CORPORATE GOVERNANCE REFORM: HOW TO PROMOTE THE LONG-TERM HEALTH AND VALUE OF U.S. CORPORATIONS

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I. INTRODUCTION

In the wake of the recent financial crisis, there will undoubtedly be many calls for reform in the corporate legal system. One area that will likely face additional scrutiny is the corporate governance system. In his recent article, "Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance," George Dent argues that CEOs dominate our present corporate governance system.[1] This paper will examine the evidence supporting Dent's theory and discuss the various costs of such a system, including the ways in which the CEO-dominated corporate governance system helped to create the current economic crisis.This paper will also analyze various proposed alternatives to the CEO-dominated corporate governance system. In his paper, Dent argues that to reform the CEO-dominated system we must increase shareholder rights.[2] I argue, however, that transferring power from CEOs to shareholders will not necessarily remedy this problem. Instead, any corporate governance reform must focus primarily on promoting the long-term health and value of the corporation. In light of this goal, I will examine various proposals for corporate governance reforms. Specifically, this paper will first look at two shareholder rights proposals that have recently been proposed to Congress and the SEC. Next, as an alternative to increasing shareholder rights, I consider proposals to insulate management from shareholder demands. As a second alternative I look at executive compensation reforms. Then, as a third alternative to increasing share-

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1. George W. Dent, *Academics in Wonderland: The Team Production and Director Primacy and Models of Corporate Governance*, 44 Hous. L. Rev. 1213 (2008).

2. *Id.*

holder rights, I explore the possibility of allowing employees to elect a number of board members. Finally, as a fourth alternative, I will examine various ways in which creditors can be incentivized to play a greater role in monitoring boards.

After examining which of these proposals most effectively combats the problem of CEO-dominance and incentivizes directors to focus on the long-term health of the company, I conclude that the most reasonable and effective solution is a combination of two of these proposals. Specifically, executive compensation should more closely tie director pay to the long-term success of the company, and creditors should play a greater role in monitoring the behavior of their corporate debtors; for example by allowing a minority creditor representation on the board of directors.[3] These policies will create incentives for directors to focus on the long-term value of their companies, which in turn will help to create increased stability in the market.

II.
EVIDENCE OF CEO DOMINANCE

The evidence is clear that today most boards are passive; they are dominated by CEOs who exert power in pursuit of their own interests.[4] However, this insight is far from new. Seventy-years ago, William O. Douglas characterized outside directors as "business colonels of the honorary type—honorary colonels who are ornamental in parade but fairly useless in battle."[5] There are many reasons that boards are passive. First, most board openings are filled by recommendations made by the CEO, and as such, the most common choice for outside directors are people who are CEOs at their own companies.[6] The reasoning behind this preference is simple: a CEO knows that on his own board he wants directors to defer to him, so when he serves as a director on a board run by another CEO,

3. It is important to qualify that I would only recommend this reform for large public companies, and not for small or private companies, which are less likely to suffer from CEO dominance over the board of directors.

4. Dent, *supra* note 1 at 1240 (describing the reality of CEO domination and its costs to companies).

5. William O. Douglas, Democracy and Finance 46 (1940) as cited in Dent, *supra* note 1 at 1240.

6. Dent, *supra* note 1 at 1242.

he will extend him or her that same courtesy.[7] Second, being a director on a board is a desirable position, and directors naturally feel beholden to the person responsible for their selection, which in most cases is the CEO. Not surprisingly, a board position becomes much less desirable, if a director is unwilling to defer to the CEO and becomes a constant dissenter to the will of the board. Even if a director accepts a board position with the intention of opposing the CEO on major corporate decisions, the atmosphere of "group think," in which members of the board "adopt the goals and methods of the group uncritically," is prevalent on many boards, making it very difficult to be the one dissenting voice.[8] Therefore, a dissenting director is likely to either accede to the will of the majority or resign rather than continuously fighting with the CEO. Finally, most boards meet infrequently, and outside directors often have other jobs. Therefore, outside directors must rely on the CEO and management for all of their corporate information. The resulting informational disparity creates incentives such that most boards find it easier to remain passive in the face of CEO dominance.

Thus far, regulatory efforts to improve board independence have been ineffective. According to rules imposed by the SEC and various national exchanges, most large public companies must now have a majority of "independent" directors on both the board and several oversight committees, but these reforms have not improved board performance.[9] Directors continue to lack an independent source of information, so they must rely on information provided by the CEO and management, the very people that they are supposed to oversee.[10] Additionally, most regulation has addressed only certain affiliations that an outside director may have with the company

7. *Id.*

8. *See* Stephen J. Choi, *Behavioral Economics and Regulation of Public Offerings*, 10 Lewis & Clark L. Rev. 85, 124 (2006) (noting that "when individuals in a group work toward a particular goal, they may come under the influence of groupthink. Under groupthink, individuals may think less about the actions of the group, instead adopting the goals and methods of the group uncritically."); Dent, *supra* note 1 at 1241-42 (stating that the problem of "group think" pervades most boards and makes it awkward to step out of line).

9. Dent, *surpra* note 1 at 1242.

10. *Id.* at 1243.

and its managers. Thus, many outside directors are permitted to have "soft" conflicts of interest that do not fall within the regulatory definition of independence.[11] Moreover, CEOs still have the ability to gain favor with a particular director by arranging company gifts to a director's favorite charity, consulting with mutual business ties, or through personal and social contacts.[12] Therefore, although regulation has removed formal affiliations between management and outside directors, it has failed to effectuate an actual increase the independence of the board.

III.
COSTS OF CEO DOMINANCE

CEO-dominated boards can inflict large costs on investors. CEOs often hold little stock in their companies.[13] Instead, CEOs are compensated in a manner that often motivates them to attempt to increase accounting earnings, rather than the value of the firm.[14] This can contribute to a short-term bias by the CEO and management, which can have dire consequences for the long-term health and value of the company.[15] When managers seek to boost the short-term earnings and stock price of a company, the easiest expenditures to forgo are investments in the future.[16] Such a myopic focus on the short-term often comes at the expense of long-term planning, investment, and business development. In addition, CEO-dominated boards are also less likely to police manager misconduct.[17] This is evidenced by many of the recent scan-

11. *Id.* at 1242.

12. *Id.* at 1243.

13. *Id.* at 1238 (the average CEO of a fortune 500 company owns about 1/4 of one percent of his company's stock).

14. *Id.* at 1246 (noting that executive pay is often tied to reported earnings, and many managers choose accounting methods that increase reported earnings instead of maximizing share price).

15. *Id.* at 1238 (noting that the manner in which CEO's are compensated can lead to a short term bias).

16. Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquenial Election of Directors*, 58 U. Chi. L. Rev. 187, 210 (1991).

