.

[29] Larry Fink, *A Sense of Purpose*, Harv. L. Sch. F. on Corp. Governance (Jan. 17, 2018), https://corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose/. BlackRock is the world's largest global asset manager.

[30] *Statement on the Purpose of a Corporation*, *supra* note 2.

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return to managerialism.[31] Support was given by Martin Lipton, who frequently defended companies against hostile takeovers.[32] Lipton's views were then criticized by Skadden Arps, a firm that generally appeared on the opposite side of takeover battles with Lipton's firm.[33] Other voices in this debate advocate for corporate purpose.[34]

What is going on? Is this renewed fight about corporate purpose just a rehash of old battles or is it something new? Professor Edward Rock has hypothesized that this is part of a post-2008 upsurge in populism combined with legislative deadlock and a pessimism concerning the possibility of legislation to address climate change and other societal issues.[35] I agree, but I believe there is a further cause that I will address in this essay, and that is the financialization of corporate governance. By this phrase I mean the measurement of corporate success by the price of its shares on the stock market. Activist hedge funds and other institutional investors and Wall Street bankers have pushed corporate boards to equate shareholder primacy with stock price. This has had several deleterious results. During the 1980s, old line manufacturing companies were dismantled, and their assets were sold and their workers off-shored. Executive and director compensation are now primarily in stock or stock options. In order to pay for such largess, stock buybacks have replaced investment in research and development. A phony productivity has led to the creation of dangerous and shoddy products.[36]

What is the interest of the individual investor in all of these shenanigans? As argued by retired Delaware Supreme Court Chief Justice Leo Strine, most individual investors no longer purchase individual stocks. Rather, their investment funds are tied up in retirement accounts managed by institutional investors. If anyone bothered to ask their opinion, they would probably wish to keep their jobs and have money in their retirement.[37] The latter is clearly a long-term goal.

The false premise that individual shareholders are the corporation and therefore corporations are "persons" with constitutional rights led to the *Citizens United* decision that gave free reign to corporate influence on political elections.[38] This is shareholder primacy gone amok and has contributed to laissez-faire government policies underlying the financialization of corporate governance. Does this mean we need to switch to stakeholder governance or some other substitute for shareholder primacy? Given the extent to which shareholder primacy is embedded in the law and theories of governance, a switch to stakeholder governance would be difficult, unless we can figure out a way to make stakeholder governance accountable. Rather, in my view, the best way to counter the financialization of corporate governance within existing capitalist legal structures is by reexamining executive compensation.

As Professors Bechuk and Rock have pointed out,[39] whether or not shareholders are viewed as "owners" of a corporation, they vote for directors, and they have the right to sue directors for breach of their fiduciary duties of care and loyalty. I do not believe shareholders should be considered "owners" of the corporations in which they invest because they own stock, but do not

[31] Bebchuk & Tallarita, *supra* note 1.
[32] Lipton, *supra* note 3.
[33] Atkins et al., *supra* note 3.
[34] Mayer, *supra* note 1.
[35] Edward B. Rock, *For Whom Is the Corporation Managed in 2020? The Debate over Corporate Purpose* (Eur. Corp. Governance Inst., Working Paper No. 515/2020, 2020).
[36] *See infra* notes 56–61.
[37] Strine, *Who Bleeds*, *supra* note 8.
[38] Citizens United v. Fed. Election Comm'n, 558 U.S. 310 (2010); *see* Adam Winkler, We the Corporations 364, 370 (2018).
[39] *Supra* notes 31 and 35.

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have ownership interests in corporate assets. Other stakeholders, however, do not have the rights of shareholders, with the very limited exception of creditors in some situations. Yet, Delaware law and the law of other states give directors considerable latitude under the business judgment rule to consider the interests of stakeholders in addition to shareholders and allow directors to give priority to long-term rather than short-term shareholders except in the case of the sale of the company.[40]

1.3 FINANCIALIZATION

The 1970s were grim years on Wall Street. There was a recession, inflation with high interest rates, and foreign competition. Moreover, brokerage firms had trouble adjusting to the institutionalization of the market and the unfixing of commission rates and many became insolvent. By the 1980s low stock prices made many public corporations look cheap and investment bankers and their lawyers fueled a vigorous takeover market.[41] Many of these deals were highly leveraged, especially with junk bonds.[42] In 1980, with the election of Ronald Reagan, there was little chance that the country would embrace an industrial policy to protect American manufacturing. Instead, a free-market ideology encouraged the dismantling of many old-line companies in the name of efficiency.

Corporate management switched from an emphasis on steady growth and long-term objectives to a focus on short-term increases in share prices.[43] When Alan Greenspan, a free-market ideologue, was appointed chairman of the Federal Reserve Board in 1987, any criticism of the leveraging of the economy with junk bonds and derivatives was stifled, even after the stock market crashes of 1987, 1989, and 1997.[44] The result was the much worse stock market, banking, and economic meltdown of 2008.