17. Dent, *supra* note 1 at 1246 (noting that CEO dominated boards are less responsive to shareholders, and thus, fail to police manager misconduct, such as falsifying information in order to trade company stock at inflated stock prices in management-orchestrated "pump and dump" schemes).

dals involving fraudulent disclosures, such as Enron, in which boards made little effort to detect or deter fraud, or to discipline the offenders once their misconduct was discovered.[18]

The current economic crisis also provides ample evidence of the costs that a CEO-dominated board can inflict. A major cause of the current economic crisis is the volume of mortgage-backed securities that flooded the market and that subsequently dropped significantly in value, as the number of foreclosures increased.[19] Many CEOs, especially those at major investment banks such as Lehman Brothers and Citigroup, encouraged these practices because of their short-term value and ignored the long-term risks associated with the increasingly large volume of mortgage-backed securities on their books.[20] When the board remains passive, there is no one to question the CEO and management's decisions. If the boards of these companies had successfully monitored these events, they might have been able to challenge the CEO and management on the long-term wisdom of these decisions. At the least, more active boards would have implemented adequate risk management procedures, which may have kept these companies from becoming so heavily dependent on the continued success of one type of security.

A recent New York Times article reported that after learning for the first time that Citigroup owned approximately 43 billion dollars in mortgage-backed assets, the CEO of the bank helped management quiet internal concerns about the bank's vulnerabilities.[21] As a result, the bank's risk managers never fully investigated the potential consequences of such holdings. Many Citigroup insiders noted that because of "longstanding ties that clouded their judgment, the very people charged with overseeing deal makers eager to increase short term earn-

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18. *See, e.g.*, Carrie Johnson and Ben White, *Opportunity for Corporate Fraud Has Shrunk—But It's Still There*, Washington Post, Jan. 26, 2006, at D1 (recalling that in the wake of Enron, boards of directors were found to have ignored overly aggressive business practices).

19. *See e.g.*, Steve Lohr, *Bailout Is Only One Step on a Long Road*, New York Times, Sept. 28, 2008.

20. Eric Dash & Julie Creswell, *Citigroup Saw No Red Flags Even As It Made Bolder Bets*, New York Times, Nov. 22, 2008 (describing why Citigroup failed to engage in adequate risk management procedures in relation to the volume of mortgage-backed assets the company acquired).

21. *Id.*

ings—and executives' multimillion-dollar bonus—failed to rein them in."[22] In order to prevent this type of abuse in the future, the board of directors must be able to implement effective risk management controls and challenge the CEO and management when their actions do not support the long term health of the corporation.

IV.
WHILE CEO DOMINANCE SHOULD BE ADDRESSED AND RECTIFIED, INCREASED SHAREHOLDER RIGHTS IS NOT NECESSARILY THE SOLUTION

Most academic literature has defined the interest of the corporation in terms of the interest of shareholders.[23] As a result, most of the academic literature on corporate governance reform has focused on increasing shareholder rights.[24] The assumption underlying these proposed reforms is that a corporate governance system should be crafted to ensure that the actions of a corporation's directors accurately reflect the wishes of its shareholders.[25] However this assumption is flawed in three ways. First it assumes that the modern corporation can be owned in the same manner as any other private property.[26] Second, it assumes that shareholders in a modern corporation are equivalent to the owner of ordinary private property.[27] Finally it assumes that because of this ownership relationship shareholders have certain inherent rights in the governance of the company. However there is no basis for this assumption of inherent rights and entitlements in the corporate structure.[28]

A fundamental tenet of the capitalist property system is that the owner of private property may do anything he wishes

22. *Id.*

23. *See, e.g.*, Dent, *supra* note 1; Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833 (2005).

24. *Id.*

25. Lipton & Rosenblum, *supra* note 16, at 187 (noting that academic writers commonly assume that the central goal of corporate governance is to make managers conform their actions to the desires of stockholders).

26. *Id.* at 192 (arguing that the modern corporation is not private property like any other private property).

27. *Id.* at 192-93 (arguing that the stockholder in the modern public corporation is not analogous to the owner of ordinary private property).

28. *Id.* at 188 (arguing that there is no basis for the assumption of intrinsic rights and entitlements in the corporate structure).

with his property, as long as it does not harm third parties.[29] Therefore, if shareholders own corporations in the same manner as they own other private property, corporate directors should theoretically aim simply to implement the wishes of shareholders, subject only to limitations on injuring third parties. However, the modern corporation is fundamentally different than other types of private property. It is the central productive element of our economy.[30] The health and stability of the economy depends on the ability of corporations to maintain their health and value over the long-term. Corporate action not only affects shareholders, but also employees, creditors, communities, suppliers, and customers. As such, all of these constituencies contribute to and have a stake in the operation and success of the corporation.[31] Moreover, the nation and the economy as a whole have a direct interest in creating an economic environment that will incentivize corporations to maintain their long-term health and value.[32] Therefore, the rules of corporate governance must take into account many more interests than the rules governing less complex forms of private property.

Secondly, the role of a shareholder in a modern corporation is different from that of the owner of ordinary private property. The shareholder is entitled to a percentage of the company's profits and residual value.[33] Therefore, the shareholder's ownership interest is a financial interest, on which there is a return in the form of dividends or appreciation in trading price, rather than the "use and enjoyment" interest that characterizes the ownership interest of ordinary personal property.[34] Therefore, the paradigm of the stockholder as the owner of private property does not provide a compelling basis for the assumption that increasing shareholder rights should

29. *Id.* at 191.

30. *Id.* at 192 (describing the modern corporation as the central productive element of our economy).

31. *Id.* (stating that the corporation affects the destinies of employees, communities, suppliers and customers).

32. *Id.* at 192 (stating that the nation and the economy as a whole have a direct interest in ensuring an environment that will allow the private corporation to maintain its long-term health and stability).

33. *Id.* at 193-94.

34. *Id.*

be the central focus in reforming the corporate governance structure.[35]

Lastly, there is no basis for the assumption that shareholders have inherent rights and entitlements in the corporate structure. The U.S. corporate form is a creation of the state, which was originally conceived as a privilege to be granted to specified entities for the public good.[36] Over time, the corporate form has become widely available; however, it still remains a legal creation, and as with any legal construct, the rules governing it must be justified on the basis of economic and social utility, not inherent rights.[37] If corporate governance rules benefit the economic system and the long-term health and value of the corporations themselves, notions of shareholders' "inherent rights" should not stand in the way of achieving that goal.[38]

The goal of corporate governance should not solely be to align the interests of directors and shareholders. Instead, it is in society's best interest to focus corporate governance reform on enhancing the long-term health and value of the corporation. If each company in the economy focuses on its own long-term success, the economy as a whole will achieve more stability, and diversified investors will achieve maximum value over time. The health and stability of the economy as a whole depends on the ability of corporations to maintain healthy and stable business operations over the long-term. A stable and healthy economy, in turn benefits shareholders. Most individual investors have diverse investment portfolios, which are invested for the long-term to provide the funds necessary to pay

35. *Id.* at 194-95 (arguing that the paradigm of the stockholder as the owner of private property, does not provide a compelling basis for the managerial discipline model of corporate governance).

36. *Id.* at 188.

37. *Id.* at 188 (stating that the corporate form is a creation of the state, conceived originally as a privilege to be conferred on specified entities for the public good and welfare, and while the corporate form is now generally available to any business, it remains a legal creation).

38. See *id.* (arguing that given the corporation's origins as a historical and legal construct created for specific policy reasons, the state naturally may choose to condition the use of the corporate form upon compliance with rules that advance societal goals, even if those goals clash with stockholder interests).

for their children's education and their own retirement.[39] Therefore, shareholders need a corporate governance structure that creates stability in the economy and durable value for diversified investors.

The corporate form is based essentially on contractual, market-based interactions between a variety of different parties including shareholders, employees, creditors, customers, and suppliers.[40] If the goal of corporate governance is to maximize the long-term health and value of the corporation, then it is not clear that shareholders are necessarily the corporate constituents who are in the best position to achieve this goal. Increasing shareholder rights is the optimal manner in which to reform corporate governance only if it results in greater corporate value over the long-term. It is this goal of increasing long-term value that will ultimately be the most beneficial to the greatest number of corporate constituents, including shareholders, and to our economy as a whole.[41]

In order to achieve this goal, the corporate governance system must incentive the board of directors to focus on the long-term value of the corporation. A long-term view on the part of directors permits public corporations to invest in the future and take strategic risks to compete in the world economy.[42] It also incentivizes directors to implement effective risk management procedures to prevent unnecessary corporate risk, which will be harmful to the company in the long-term. This paper will examine a variety of proposed corporate governance reforms to determine which reforms will best achieve this goal. In particular, I will examine proposals that increase shareholder rights, insulate management, reform executive

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39. Leo E. Strine, *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 Bus. Law. 1079, 1082 (2008) (stating that individual investors have two key-objectives, having the funds necessary to pay for their children's education and to provide for themselves in retirement).

40. Brett H. McDonnell, *Employee Primacy, or Economics Meets Civic Republicanism at Work*, 13 Stan. J. L. Bus. & Fin. 334, 341 (2008) (describing the corporate entity as interactions between its many stakeholders).

41. Lipton & Rosenblum, *supra* note 16, at 189 (arguing that the ultimate goal of corporate governance is the creation of a healthy economy through the development of business operations that operate for the long-term).

42. *See id.* at 216 (arguing that corporations must be permitted to sacrifice some immediate value to investments in capital assets, research and development, new ventures, or market share).

compensation, provide an increased governance role for employees, and increase the ability of creditors to monitor the board.

V.
PROPOSALS INCREASING SHAREHOLDER RIGHTS

Some supporters of greater shareholder rights seem to regard increases in shareholder rights as intrinsically desirable.[43] Increasing shareholder power, however, should not be seen as an end in and of itself.[44] Instead, effective corporate governance, which enhances the long-term health and value of the company, should be the primary objective. From this perspective, increased shareholder power is only desirable if it would operate to improve the long-term vitality of the company.

Proponents of increasing shareholder rights typically argue that increasing shareholder rights will more closely align the interests of management and shareholders, which will enhance shareholder value, and ensure greater director accountability.[45] Increased accountability, it is argued, should then translate into a decrease in corporate fraud and misconduct, as well as greater efficiency and increased financial returns.[46] However, critics of these proposals express skepticism over the merits of increasing shareholder power. If the goal of corporate governance reform is to increase the long-term health and value of the corporation, shareholders may have a short-term bias that prevents them from effectively achieving this goal. Dividends for common stock in most American companies are nominal.[47] As such, in order to profit from their investment, shareholders tend to buy stock with the goal of selling the

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43. Lipton & Rosenblum, *supra* note 16, at 187.

44. Bebchuk, *supra* note 23 at 842.

45. *See e.g., id.* at 908; Lisa M. Fairfax, *Shareholder Democracy on Trial: International Perspective on the Effectiveness of Increased Shareholder Power*, 3 Va. L. & Bus. Rev. 1, 21 (2008).

46. Fairfax, *supra* note 45, at 21 (stating that proponents of shareholder democracy maintain that increasing shareholder power will create greater accountability and decrease the amount of fraud and corporate misconduct).

47. According to research by the Market Research, and Education (MARE) group, a unit of Fidelity Management & Research Co., the average dividend yield on S&P 500 stocks from 1/1/2000 through 6/30/2008 was 1.7 percent.

stock after its market value increases. Because shareholders can simply sell their stock in the short-term and make a profit, they are not incentivized to discourage directors from making decisions that, while creating short-term gains, are disadvantageous for the company in the long-term. Similarly, shareholders are unlikely to encourage directors to make expensive investments in the company which will not produce gains in stock price in the short-term, but which may enhance the long term health and value of the company.

In addition to the potential short-term bias of shareholders, proposals to increase shareholder power are also criticized for being ineffective.[48] Studies by Professor Bernard Black and other scholars suggest that shareholders tend to be apathetic, failing to exercise the voting power provided to them or to otherwise engage in shareholder activism.[49] This passivity makes it unlikely that either shareholders or their companies will benefit from increased shareholder power. Furthermore, experience in other countries confirms the view that the natural apathy of shareholders will limit the extent to which the company can benefit from any increase in power that shareholders receive.[50] For example, the practice of majority voting,[51] which is the norm in most modern markets outside the United States, does not appear to have a significant impact because shareholders do not appear to have used their vote to challenge directors.[52] In addition, data from other countries reveals that increasing shareholder rights does little to prevent corporate fraud and misconduct.[53] Shareholders in other countries operate under a majority vote and have an expanded ability to remove directors from office.[54] However, these additional rights have not had an appreciable impact on prevent-

48. *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520 (1990).

49. *Id.*

50. Fairfax, *supra* note 45, at 22.

51. The default standard in most U.S. state corporate statues is plurality voting, meaning a director is elected by virtue of receiving the most votes in the election. Majority voting, on the other hand, requires that a director receive a majority of votes in an election in order to be elected to the board. The rationale behind the push for majority voting is that it makes directors more accountable to stock holders.

52. Fairfax, *supra* note 45, at 23.

53. *Id.* at 26.

54. *Id.* at 23.

ing corporate misconduct.[55] Instead, similar to the United States, those countries continue to experience corporate mismanagement and fraud.[56]

Another criticism of increasing shareholder power is that shareholders are inadequate corporate decision-makers because of their informational disadvantage. Due to the large size of their portfolios even institutional investors are unlikely to spend the significant amount of time and money required to do the research necessary to become adequately informed about all of the companies in their portfolio.[57] Even where a shareholder wants to spend the time and money to adequately investigate the companies they have invested in, the most likely source of this information will be the directors who are already in charge. Therefore, it is not clear that shareholders are well situated to play a greater role in corporate decision-making.

Empirical studies assessing the impact of shareholder democracy and activism on firm value have yielded mixed results.[58] Some studies suggest that shareholder activism has a minimal impact on corporate performance.[59] Other studies, however, indicate that increased shareholder activism has little or no link to increased share value and corporate earnings.[60] Overall, these findings suggest that increased shareholder participation does not necessarily translate into greater value for shareholders or the companies in which they are invested.[61]

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55. *Id.* at 26.