An important change between the 1950s and 1960s and today was the exponential growth of institutional investors. In 1950, institutions were about 7% or 8% of market capitalization and today they are over 70%.[45] Furthermore, these institutions became concentrated,[46] and although the largest funds do not typically initiate takeovers and other strategies to increase short-term stock market profits, they often followed on to moves by activist hedge funds.[47] They also have lobbied for increased power for stockholders.[48]

The trend toward financialization of corporate governance was encouraged by the takeover boom that began in the 1980s and was fueled by junk bonds. Leveraged buyouts enriched

[40] Jill E. Fisch & Steven Davidoff Solomon, *Should Corporations Have a Purpose?* (Eur. Corp. Governance Inst., Working Paper No. 510/2020, 2020), at 115–21.

[41] Jeff Madrick, Age of Greed 71–85, 202–21 (2011).

[42] In the mid-1980s, it seemed that the Federal Reserve Board might curtail this use of securities credit to restructure the economy. *See* Roberta S. Karmel, *Applying Margin Rules to Junk Bonds*, N.Y.L.J., Feb. 20, 1986. Then derivatives injected a different kind of leverage into the securities markets, and after the 1987 stock market crash the Federal Reserve Board and other financial regulators abandoned any efforts to curtail securities credit. *See* Report of the Presidential Task Force on Market Mechanisms (Jan. 1988).

[43] June Carbone, Naomi Cahn & Nancy Levit, *Women, Rule-Breaking, and the Triple Bind*, 87 Geo. Wash. L. Rev. 1105, 1114 (2019).

[44] *See* President's Working Group on Fin. Mkts., Hedge Funds, Leverage and the Lessons of Long-Term Capital Management (1999), https://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf.

[45] Leo E. Strine Jr. & Kirby M. Smith, *Toward Fair Gainsharing and a Quality Workplace for Employees: How a Reconceived Compensation Committee Might Help Make Corporations More Responsible Employers and Restore Faith in American Capitalism*, 76 Bus. Law. 31 (2021) [hereinafter "Strine & Smith, *Gainsharing*"].

[46] Berger, *supra* note 7, at 662 n.12.

[47] Strine, *Who Bleeds*, *supra* note 8.

[48] Strine & Smith, *Gainsharing*, *supra* note 45, at 5 n.9; Berger, *supra* note 7, at 662.

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shareholders but resulted in the sale and transfer of US manufacturing abroad. These transactions resulted in a decapitalization of US business. As a result, when COVID-19 struck the United States, we did not have the manufacturing capability internally to make masks, other protective equipment for health care workers, or ventilators. Our health care system is so broken that we do not have the ingredients in this country for generic drugs and so we need to import them from abroad, especially from India and China, where many of these drugs have been found to be defective.

During the 1980s and 1990s, institutional investors were given free rein by the Delaware judiciary[49] and the SEC[50] in the name of shareholder primacy. Focus was on how boards of directors were reacting to the merger and acquisition tsunami, not whether hedge funds and other activist investors were reshaping American business, shifting it from an industrial to a financial and service economy. One of the mantras of these institutions was that directors should think like stockholders and have their compensation measured in equity. As a result, and because of hostile takeovers, corporate boards began to measure success according to the stock market price of their securities. Furthermore, in order to keep up stock market prices in the face of dilution caused by skyrocketing executive compensation, companies engaged in aggressive buying of their own securities. This was justified as being favorable for stockholders, but it came at the price of fewer profits being invested in research and development and other strategies for growing a business.

Little was done to reduce the growing disparity between compensation for executives and for average employees, or to reduce the fees paid to investment bankers and their attorneys. Historically, executive compensation was primarily cash salaries and bonuses tied to metrics such as earnings per share and meeting softer goals such as employee safety. Similarly, directors were paid an annual fee and meeting fees. Beginning in the mid 1980s, institutional investors pushed executives and directors to discard cash compensation and cash pensions in favor of equity so that they would think like shareholders.[51]

This movement led to intense focus by managers and directors on stock market prices as their compensation came to be paid largely in the form of fixed-price stock options and other equity investments. Cash pension payouts which would have encouraged managers and directors to worry about capital structures and the company's long-term creditworthiness were eliminated. Employee-defined benefit plans were also eliminated by many corporations in favor of defined contribution plans, another move to please institutional investors.[52] This also left employees dependent on the stock market for retirement benefits, but with little ability to invest wisely as individuals or to influence the policies of their money managers.

In 1980 the average S&P 500 CEO earned forty-two times the average worker; in 2017 he earned 361 times the average worker.[53] Over the past four decades, equity compensation pushed CEO pay "obscenely high" rising more than 900%.[54] Furthermore, this contributor to income

[49] Berger, *supra* note 7, at 661–62.

[50] Janice Kay McClendon, *Bringing the Bulls to Bear: Regulating Executive Compensation to Realign Management and Shareholders' Interests and Promote Corporate Long-Term Productivity*, 39 Wake Forest L. Rev. 971, 985 (2004).

[51] Carbone, Cahn & Levit, *supra* note 43, at 1115.

[52] James McWhinney, *The Demise of the Defined-Benefit Plan*, Investopedia (Feb. 18, 2020), https://www.investopedia.com/articles/retirement/06/demiseofdbplan.asp. This was a cost-cutting measure for corporations, which no longer had to account for their pension fund liabilities for employees. Bartleby, *Cutting the Pie*, Economist, Feb. 22, 2020, at 66.

[53] Strine & Smith, *Gainsharing*, *supra* note 45, at 2 n.1.