56. *Id.*

57. *See* Lipton & Rosenblum, *supra* note 16 at 206 (stating that as stock portfolios have grown in size, institutional investors have increasingly lost the ability to assess adequately the business performance of each portfolio).

58. Fairfax, *supra* note 45, at 24.

59. See Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance,* 18 Yale J. on reg. 178, 187-89 (2001).

60. See Bernard Black, *Shareholder Activism and Corporate Governance in the U.S.*, in The New Palgrave Dictionary of Economics and the Law (Peter Newman ed., 1998).

61. Fairfax, *supra* note 45, at 25 (summarizing the results of a variety of studies on the impact of increased shareholder activism).

VI.
Increased Power of Institutional Investors

Many recent proposals involving shareholder rights focus specifically on increasing the power of institutional investors.[62] In his article, *Academics in Wonderland*, George Dent proposes that a committee of ten to twenty of a company's largest shareholders nominate the board of directors.[63] According to Dent, the most effective way to make directors responsive to shareholders is to have directors chosen by the shareholders.[64] Another more modest proposal to increase the power of institutional investors, commonly referred to as "proxy assess," has recently been proposed to the SEC by institutional investors.[65] The proposal was ultimately rejected,[66] at least for the time being, but it would have allowed institutional investors, meeting certain criteria, to use Rule 14a-8 as a means to propose electoral reforms.[67] Specifically, it would have permitted institutional investors to nominate director candidates and to have those candidates' names appear on the company's proxy card.[68] The rationale behind "proxy access" is that it is supposed to materially reduce the cost of running a proxy contest, which will arguably promote more competitive elections and create more accountable boards.[69]

In addition to the general criticisms of increasing shareholder rights described above, institutional investors, in particular, have a short-term bias. Institutional investors tend to focus on the current market price of a corporation's stock, instead of working actively towards the long-term operating

62. *See, e.g.*, Dent, *supra* note 1.

63. *Id.* at 1274.

64. *Id.*at 1272.

65. Strine, *supra* note 39, at 1079 (stating that if adopted in its original form, proxy access, essentially would have allowed institutional investors meeting certain criteria to nominate director candidates and have these candidate's names appear on the company's proxy card).

66. *Id.* at 1092.

67. Rule 14a-8 is part of the federal regulation scheme promulgated under the 1934 Securities Exchange Act governing the solicitation of proxies. Specifically, Rule 14a-8 addresses when a company must include a shareholder's proposal in its proxy statement for an annual or special shareholder's meeting.

68. Strine, *supra* note 39, at 1085.

69. *Id.* at 1085.

success of the company.[70] As the portfolios of institutional investors have grown, institutional investors have become increasingly unable to adequately assess the business performance of each company in their portfolio.[71] Therefore, the market price of a given company's stock has become one of the most important valuation measures for the company. Thus, any action which boosts the short-term price of the company's stock is viewed as desirable.[72] Institutional investors assess corporate performance over a short time frame, usually on a quarterly or yearly basis.[73] Therefore, an investment manager who is trying to outperform the market average in each quarter or year will always have an incentive to accept or even seek a short-term premium for a portfolio's shares.[74] Under the efficient capital markets theory, the short-term price of a stock arguably reflects the present value of the corporation's long-term results.[75] Adherents to this theory would thus argue that there is no distinction between short and long-term investor orientations.[76] However, recent events have drastically undermined the efficient markets theory. The large drops and gains in the market over the past few months illustrate the fact that the market price of a stock does not necessarily reflect its underlying value. As a result of the inherent short-term bias of institutional investors, it is unlikely that increasing the rights of institutional investors will result in a greater focus on the long-term health and value of the corporation.

VII.
"SAY ON PAY"

Another proposal to increase shareholder rights, which has been presented to Congress, has been termed "say on pay" legislation. The "say on pay" proposal requires that at each an-

70. Lipton & Rosenblum, *supra* note 16, at 206.
71. *Id.*
72. *Id.* at 206 (describing why institutional investors have little incentive or inclination to work actively towards the long-term operating success of the corporation.
73. *Id.*
74. *Id.* at 206-07.
75. *Id.* at 208.
76. *Id.* (describing how the influence of the efficient capital markets theory, has affected the academic literature on investor short-term bias, causing the academic literature to often ignore the problem).

nual meeting of a public company a non-binding shareholder vote must be held to approve the corporate executives' compensation packages. Any proxy statement soliciting a vote on a merger, acquisition, or sale of substantially all assets of a company must also contain a non-binding vote on "golden parachute" compensation for affected executives.[77] However, while this legislation has passed the House of Representative with bipartisan support, the bill has yet to progress in the Senate.[78] Although executive compensation is certainly in need of reform, this proposal does not incentivize directors to invest in long-term improvement projects that may not exhibit immediate gains in stock price. Nor does it prevent directors from engaging in behavior that may increase stock prices in the short-term, but will diminish the value and health of the company in the long-term. Because these resolutions are non-binding and occur at least yearly, executives will, at most, be incentivized to work to raise stock prices in the months leading up to the annual meeting. Thus, the resolution may incentivize directors to engage in behavior that may temporarily raise stock value, while simultaneously creating long-term risks for the company. These short-term gimmicks will not create long-term stability in the company.

VIII.
INSULATING MANAGEMENT

While the majority of literature on reforming the corporate governance system has focused on increasing shareholder rights, a minority of writing, including this paper, has looked at ways to reform corporate governance to promote the long-term health and value of the company.[79] Much of this writing has focused on ways to insulate management in order to give them the opportunity to invest in the company through research and development.[80] Such decisions may be unpopular because of their substantial short-term costs yet they may ultimately enhance the value of the company.

One such proposal has been outlined by Martin Lipton and Steven Rosenblum, in their paper, "A New System of Cor-

77. Strine, *supra* note 39, at 1103.
78. *Id.*
79. Lipton & Rosenblum, *supra* note 16.
80. *Id.*

porate Governance: The Quinquennnial Election of Directors."[81] Under the quinquennial election system, stockholders elect directors for five-year terms.[82] With regard to directors seeking re-election, shareholders would base their vote on a detailed report of the company's performance for the past five years and its strategic plan for the coming five years, together with industry averages and other relevant data.[83] Stockholders would also receive a detailed independent evaluation of the corporation's performance and projections put together by an accounting firm or an investment bank.[84] In addition, the corporation's five-year performance, including its success in meeting its five-year plan, would serve as the sole basis for executive compensation.[85] Under this regime, the shareholders' ability to effect changes in corporate control would be severely limited during the five years between elections.

While such a system would certainly addresses directors' need to make unpopular decisions that may decrease capital in the short-term but increase the long-term value of the corporation, it fails to provide adequate monitoring of the board. In particular, nothing in this plan addresses the problem of CEO-dominance. CEOs and management may still have incentives to take risks that increase earnings in the short-term, but risk the long-term health of the corporation, especially in the months or year immediately preceding the quinquennial election. In order to craft an effective corporate governance system that will successfully promote the long-term health and value of corporations, it is necessary to find a system that balances giving directors the ability to invest in long-term improvements that may not create immediate benefits for shareholders, while still addressing the need for effective risk management. While unsatisfying as a whole, one aspect of Lipton and Rosenblum's system—reforming executive compensation—offers a promising vehicle to incentivize directors to focus on the long-term health and value of their companies.

81. *Id.*

82. *Id.* at 225.

83. *Id.*

84. *Id.* at 233-236.

85. *Id.* at 227.

IX

ALTERNATIVE EXECUTIVE COMPENSATION STRUCTURE

One of the strongest elements of the quinquennial election proposal is its executive compensation component. The serious defects in many companies' executive compensation structure are critical in enabling the CEO to dominate a passive board of directors. There are a variety of ways in which CEOs can benefit individual directors or board members as a group.[86] As the leader of the company and a board member (often the chairman of the board), the CEO has the power either to discourage or to encourage director pay increases. Independent directors who are generous to the CEO can reasonably expect the CEO to use his or her power to support higher director compensation.[87] In fact, a recent study has shown that companies with higher CEO compensation also have higher director compensation and that such high pay levels appear to reflect insider "cooperation" rather than actual superior corporate performance.[88] In addition, because there is no limit to the amount of money that a CEO can have the company pay an independent director's immediate family members, as long as the family member is a non-executive employee of the company, the CEO may reward an accommodating director under such a pretext.[89] Compensation schemes can also lead to distortion in corporate disclosures. Pay is often tied to reported earnings, and many managers and executives choose accounting principles that increase reported earnings instead of other preferred goals.[90] This ability to increase compensation by increasing earnings in the short-term provides executives with incentives to inflate short-term earnings at the expense of long-term value.

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86. Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 30 J. Corp. L. 647, 656 (2005) (describing the power that CEO's have to benefit directors).

87. *Id.* at 656.

88. Ivan E. Brick, Oded Palmon & John K. Wald, *CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism*, 12 J. Corp. Fin. (2005).

89. Bebchuk & Fried, *supra* note 86, at 656.

90. Dent, *supra* note 1 at 1246 (noting that executive pay is often tied to reported earnings, and many managers choose accounting methods that increase reported earnings instead of maximizing share price).

Furthermore, CEO and director pay is often not tied to corporate performance. In fact, one recent study even found a negative correlation between executive compensation and performance in firms with no large shareholders.[91] The best evidence of the disconnect between corporate performance and executive compensation is the fact that executive compensation packages have rapidly increased in size in the years leading up to the current economic crisis. Executives were being paid increasingly large amounts of money as they made corporate decisions that directly led to the greatest economic crisis since the Great Depression.[92] President Obama has recently responded to public outrage over the large compensation packages paid to executives at financial institutions receiving tax payer money as part of the Troubled Asset Relief Program ("TARP").[93] In the executive compensation requirements set forth in the Emergency Economic Stabilization Act ("EESA") Section 111(b), financial institutions receiving TARP funds cannot claim tax deductions for senior executive officers' compensation that exceeds $500,000.[94] However, this provision only applies to financial institutions receiving TARP funds and is only effective as long as TARP remains in effect.[95] Thus, a more permanent and expansive reform of the executive compensation structure is required to create a corporate governance system that can effectively promote the long-term value of a corporation.

Two elements are necessary for successful compensation reform. Compensation must be tied more effectively to corpo-

91. *See* Robert Daines et al., *The Good, the Bad, and the Lucky: CEO Pay and Skill* 17 (N.Y.U. Law & Econ. Research Paper Series, Working Paper No. 04-035, 2005), available at http://ssrn.com/abstract=622223.

92. *See* Ben White, *On Wall Street, Bonuses, Not Profits Were Real*, New York Times, Dec. 17, 2008 (describing how in the past few years many on Wall Street ignored or played down the risks they were taking in order to collect larger bonuses).

93. Greg Gordon, *Executive Compensation Limits for Financial Institutions Participating in the Troubled Asset Recovery Program*, 1710 PLI/CORP 903, 905-06 (2009).

94. The text of the Emergency Economic Stabilization Act of 2008 (Pub. L. No. 110-343 122 Stat 3766 (2008), Treasury's Interim Final Rule (73 FR 62205, Oct. 20, 2008) implementing the compensation provisions of EESA and related guidance issued by Treasury an Internal Revenue Service may be found at http://www.ustreas.gov/initiatives/eesa/.

95. Greg Gordon, *supra* note 93, at 905-06.

rate performance and executives and directors must be rewarded not for short-term results, but only for improvements that are sustained over a long period of time.[96] Combining a version of the "say on pay" legislation with a mandate that director and executive compensation be predominantly composed of slowly vesting stock options will incentivize directors and executives to focus on the long-term health of their corporations. This plan will also increase the equity stake that executives have in the companies they manage, improve transparency in the compensation process, and reward executive performance that increases corporate value. Specifically, at least 50 percent of director and executive compensation should be composed of stock options that do not vest for a period of at least one year and then vest slowly over time. Additionally an informed vote of a majority of outstanding shareholders should be required to approve all director and executive compensation packages.[97] A dollar amount can be determined for stock options by looking at the fair market value of the options when they are distributed. Pricing the options this way will help to filter out some of the gains in the stock price that result from general market or industry movement rather than any actual value added to the company by its executives and directors.[98] Valuing the options based on their current market value will achieve this goal because if the market expects the industry or market to trend upward, it will value the option at a higher price, thereby mitigating any gains the company's stock price ends up achieving based on overall market or industry movement. Compensation through stock options provides the most promising way of incentivizing executives

96. *See* White *supra* note 92 (describing the contention that the current Wall Street pay structure, in which bonuses are based on short-term profits, encouraged employees to act like gamblers at a casino and let them collect their winnings in the form of bonuses while the roulette wheel was still spinning).

97. I have chosen to recommend that 50 percent of overall pay be comprised of deferred stock options because 50 percent constitutes a substantial percentage of overall compensation. It is necessary that the percentage of compensation that is deferred is substantial to incentive directors to focus on the long term value of the company. Therefore 50 percent seems to be a reasonable amount.

98. *See* Bebchuk & Fried, *supra* note 86, at 669 (arguing that bonus plans should not be based on absolute increases in earnings, sales and revenue, but rather on such increases relative to peer companies).

and directors to focus on the long-term value of the company. However, it is necessary that these plans be crafted so that executives and directors can maximize their own rewards by promoting their company's health over the long-term. This goal can be achieved by making equity compensation a substantial part of every executive and director compensation package and then requiring that equity compensation pay out slowly over time, so that management is incentivized to promote policies that will create sustainable value for the company in the long-term.