[54] Nitzan Shilon, *Replacing Executive Equity Compensation: The Case for Cash for Long-Term Performance*, 43 Del. J. Corp. L. 1 (2018) [hereinafter "Shilon, *Replacing Executive Equity*"].

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inequality has been made possible by stock buybacks. Over the past decade US public companies have tripled the amount spent on buybacks to a record of $1 trillion in each of the past two years.[55] Furthermore, executives have cleverly taken advantage of anticipated good news in obtaining equity and anticipated bad news in disposing of their equity.[56]

These trends led to exorbitant payouts for corporate executives and contributed to the extreme income inequality that is the background for the current corporate governance reform efforts.[57] The Delaware judiciary completely abdicated any responsibility for checking on excessive executive compensation, essentially adhering to a waste standard for director fiduciary duty.[58] Tax laws, SEC regulations, and accounting standards endorsed fixed price options.[59] Tax laws in the United States generally favor equity compensation over cash compensation and advantageous provisions allow executives to further reduce their tax on stock grants.[60]

When Congress and the SEC reacted to runaway executive compensation, they made matters worse. As compensation was ratcheting upwards, Congress passed section 162(m) of the International Revenue Code (since repealed) which disallowed any cash compensation over $1 million to executives from being deductible from corporate income unless it could be computed according to an objective formula. This provision, pressure from institutional shareholders, and the proclivity of Silicon Valley companies to award stock to employees and executives changed the currency of executive compensation from cash to equity. The mantra that executives and directors should think like shareholders caused them to focus on stock market prices rather than long-term value or the continuation and stability of the business enterprise.

When Congress and the SEC woke up to the damage equity compensation was doing in the form of finagling of corporate financial statements, they decided that independent directors and shareholders should fix escalating executive payouts. The problem was that independent directors were already in place at listed companies, including Enron, WorldCom, and other companies that had to restate their financials, but the independent directors had ended neither bloated compensation practices nor short-termism. As for shareholder corrective action, it was pressure from institutional investors that had created the problems, so expecting them to solve inequality, cooked books, or overly leveraged companies was chimerical.

Two other efforts to deal with executive compensation also proved ineffective. The "say on pay" requirements inserted into the securities laws by Dodd–Frank[61] were ignored by individual investors and led institutional investors to endorse generous pay packages for corporate executives.[62] The requirement that corporations compare the compensation of corporate executives to the average compensation of other employees was so complicated to regulate, it took the SEC years to do so and did not lead to the kind of shaming that Congress envisioned.[63]

[55] Nitzan Shilon, *Executive Pay Sensitivity to Stock Buybacks: Evidence, Implications, and Proposed Remedy*, 25 Lewis & Clark L. Rev. (forthcoming) (manuscript at 1) [hereinafter "Shilon, *Executive Pay Sensitivity*"].

[56] *Id.* at 30–31; Shilon, *Replacing Executive Equity*, *supra* note 54, at 12–13.

[57] Strine & Smith, *Gainsharing*, *supra* note 45, at 10 n.21.

[58] *See* Freedman v. Adams, 58 A.3d 414 (Del. 2013). *See also In re* Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006). This shows the weakness of Delaware, or any single state, as a regulator.

[59] McClendon, *supra* note 50, at 980–84.

[60] Shilon, *Replacing Executive Equity*, *supra* note 54, at 30–31.

[61] Pub. L. No. 111–203, § 951, 124 Stat. 1899 (codified as amended at 15 U.S.C. § 78n-1 (2018)).

[62] Emily Barreca, *Accountable Compensation: The Progressive Case for Stakeholder-Focused, Board-Empowering Executive Compensation Laws*, 37 Yale J. Reg. 338, 352–53 (2020).

[63] This 2010 Dodd–Frank mandate was not adopted until 2015, 80 Fed. Reg. 50,103 (Aug. 18, 2015) amending Item 402 of Regulation S-K. Barreca, *supra* note 62, at 355.

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The use of equity compensation for executives and directors and stock buybacks are complementary.[64] Equity compensation results in dilution of a corporation's common stock and buybacks are the antidote to this hit to shareholders.[65] Buybacks were justified as a way to return profits to shareholders, but in fact they were a smokescreen. Buybacks supported the financialization of executive compensation and increased share prices in the short term.

The funds used for stock buybacks could not be utilized for other corporate purposes, including research and development in quality new products.[66] I believe this is at least a partial explanation for the proliferation of shoddy and dangerous products such as the Boeing 737 Max airplane.[67] David Calhoun, Boeing's current CEO, criticized his predecessor because he turbocharged Boeing's production rates before the supply chain was ready, a move that sent Boeing's shares to an all-time high, but compromised quality.[68] Others have complained that stock buybacks diverted funds from fair payment to workers even as their productivity increased.[69] Boeing and many other American corporations were "shoveling money to investors and executives, while shortchanging its employees and cutting costs."[70]

Another example of the financialization of corporate governance is General Electric. Jack Welch was a greatly admired CEO in the 1980s and 1990s. He was laser focused on enriching shareholders and in the process, he made deep payroll cuts.[71] His own compensation was so greedy that as a result of his post-retirement benefits disclosed in his divorce proceedings, the SEC changed its disclosure of corporate executive's post-retirement benefits.[72] Further, Welch reorganized GE so that its profitability depended on GE Capital, a financial firm that had to be bailed out after the 2008 stock market meltdown.

Another deleterious effect of buybacks and dividends to boost stock prices is that companies are leveraged and did not have the cash cushion to see them through the COVID-19 pandemic.[73] Yet, companies that have filed for bankruptcy reorganization have switched from equity to cash compensation and their executives are doing well.[74] Despite the high payouts from equity compensation during bull markets, corporate executives gamed equity grants through options backdating[75] and options repricing.[76]

Forty years of a free-market political ideology, fueled by corporate campaign and lobbying funds and individual greed, laid bare an economy and a society in crisis when COVID-19 hit the United States. The extent to which overly leveraged corporate structures at the end of 2019 will make an economic recovery slow and difficult will emerge from the bankruptcies of the next few

[64] Bruce Dravis, *Dilution, Disclosure, Equity Compensation, and Buybacks*, 74 Bus. Lawyer 631 (2019).

[65] *Id.*

[66] Shilon, *Executive Pay Sensitivity*, *supra* note 55, at 27.

[67] *See* Niraj Chokshi & David Gelles, *F.A.A. Suggests Boeing Face Fine of $20 Million*, N.Y. Times, Mar. 7, 2020, at B6.

[68] Natakie Kitroeff & David Gelles, *"It's More Than I Imagined": Boeing's New CEO Confronts Its Challenges*, N.Y. Times, Mar. 5, 2020, htpps://www.nytimes.com/2020/03/05/business/boeing.

[69] Strine & Smith, *Gainsharing*, *supra* note 45.

[70] David Gelles, *Boeing's Saga of Capitalism Gone Awry*, N.Y. Times, Nov. 29, 2020, at B2.

[71] Steve Lohr, *Jack Welch, G.E. Chief Who Became a Business Superstar, Dies at 84*, N.Y. Times, Mar. 2, 2020, https://www.nytimes.com/2020/03/02/business/jack-welch-died.html.

[72] *See* Press Release, Sec. & Exch. Comm'n, General Electric Settles SEC Action for Disclosure Failures in Connection With its Former CEO's Benefits Under His Employment and Retirement Agreement (Sept. 23, 2004). Item 402 Regulation S-K now specifically requires that reporting companies make disclosures about post-retirement benefits.

[73] Emily Flitter & Peter Eavis, *The Buybacks That Ate Restaurants' Cash Up*, N.Y. Times, Apr. 25, 2020, at B1.

[74] Peter Eavis, *Bankruptcy? For C.E.O.s, It's a Bonus*, N.Y. Times, June 24, 2020, at B1.

[75] Jesse M. Fried, *Option Backdating and Its Implications*, 65 Wash. & Lee L. Rev. 853 (2008).

[76] *See COVID-19: Addressing Underwater Stock Options and Stock Appreciation Rights*, DavisPolk (Apr. 14, 2020), https://www.davispolk.com/publications/covid-19-addressing-underwater-stock-options-and-stock-appreciation-rights.

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years. Many large and small companies are in bankruptcy already or teetering on the edge.[77] The financialization of corporate governance is a cancer eating away at the health of the capitalist system. Returning business to a condition where it can supply jobs, products, and long-term earnings and deal with the challenges of climate change, racial disparity, and other ESG concerns will require non-partisan political will from government and greater communitarian vision from big business than it has exhibited in the last forty years.

I do not believe stakeholder governance is the answer because it is essentially a poor substitute for competent and effective government regulation and tax policy with respect to employee and product safety, environmental degradation, income inequality, and other social ills. If the United States cannot renew public faith in government and if the government cannot conduct itself as a public service organization, I would not count on big business, which has created many of our current problems. Further, while individual philanthropists and foundations can often assist in crises and lead the way toward important social and economic goals, they are not accountable to the public, they are not elected, and their funding comes from the 1% of the 1% who have created the problems of this society. Nevertheless, some proposals for reforming executive compensation deserve consideration because income inequality is at the root of our social unrest.

1.4 DUTIES TO INVESTORS

Let me return to the protection of the individual shareholder, the human being whose savings are funding the pathologies of short-termism and the financialization of corporate governance. The way in which short-term focus on stock market prices has wrecked the US economy is one way to look at the deleterious fall-out from the financialization of corporate governance. Another serious problem is the effect of this greed by large investors and executives on the small investor, whose retirement savings are in pension funds and mutual funds and who is never consulted about corporate strategies.[78] As Justice Strine has pointed out, this individual investor, whose funds are utilized by institutions for their own purposes, is interested in a good paying job and a sound retirement nest egg. These goals are in no way taken into account in the purchase and sale of public companies and their assets or executive compensation payouts. These individuals do not get to vote in proxy contests; they do not get to vote on say-on-pay proposals.

One possible reform to assist individual shareholders and the public is to impose fiduciary duties on hedge funds and other activist investors to the corporations in which they invest and minority shareholders. Another possible reform would be to change and better enforce the fiduciary duties that institutional investors, especially pension funds, owe to their beneficiaries.