The entire compensation package, including the remaining 50 percent (or less) of non-equity compensation should then be approved by a binding vote of the majority of all outstanding shareholders at each annual meeting. It is important that shareholders have adequate information on the proposed compensation packages so that they may make an informed decision. The amount of non-equity compensation presented to shareholders for their approval must include all forms of compensation,[99] and shareholders must be given a detailed list of the contents of the compensation package. This will create more transparency in the compensation process, and will help to prevent the practice of "stealth compensation" wherein directors and executives receive additional compensation in the form of pensions, deferred compensation, post-retirement perks, and consulting contracts.[100] Before voting, shareholders should also receive a report on the percentage of the company's profits from the prior year that are attributable to general market and industry movement, rather than actual value added to the company by its current management.[101] This can be done by requiring firms to create a comprehensive report for shareholders comparing the company's stock performance

99. Examples of non-equity compensation include annual salary, pensions, post-retirement perks, use of corporate assets, such as jets and properties and consulting contracts.

100. Bebchuk & Fried, *supra* note 86, at 668 (describing the problem of "stealth compensation," which is benefits that companies are not required to place a dollar amount on, nor are they required to include this value in the summary tables that receive the most attention from investors and the media).

101. *Id.* at 668. (arguing that companies should disclose the extent to which the company's equity-base plans reward managers for good performance relative to industry peers).

over the past two years to its industry peers. This will allow shareholders to see how well their company is doing in relation to other companies in the industry. If the company is outperforming its industry peers, then it is more likely that the company's performance is the result of value added by executives. However, if the company is performing only as well as the median or below-average companies in the industry, this will reflect poorly on executive performance. Such information will help shareholders separate general industry gains from actual value added by executives and more accurately reward executives for their performance. If shareholders are provided with all this recommended information, they should be able to make an informed vote and ensure that the non-equity portion of executive compensation is actually reflective of executive performance. Additionally, the short-term bias of shareholders should not affect shareholders' ability to vote on executive compensation packages that promote the long-term health of the company because at least half of a company's compensation package will be comprised of stock options that vest slowly over time. Therefore, any compensation package that shareholders approve will be structured in such a way that it will incentivize directors and executives to focus on the long-term health and value of the company.

Overall, this proposed compensation structure adds more transparency to the compensation process and increases the equity stake that executives have in the corporations they manage. Moreover, giving shareholders the final say in what compensation each executive and director receives, also weakens the ability of CEOs to use their power over compensation to influence other board members. Finally, and most importantly, this plan reforms the current incentive structure, which rewards executives for short-term gains at the possible expense of the long-term health of the company. By deferring a substantial amount of executive and director compensation for at least one year, this plan both rewards executives and directors who make investments in the future of the company and discourages decisions that may result in substantial short-term gains, but which are unnecessarily risky for the long-term health of the company.

Realistically, it is not possible to mandate a definitive limit on the amount of compensation that directors and executives can receive. Critics of this plan may argue that executives will simply use their influence to create compensation packages that are even larger than they are now, to ensure that their yearly guaranteed pay is not substantially reduced. However, in deciding whether or not to approve any compensation package, shareholders will be presented with the total amount of compensation that each executive will be receiving, and will have the power to veto any compensation package which they consider unreasonably large. As described above, shareholders will be provided with information on the company's performance in comparison to its industry peers, as well as information on the total amount of compensation each executive will receive. With this information shareholders will be able to determine whether a compensation package seems to accurately reward the value that the executives have added to the corporation. If they find the package too large in relation to the executives' performance, shareholders can veto the package.

Critics may also argue that because the equity portion of compensation will vest over time, an executive or a director who leaves the company will be compensated based on the work of his or her successor, rather than his or her own merits. However, an executive, who during his or her tenure, invests in corporate improvements, which continue to enhance the health and value of the company over time, should continue to reap the benefits of his decisions even if he has left the company. Also, many executives who leave a company either do so because they are moving to a more profitable position or because they are removed for substandard work. If a high performing executive is tempted to leave for a more profitable position, he or she may actually be incentivized to stay at their current company in order to reap the full benefit of their stock options. Conversely, when executives depart due to poor work product, it is unlikely that they deserve higher compensation in the future, so there is little downside in giving them a substantial part of their compensation in the form of stock options that vest over time.

Finally, any reform of executive compensation must confront the argument that companies, which are restricted in their ability to pay executives, will lose top executives or have trouble attracting executive talent.[102] However, if all public companies are subject to these restrictions, no company will be advantaged or disadvantaged in the competition for top executives. Additionally, this plan does not necessarily limit the amount of executive compensation available to top executives, but rather ties long-term corporate performance to executive and director compensation more closely. Executives and directors who effectively promote the long-term health and value of their companies will still be very well compensated.

X.
Employee Role in Monitoring the Board

The addition of employee representatives to the board of directors is yet another corporate governance reform that has been proposed to strengthen the long-term stability of corporations.[103] In some countries, employees play a much greater role in the governance of their corporations.[104] Specifically, in Germany corporations are governed by a co-determination system in which there is a two-tier board and employees elect a percentage of the directors on the supervisory board.[105] While this system has been criticized for inhibiting growth in the capital markets,[106] a small number of academics in the United States, such as Brett McDonnell, have proposed that U.S. corporations should also be encouraged to allow employee representation on their boards.[107] The incentives governing em-

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102. *See* Gordon, *supra* note 93, at 911 (addressing the concern that companies which comply with the compensation restrictions of the EESA will be less attractive to employees and will have trouble attracting executive talent).

103. McDonnell, supra note 40.

104. Alissa Mickels, *Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Profit Corporation With Director Fiduciary Duties in the U.S. and Europe,* 32 Hastings Int'l & Comp. L. Rev. 271, 292 (2009).

105. *Id.* (describing German corporate governance law which requires that all stock corporations and business entities over a certain employee base have a two-tiered board that includes a significant employee representation on the supervisory board; the supervisory board then appoints the management board, which is responsible for the company's daily operations).

106. Alan Dignam & Michael Galanis, *Corporate Governance and the Importance of Macroeconomic Context,* 28 Oxford J. Legal Stud. 201, 202 (2008) (discussing the criticism of Germany's corporate governance system).

107. McDonnell, supra note 40, at 380 (suggesting that governments should provide positive incentives to businesses that have employee board representatives).

ployee action and the wealth of information that employees possess provide the basis for the strongest arguments in favor of allowing employee representation on the board. It can be argued that employees have a greater interest in the long-term health and value of a corporation than any of its other stakeholders. Like shareholders, employees have claims against the corporation that become more valuable if the corporation does well. When the corporation does well, employees' pensions are safer and their jobs are more secure; in many ways, this gives employees a stronger incentive to work for the long-term health and value of the corporation than a shareholder. Once the stock price rises, even if the gain is only for the short-term, shareholders can sell their shares for a profit, eliminating any interest they had in the future of the company. On the other hand, employees, especially those who receive part of their compensation through profit-sharing or stock options, have a great interest in the future of their employer. Also, shareholders often have diversified investment portfolios, whereas employees cannot diversify their jobs; thus, they are even more invested in the long-term success of the company than shareholders with a variety of investments.[108]

The other advantage that employees have over shareholders is that they have greater access to information.[109] Through their daily exposure to their employer's business, employees naturally know more about the business through their jobs. They know much more about the company than absentee shareholders.[110] Moreover, employees are naturally motivated to use their corporate information to improve the company, and thus, be rewarded for performing their jobs well. Therefore, it would seem that employees, as informed and motivated corporate stakeholders, are well situated to act as a check on management.[111] However, this informational advantage has its ambiguities. Employees in a large corporation may know a great deal about their own department but much less about the kind of financial and strategic issues that the board of directors must focus on. One possible solution to this problem is

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108. *Id.* at 355.