Shareholders do not generally owe duties to other shareholders or to the companies in which they invest, but there are some exceptions. The most important is that controlling shareholders owe duties of fair dealing to minority shareholders. Generally, this principle is applied in change of control situations involving the sale of a corporation,[79] but it can be applied in other situations also.[80] The fact patterns in these cases generally look at control as majority ownership or control of the board with less than majority ownership. These cases are not helpful in dealing with the influence of activist hedge funds and other investors who exert control or influence on a board to

[77] Mary Williams Walsh, *A Wave of Bankruptcies May Swamp the System*, N.Y. TIMES, June 22, 2020, at B1.

[78] *See* Jesse M. Fried, *Share Repurchases, Equity Issuances, and the Optimal Design of Executive Pay*, 89 TEX. L. REV. 1113, 1114–18 (2011).

[79] *See* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947).

[80] Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

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the detriment of individual investors. Further, the cases do not recognize that a controlling influence can occur with much less than 50% stock ownership.

Another doctrine imposing fiduciary duties on shareholders has been to treat control corporations like partnerships and impose fiduciary duties on the shareholders. In these cases, which originated in Massachusetts[81] and may not be the law in Delaware and other states,[82] the fact patterns generally involve self-dealing by one shareholder or group overreaching other shareholders. Whether these cases could be extended into the realm of public corporations is unclear. However, the idea that a shareholder with much less than a 50% ownership interest may be able to force a corporation to reject a policy that is injurious to the company could be useful.

Another useful idea would be to change the doctrine that directors owe a duty to creditors only when a corporation is on the brink of insolvency.[83] The courts gave short shrift to the injuries suffered by bondholders during the leveraged buyout craze of the 1980s.[84] However, some class actions by bond holders have proved more successful.[85] In my view, directors should be obligated to pay more attention to the risks of excessive leverage of a corporation's capital structure when adopting payouts to shareholders.

Private investment partnerships are a cosseted group. Hedge fund advisers were required to register with the SEC only after 2010, and they are not regulated or required to make the kind of disclosures other market players make.[86] Not all private investment partnership managers are required even to register. Hedge funds have significant tax advantages over other funds.[87] Some academics and the SEC view them as a worthy check on corporate managers. They fly under the banner of shareholder democracy. Yet, the influence of many activist investors is hardly democratic but directed at their own profit. Further, many of their policies have had deleterious effects. In particular, they are focused on short-term rather than long-term profitability.[88] In addition, they are a significant part of the shadow banking industry and have contributed to the leveraging of corporate capital structures.[89]

Activist investors have not improved operating performance.[90] Further, they have limited investment expenditures and increased leverage.[91] Their primary influences on corporate governance have been to increase expected takeover premiums[92] and to increase payouts to senior executives who enjoy the benefits of equity rather than cash compensation.[93] The push for ever increasing shareholder power and the manner in which money managers are evaluated

[81] Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505 (Mass. 1975).
[82] Nixon v. Blackwell, 626 A.2d 1366, 1380-81 (Del. 1993).
[83] North Am. Catholic Educ. Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007).
[84] Metropolitan Life Ins. Co. v. RJR Nabisco, Inc. 716 F.Supp. 1504 (S.D.N.Y. 1989). *See also* Katz v. Oak Indus., Inc., 508 A.2d 873 (Del. Ch. 1986).
[85] James J. Park, *Bondholders and Securities Class Actions*, 99 Minn. L. Rev. 585 (2014).
[86] Pub. L. No 111–203, § 403, 124 Stat. 1376 (2010).
[87] The carried-interest loophole allows the profits from investment paid to a hedge fund manager as compensation to be taxed as capital gains, rather than as earned income.
[88] John H. Matheson & Vilena Nicolet, *Shareholder Democracy and Special Interest Governance*, 103 Minn. L. Rev. 1649 (2019); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021, 1087 (2007).
[89] *Putting the Capital Into Capitalism*, Economist, July 25, 2020, at 55.
[90] John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. Corp. L. 545, 586–87 (2016).
[91] *Id.* at 589.
[92] *Id.* at 588.
[93] *Id.* at 593–94.

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created ground for the growth of activist investors.[94] Although not all hedge funds are the same, activist hedge funds typically push for short-term financial engineering, including borrowing to finance stock buybacks or special dividends, selling or spinning off parts of a company, or selling the entire company.[95] The incentive compensation structures of financial firms, especially hedge funds, led to a focus by general business managers on executive compensation based on stock market price increases.[96] This focus, in turn, led to a dramatic disparity between executive compensation and the compensation of average corporate employees.[97]

Iman Anabtawi and Lynn Stout have suggested that activist shareholders be subject to fiduciary duties in transactions involving a conflict of interest between such shareholders and other shareholders.[98] Adopting these principles would be a good start in curtailing such transactions as repurchases, special dividends, sale of assets, and sale of the firm. Curtailing the influence of these investors in how firms should be managed probably cannot be achieved within the strictures of traditional corporate law and is essentially a political problem. Stakeholder purpose is an effort in this direction, but it is unlikely to succeed without some mechanisms for accountability. A critic of the Anabtawi and Stout article has suggested that the board of directors is a better player for reining in abusive shareholders to protect stakeholders.[99]

Institutional investors owe their investors fiduciary duties either under state trust law, the federal securities laws, or ERISA,[100] depending on the form of the vehicle in which individuals invest. Yet, even public pension funds tend to be short-term oriented in their corporate governance policies and their votes do not focus on whether their beneficiaries will be paid robust pensions when they retire. Due to a reluctance by many states to adequately fund government pensions, which could require tax increases, many such pension funds are underfunded. In order to compensate for a shortfall in funding, pension funds are incentivized to make up such gaps with stock market gains.

The regulation of pension fund investment is primarily aimed at the risk and reward of their investments. The focus is on total return and diversification.[101] Under ERISA, because of the rule of prudence and the exclusive purpose rule, trustees cannot sacrifice investment yield for social purpose.[102] It is therefore difficult for an ERISA trustee to consider the effect of short-term investment strategies on worker beneficiaries, let alone such social purposes as climate change. Consideration of ESG values has become even more difficult due to a Department of Labor rule requiring ERISA trustees to evaluate investments based on pecuniary factors rather than non-pecuniary benefits.[103] This rule was strenuously opposed by many investment managers, including Fidelity Investments, BlackRock, State Street Global Advisors, the AFL-CIO, and others.[104]

[94] Steven A. Rosenblum, *Hedge Fund Activism, Short-Termism, and a New Paradigm of Corporate Governance*, 126 Yale L. J. F. 538, 542–43 (2017).

[95] *Id.*

[96] Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance*, 37 J. Corp. L. 265, 320–21 (2012).

[97] *Id.*

[98] Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 Stan. L. Rev. 1255 (2008).

[99] Michelle M. Harner, *Corporate Control and the Need for Meaningful Board Accountability*, 94 Minn. L. Rev. 541 (2010).

[100] Employee Income Security Act of 1974, 29 U.S.C. §§ 1001 et seq (2018).

[101] Unif. Prudent Inv'r Act (Unif. Law. Comm'n 1995). *See* Robert J. Aalberts & Percy S. Poon, *The New Prudent Investor Rule and Modern Portfolio Theory: A New Direction for Fiduciaries*, 34 Am. Bus. L.J. 39 (1996).

[102] Norman Stein, *ERISA and the Limits of Equity*, 56 Law & Contemp. Probs. 71, 84 n.86 (1993).

[103] 29 C.F.R. § 2250.404(c)-5 (2020).

[104] Pete S. Michaels & Alyssa C. Scruggs, *You Can't Always Get What You Want: The End of ESG Investing in ERISA Accounts*, X Nat'l L. Rev. 300 (2020), https://www.natlawreview.com/article/you-can-t-always-get-what-you-want-end-esg-investing-erisa-accounts.

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1.5 REFORM PROPOSALS

Some of the reforms suggested by others to deal with the financialization of corporate governance have included: prohibiting executives from cashing out restricted stock and options for some period of time after vesting and after retirement; more rigorous analysis of voting on say-on-pay and shareholder proposals by institutional investors; bans on stock buybacks; greater disclosure requirements for activist hedge funds; and more stringent requirements for tender offers. While these reforms could be helpful, they do not address the root of the problem, which is equity compensation and the focus on stock market prices to the exclusion of other metrics of corporate success. Nevertheless, let me unpack these possible reforms.

According to Professor Bebchuk, the solution to excessive executive compensation is to compel directors to focus on the long-term by blocking managers from cashing out their equity for some specified time after vesting. Further, retirement-based holding metrics should be eliminated, and the use of derivatives to game the system should be prohibited. Also, the date of grants should be specified and should not be discretionary.[105] Justice Strine has expressed similar ideas.[106]

Say-on-pay appears to have failed to dent high executive compensation levels. Individual shareholders may not understand the complex disclosures in SEC documents regarding compensation.[107] Institutional investors are highly deferential in say-on-pay votes because company shares are held by the wealthiest American households. They fear an adverse market reaction to a vote against say-on-pay votes and they are not outraged by income inequality.[108]

Greater regulation of hedge funds, in my opinion, is a good idea. Justice Strine has advocated standardized disclosure of hedge fund performance, especially past track records, and the compensation of managers.[109] The justification that because investors in such funds are wealthy and/or sophisticated they do not need the kind of regulation that applies to mutual funds may be based on a faulty premise. Further, better disclosure of their financial results might be useful to their investors and the markets. But in my view such regulation is more important from a systemic perspective concerning the shadow banking industry than from a corporate governance perspective. I do not understand how better regulation of hedge funds for the benefit of their investors would curtail their efforts in forcing short-term strategies on public corporations.[110] Nevertheless, the IPOs (initial public offering) of special purpose acquisition companies by hedge funds is concerning as these activist investors will garner even greater market power and influence on the direction of business strategies.

Professor Coffee has advocated reform of the SEC rules regarding disclosure by tender offerors of their accumulation of 5% or more of a target company's stock. Currently, activist investors have ten days to do so, but in other jurisdictions such disclosure is required after two

[105] Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1956–59 (2010).
[106] Strine, *Who Bleeds*, *supra* note 8.
[107] *See* Barreca, *supra* note 62, at 355–56.
[108] *Id.* at 357–59.
[109] Strine, *Who Bleeds*, *supra* note 8, at 100.
[110] One of the most controversial hedge funds went public in the middle of the COVID-19 epidemic. Bill Ackman and Pershing Square raised $4 billion in an IPO of Pershing Square Tontine Holdings Ltd. as a special-purpose acquisition company. Tomi Kilgore, *Bill Ackman's Pershing Square Tontine Raises $4 billion as IPO prices at $20 a share*, MARKETWATCH (July 22, 2020, 8:15 AM), https://www.marketwatch.com/story/bill-ackmans-pershing-square-tontine-raises-4-billion-as-ipo-prices-at-20-a-share-2020-07-22.