109. *Id.*

110. *Id.*

111. *Id.* at 355 (arguing that if we are looking for informed and motivated participants to act as a check on managers, employees may be a natural choice).

to limit board participation to employees in management positions. Managers, in particular, are at an informational advantage over shareholders, and their knowledge is more likely to encompass the types of issues that typically confront the board.

However, there is another major weakness of the employee representation plan that continues to exist even if employee representation is limited to management. The strength of employee motivation and knowledge can be a mixed blessing.[112] Insofar as employees are motivated to use their knowledge to support actions that promote the long-term health and value of the company, all company stakeholders will benefit. However, if employees are motivated to advocate ideas that benefit them personally at the expense of others, employee participation can lead to problems.[113] For example, an employee may be motivated to divert resources to his or her own department at the expense of other departments. Moreover, employee board representatives may still fall prey to the problem of CEO-dominance. Furthermore, employees may be especially incentivized to cooperate with the CEO since they may feel that their position as an employee at the company is at stake. While it is never pleasant to be the lone dissenting board member, employee board members may find it even more disagreeable, since they will have to challenge not only the other directors, but also their boss, the CEO. There is also no reason to think that employee board representatives will be any less likely to get caught up in the "group think" that currently plagues many boards.[114] As such, it does not seem that employee board representation will necessarily combat the problem of board passivity and CEO dominance. There are also several practical problems with implementing employee board representation. Specifically, there are currently no laws in support of companies that adopt this new structure, and creditors may be reluctant to lend money to companies with this unfamiliar structure. Overall, implementing employee board representation does not seem to be the most effective

112. *Id.* at 356 (conceding that the advantage of employee motivation and knowledge has its ambiguities).

113. *Id.* (acknowledging that botched attempts at participation can backfire, and employees who feel that their employer does not really care about or listen to their input can grow resentful and counter-productive).

114. Dent, *supra* note 1, at 1241-42 (stating that the problem of "group think" pervades most boards).

way to reform the current problems with the corporate governance system. Creditors, on the other hand, also have strong incentives to promote the long-term health of the company, and they may be in a better position to ensure that the board is implementing effective risk-management strategies and is acting in the best long-term interest of the company.

XI.
Creditor Role in Monitoring the Board

Like shareholders and employees, creditors are invested in the long-term health and value of their corporate debtors; like shareholders, creditors invest funds in the company.[115] Thus, creditors have a fundamental interest in the ongoing success of their corporate debtors.[116] In fact, there are many functional and financial similarities between equity and creditor corporate relationships. Both relationships involve an investment of capital and both entail the possibility of loss and the possibility of gain. Thus, the fundamental risk in each relationship is essentially the same: both the shareholder and the unsecured creditor stand to lose their entire investment if the debtor suffers financial distress or becomes insolvent.[117] It is also possible for both equity shareholders and creditors to decrease their exposure to risk. For example, creditors can use secured lending arrangements, contractual priority agreements, or adjustable maturity terms to decrease their risk, and equity holders can decrease their risk exposure through generous dividend payments.[118]

It is true that, in theory, the potential gains from an equity investment can be very different than the gains from a debt investment. Generally, creditors expect to earn a rate of interest, while shareholders hope to profit from an increase in the value of their shares and may expect additional payments through dividends, as well.[119] Thus, some corporate action,

115. Adam Feibelman, *Commercial Lending and the Separation of Banking and Commerce*, 75 U. Cin. L. Rev. 943, 946 (2007).
116. *Id.* at 949.
117. *Id.* 948. (describing how the practical differences between debt and equity relationships are often over-emphasized).
118. *Id.* at 948.
119. Feibelman, *supra* note 115, at 948 (explaining the basic differences between equity and debt investments).

such as pursuing risky positive-value projects, may potentially reduce the value of a debt holding but increase the value of an equity holding.[120] However, in practice the differences in expected gains between equity and debt investments are less than is conventionally assumed.[121] Both types of investors can expect some indirect gains from their investments, in particular, the opportunity for future investments.[122] Additionally, a creditor who has extended a revolving line of credit, or wants to derive other fee income or provide other services to the company, is strongly invested in the ongoing health and value of their corporate debt. Furthermore, even though the return for an equity investor is theoretically unlimited, in reality, the actual expected gain is much more modest.[123] Given the functional similarities between equity and debt investments, it follows that creditors, like shareholders, have a strong interest in monitoring the management and directors of their corporate debtors. In particular, creditors want their loans repaid in full (with interest), or they want to be able to sell their debt for present value.[124] They want to ensure that nothing is done to threaten the value of their investment.

Creditors are strongly motivated and well-situated to monitor the boards of their debtor corporations. For example, lenders can insist that borrowers provide a significant amount of information about their assets, liability and operations before extending credit. As a condition of extending credit, lenders can require that they are informed of any significant events or transactions, and they can require subsequent, ongoing disclosures.[125] They can also structure credit to revolve or turn over with relatively short maturities giving the lender the opportunity to require updated information before extending any new credit. Furthermore, once a creditor has extended credit to a corporation, there is much that creditors can observe about the health of a firm in the course of their dealings. For example, creditors will know if a firm is having trouble

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120. *Id.*

121. *See id.* (explaining the functional similarities between equity and debt investments).

122. *Id.* at 948-49.

123. *Id.* at 949 (noting the historical average return on equity investments is not dramatically higher than the expected gains for a lender).

124. *Id.* at 944.

125. *Id.* at 950.

meeting a fixed obligation, or if the firm is late in making a payment, or if the firm does not have enough liquidity readily available.[126] Just as creditors can negotiate for information, they can also negotiate for the power to directly influence the behavior of their corporate debtor.[127] For example, creditors can contract for the power to approve or veto major corporate decisions, such as whether to sell a division or replace the managers.

Creditors should be incentivized to use the tools that are already available to them to assume a greater role in monitoring the boards of their corporate debtors. If creditors play a larger role in corporate governance, it will increase the long-term health of the company. First, the more creditors feel they are able to monitor and engage in governance, the less risky their investment will seem. This decrease in risk will be priced into the cost of the loan, providing companies with lower-cost loans.