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days.[111] Although I believe closing the ten-day window is a good idea, since it would put sand in the wheels of surprise tender offers, its influence on executive compensation would likely be indirect.

Some academics have focused on corporate purpose that would direct corporations and their executives to take ESG factors into account in running their businesses and in compensating executives. The SEC requires corporations to report on ESG matters if they are material, but there is insufficient uniformity in reporting such matters to measure company performance.[112] Nevertheless, many companies now report on ESG or sustainability matters and discuss sustainability goals in their annual reports or on their websites. ESG metrics could be incorporated into performance-based executive compensation, and a few corporations have done so.[113] Yet, there is a wide gap between professed sustainability goals, executive compensation measurements, and company stands on shareholder proposals.

The most urgent ESG policy for many companies and investors is climate change. Although the SEC has disclosure requirements for climate change, and many companies go beyond the minimum required disclosures with regard to this issue, these disclosures appear to have little impact on the conduct of public corporations.[114]

Walmart is a good example of this hypocrisy. The Walmart website has a whole section devoted to ESG Investors. Its environmental goals include climate change, sustainable supply chain, and waste. Regarding waste, the company has goals to achieve 100% recyclable, reusable, or industrially compostable packaging in all private brand products by 2025 and other similar goals.[115] There are also goals for responsible recruitment and culture, diversity, and inclusion.[116] Yet, Walmart does not have any portion of its executive compensation tied to its ESG and sustainability goals. Only financial performance metrics are considered in determining executives' annual cash incentive and long-term equity. Regarding culture, diversity, and inclusion, the only metric relating to compensation is that an associate's cash incentive payment may be reduced by up to 30% if the associate engages in behavior inconsistent with the company's discrimination and harassment policies.[117]

A much more nuanced proposal for redirecting executive compensation has been put forth by Justice Strine and Kirby M. Smith.[118] They advocate a reform of the compensation committee that would require the committee to focus on a corporation's entire workforce, not just senior management, and to oversee an effective system to compensate workers fairly. Although worker pay and benefits would be the primary focus of this reimagined committee, safety, racial and gender equality, sexual harassment, inclusion, and training and promotion would also be within

[111] Coffee & Palia, *supra* note 90, at 595–97.
[112] Fisch, *supra* note 25; Brett McDonnel, Hari M. Osofsky, Jacqueline Peel & Anita Foerster, *Green Boardrooms?*, 53 Conn. L. Rev. 535 (2021).
[113] Ben Schwefel, *"Green" Performance: The Future of Performance-Based Executive Compensation?*, 6 San Diego J. Climate & Energy L. 247 (2015).
[114] McDonnel et al., *supra* note 112, at 5.
[115] 2019 Walmart Environmental, Social & Governance Report, https://corporate.walmart.com/media-library/document/2019-environmental-social-governance-report/_proxyDocument?id=0000016c-20b5-d46a-afff-f5bdafd30000.
[116] *Id.*
[117] Notice of 2020 Annual Shareholders' Meeting, Walmart (June 3, 2020), https://corporate.walmart.com/media-library/document/2020-walmart-proxy-statement/_proxyDocument?id=00000171-a3e6-de83-a7fd-f7eeef900000. Walmart's position on a shareholder proposal relating to waste contradicted its pious statements on sustainability. There was a proposal on impacts of continuing to use single-use plastic bags, emphasizing that Walmart has lagged competitors including Kroger, Costco, Trader Joe's, and Whole Foods. Walmart opposed the proposal.
[118] Strine & Smith, *Gainsharing*, *supra* note 45.

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the purview of the committee. This is an interesting and comprehensive reform idea, but it would seem to inject the board of directors deep into managerial functions. The authors suggest that ESG and employee practices should be considered in compensation and not just stock price. Yet, they seem to contemplate that equity would continue to be the coin used for payment of executive compensation.

The way in which the Financial Accounting Standards Board permitted corporations to account for options encouraged the use of fixed price stock options because they were not required to be accounted for as a corporate expense.[119] Only after widespread abuses in the granting of such options came to light was this accounting provision rectified.[120] Colin Mayer has proposed some radical changes to corporate accounting in order to realign corporate purpose from shareholder primacy to a more public interest orientation. He has advocated that companies should record their investments in human, natural, and social capital on their balance sheets the way they record their investments in material capital and charge the costs of maintaining such capital against their profits.[121]

Changes to accounting conventions to cut back executive compensation are not as common as recommended changes to the tax laws. One common target is carried interest, whereby hedge funds and private equity funds treat the income they receive from their funds as capital gains rather than ordinary income. There have been frequent efforts to do away with this abuse, always beaten back by aggressive lobbying.[122] A more sweeping reform would be to treat all income the same, whether it is earned or unearned. Future reformers will no doubt be grappling with changes to the tax laws if only to deal with the enormous deficits incurred in fighting COVID-19 and the economic collapse it has engendered.

Steven Rosenblum has suggested that a private ordering model to curb short-termism should be accomplished by institutional investor support of company efforts to build sustainable long-term businesses.[123] While such a development would be salutary, many very large institutional investors are index funds that do not invest in particular companies. Further, the Department of Labor regulation concerning ESG is a serious disincentive to the kind of new corporate governance paradigm advocated by those who believe a reorientation of corporate strategies is needed.

In my view, although the foregoing recommended reforms might be helpful in curbing excessive executive compensation, none of them attacks the root of the problem which is payment of compensation in equity. While I would return to cash payments, at least in part, payment in corporate bonds might also be considered. At this time, however, the most practical and useful reform would be to curb stock buybacks.

Stock buybacks surged in the 1980s and 1990s when shareholder value became the mantra of American business and executive compensation was paid in equity. Between 1984 and 1987, US corporations purchased $864 billion of their own shares.[124] In 2019, buybacks by US companies in the S&P 500 were $728.7 billion, which was the single largest source of demand in the stock market.[125] According to the SEC, buybacks totaled $7 trillion between 2004 and 2016.[126]

[119] McClendon, *supra* note 50, at 980–84.
[120] Fried, *supra* note 75.
[121] Mayer, *supra* note 1, at 145–46.
[122] Ending the Carried Interest Loophole Act, S. 1639., 116th Cong. (2019).
[123] Rosenblum, *supra* note 94, at 539.
[124] Joan Wang, *Mirage of Wall Street*, N.Y. Times, May 31, 2020, at 57.
[125] *Id.*
[126] Dravis, *supra* note 64, at 649 n.55.

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This boost to earnings per share of public companies has drawn critics from the press and academia.[127]

The way in which buybacks have contributed to income inequality has not been lost on politicians. Senators Schumer and Sanders have proposed limiting a company from engaging in buybacks unless the company is paying a $15 hourly minimum wage.[128] Senator Baldwin has introduced a bill that would repeal SEC Rule 10b-18 that provides a safe harbor for corporate purchases of its own stock and so essentially allows public corporations to engage in buybacks.[129] Senator Marco Rubio has also criticized buybacks, and has proposed that they be taxed like dividends.[130] The CARES Act prohibits businesses that borrow money under the act from buying back company stock or paying dividends or other capital distributions.[131]

In my opinion, buybacks are manipulative and so SEC Rule 10b-18, which is one of the building blocks for the legality of buybacks, should be repealed or amended. Such an action has been recommended by Professor Robert J. Jackson, a former SEC Commissioner.[132] Such action could be taken by the SEC without the need for legislation. I like the idea of taxing buybacks, but any tax needs to be payable by the corporation since shareholders do not directly receive these payments. While curtailing buybacks is a good idea going forward, it does not rectify the income inequality that the financialization of executive compensation has accomplished.

It would be salutary if institutional shareholders could be subject to fiduciary duties to the corporation and the shareholder body but imposing such duties would require serious changes to corporate law. More aggressive and nuanced enforcement of their duties to their beneficiaries might be more feasible. Unfortunately, this would require articulation in ERISA regulations that has proven difficult to achieve.

Executive compensation needs to go back to basics and not be given in equity and measured by stock market prices. COVID-19 has exposed the huge gap between the stock market and the real economy. The stock market has been propped up by buybacks and exorbitant income inequality has occurred by way of the financialization of corporate governance. When all of these problems are unwound, as they will be, individual stockholders and the beneficiaries of retirement funds will suffer the most.

Although the objective of a corporation may be shareholder gain over time, in order to serve the large body of shareholders of a corporation, the business of the corporation must prosper over time. Fiduciary duties must be directed not only to shareholders but also to the business enterprise. This requires that corporate purpose be focused not simply on increasing the price of a corporation's stock, but on selling quality products, treating employees fairly, and supporting the communities in which the corporation operates.

[127] *Id.* at 649 n.56.
[128] Liz Moyer, *Chuck Schumer and Bernie Sanders Call for Restricting Corporate Share Buybacks*, CNBC (Feb. 4, 2019), https://www.cnbc.com/2019/02/04/senate-democrats-call-for-restricting-corporate-share-buy-backs.html.
[129] Reward Work Act, S. 915, 116th Cong. (2019).
[130] Matt Egan, *Marco Rubio Wants to End Stock Buybacks' Tax Advantage*, CNN Bus. (Feb. 12, 2019), https://www.cnn.com/2019/02/12/investing/rubio-stock-buybacks-tax/index.html.
[131] S. 3548, 116th Cong. (2020).
[132] Robert J. Jackson Jr., Comm' r, U.S. Sec. & Exch. Comm'n, Stock Buybacks and Corporate Cashouts at the Center for American Progress (June 11, 2018).

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I realize this essay is a scattershot approach to dealing with the ills of the financialization of corporate governance. But the changes in US business discussed have taken four decades or more to develop and reform will not be quick or easy. A variety of approaches needs to be considered and tried. What matters is that a consensus builds on the idea that stock market gain is not the only goal of business enterprise and the US economy.

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