Second, as mentioned above, creditors are uniquely positioned to demand important corporate information from their debtors—information that may not be easily available to either the average shareholder or the average employee.[128] Creditors also have the power to contract for a level of influence that is not available to shareholders or employees. Creditors should use this power to influence managers and directors in implementing more effective risk-management procedures that will protect the long-term health and value of the company. The current economic crisis clearly illustrates that even seemingly strong companies, such as Lehman Brothers and Bear Stearns, can actually be on the brink of collapse.

Third, creditors do not suffer from the short-term bias that plagues shareholders. Creditors almost always want to have a continuing future relationship with the company and its affiliates. They may also want to derive other fee income or provide additional services to the company and its affiliates in the future. Additionally, in order for a creditor to maximize its profit on a corporate loan, it is in the creditor's interest that the corporate debtor remain healthy for the long-term, so that

126. *Id.* (describing ways that creditors can monitor the performance of their debtors and respond to help correct problems that they identify).
127. *Id.* at 951.
128. *Id.* at 950.

it can continue paying both the interest and the principal of the loan. As a result, creditors are strongly invested in the long-term health and value of their corporate debt. Therefore it is in the best interest of all stakeholders, including creditors, shareholders and employees, that creditors use their unique position to take a more active role in monitoring their corporate debtors.

One potential way for creditors to become more involved in corporate governance is to allow a group of a company's largest creditors to nominate a minority number of directors to the board. This strategy may be implemented by providing positive incentives, such as subsidies or tax breaks to businesses that have creditor board representation. As stated at the beginning of this note, two of the leading causes of director apathy (and the resulting CEO dominance) are an informational disadvantage and a lack of incentive to challenge the CEO. However, creditors, have both the ability to require significant and ongoing disclosures about the assets and liabilities of the company and the incentive to challenge the CEO in the interest of enhancing the long-term health and value of the company. In particular, creditors can play an important role in ensuring that boards implement effective risk-management procedures. Additionally, giving creditors a board representative can lower the cost of borrowing money for companies with board representation because creditors will price the risk that the company will default on the loan at a lower rate if they know that there is a creditor representative on the company's board.

One potential criticism of allowing creditors board representation is that creditors are more risk-averse than shareholders would typically want a board member to be. It can be argued that a creditor only needs the company to survive, not necessarily to flourish, so the creditor board representative will always champion the least risky corporate actions and attempt to block any risky plans that if successful may actually be very beneficial for the long-term health of the company. However, it is actually in a creditor's best interest that their debtors continue to grow and flourish. Creditors almost always want to have a continuing relationship with the company and its affiliates and may also want to provide additional services to the company and its affiliates in the future.[129] More importantly, if the creditor group only nominates a minority number of board members, the creditor representative or representatives will not be able to unilaterally block any corporate actions. However, this means that another potential criticism of this strategy is that a minority creditor board representation will have no significant effect on the board's behavior. There is a chance that the non-creditor directors, led by the CEO, will simply ignore the creditor representatives' arguments and will continue to allow the CEO to dominate any board decisions. However, if the addition of creditor representation to the board is implemented in concurrence with the executive compensation reform discussed earlier in this paper, then this fear is unlikely to materialize. This combination of reforms can effectively realign director incentives and combat the problem of board passivity to promote the long-term value of U.S. corporations.

XII.
A Recommendation for Corporate Governance Reform: Creditor Board Representation Combined with Executive Compensation Reform

After examining a variety of different corporate governance reform proposals, the most effective proposal is a combination of executive compensation reform and creating a greater role for creditors in the corporate governance structure. As an initial matter, it is important to note that this proposal is intended solely for large, well-established, public companies, such as those in the S&P 500.[130] Specifically, half of all

129. Feibelman, *supra* note 115, at 948-49 (noting that creditors expect some indirect gains from their investment, including the benefit of future relationships with the debtor and its affiliates).

130. I am only recommending this proposal for large, well-established, public companies because the overarching goal of my proposed reforms is to promote the long-term health and value of companies in order to create stability in the economy as a whole, and the stability of smaller or newly formed companies cannot jeopardize the overall stability of the economy in the same way that larger, more established companies can. Additionally, in the bourgeoning states of these small companies, creditor representation and uncertain compensation packages may unduly hamper the ability of these corporations to attract talent or grow. Larger, more established companies do not face these same problems.

executive compensation should be composed of stock options that will not begin to vest for at least one year and then vest slowly over time. Additionally, an informed vote of a majority of outstanding shareholders should be required to approve all director and executive compensation packages. This change in the executive and director compensation structure will more closely align director and executive incentives with the long-term performance of their companies. Additionally, CEOs will lose much of their power to influence director compensation. The addition of creditor board representation will also help to combat the problem of board passivity by providing a director or directors who are willing to play the role of dissenter. This will help to overcome the problem of "group think" that currently dominates many corporate boards; making CEO dominance much less likely.[131] The addition of a director compensation structure that incentivizes directors to focus on long-term corporate performance will incentivize the other non-creditor directors to carefully examine any challenges the creditor representation makes to a CEO recommendation in order to determine what is in the best interest of the long-term value of the company. In particular, a creditor board representative can play an integral role in ensuring that the board implements an effective risk-management strategy. With effective risk-management procedures in place, companies are better able to take strategic risks that create and preserve corporate value for the long-term.[132] Therefore, the combination of executive compensation reform and the greater involvement of creditors in corporate governance can help boards to implement successful risk management procedures and prevent the short-term interests of CEO's from dominating the director decision-making process.

131. Choi *supra* note 8 at 124. (noting that "when individuals in a group work toward a particular goal, they may come under the influence of groupthink. Under groupthink, individuals may think less about the actions of the group, instead adopting the goals and methods of the group uncritically.").

132. Henry J. Istuccia, (partner at Deloitte) speaking at the NYU JLB Symposium on Feb. 20, 2009 (stating that effective risk management procedures are necessary to facilitate strategic risks that will actually create and preserve corporate value).

XIII.
CONCLUSION

The current environment presents an important opportunity for reform. This economic crisis has exposed the potentially disastrous consequences of aligning CEO compensation incentives with short-term gains while ignoring the long-term consequences. This problem has been compounded by the passivity of boards who simply acquiesce to the CEO's requests. It is clear that the corporate governance structure must be reformed in order to realign incentives in favor of the long-term health and value of the company. While the majority of proposals for corporate governance reform have focused on increasing shareholder rights, I believe this to be too narrow an approach to effectuate significant change. We must develop a corporate governance system that allows directors to make investments in research and development, which will create long-term value for the company, while still effectively managing corporate risk to prevent unnecessary risks that create short-term gains at the expense of long-term performance. After examining a variety of different corporate governance reform proposals, the most effective proposal is a combination of executive compensation reform, and a greater role for creditors in the corporate governance structure. This combination does much to realign director incentives and to combat the problem of board passivity. It is important that future proposals for corporate governance reform do not automatically assume that increasing shareholder rights will necessarily benefit the long-term health and value of corporations. Instead, any reform must focus on realigning director and executive incentives to focus on the long-term health and value of their companies. The reform proposed in this paper is one suggestion to achieve that goal.