LESSONS FROM THE SUBPRIME DEBACLE: STRESS TESTING CEO AUTONOMY

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INTRODUCTION

Corporate governance in the United States played a central role[1] in the historic subprime debacle now gripping the global economy.[2] According to Nobel Laureate Joseph Stiglitz, American CEOs run corporations as a "personal feifdom, not for the shareholders, but for their own benefit."[3] He

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1. While this article focuses on one factor of the subprime mortgage crisis—corporate governance—in reality, a complex set of factors triggered and exacerbated the subprime mortgage crisis. *See, e.g.*, Melissa B. Jacoby, *Home Ownership Risk Beyond a Subprime Crisis: The Role of Delinquency Management*, 76 FORDHAM L. REV. 2261, 2295 (2008) (arguing that the subprime mortgage crisis shows the need for a delinquency management regime as part of a unified housing policy); Steven L. Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373, 404 (2008) (arguing that conflicts, complacency and complexity each played a significant role in the subprime crisis and that these factors can be addressed through financial regulation on only a limited basis); David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 1065 (2006) (arguing that rating agencies must be regulated to prevent them from facilitating the spread of subprime mortgages and predatory loans into global financial markets). More generally, scholars identify that "money-driven American political system" pervasively eroded important elements of regulatory infrastructure within the financial sector. Thomas Ferguson & Robert Johnson, *Too Big to Bail: The "Paulson Put" Presidential Politics, and the Global Financial Meltdown (Part I)*, 38 INT'L J. POL. ECON. 3, 6 (2009).

2. Richard Katz, *The Japan Fallacy: Today's U.S. Financial Crisis Is Not Like Tokyo's "Lost Decade*,*"* 88 FOREIGN AFF. Mar–Apr. 2009, at 9, 10, *available at* http://www.foreignaffairs.org/20090301facomment88202p10/richard-katz/the-japan-fallacy.html (stating that a major cause of the financial crisis was the failure of the federal government to regulate the system of CEO compensation—"a system that in its current form gives executives incentives to take outrageous risks with other people's money").

3. Interview by Neil Conan with Joseph Stiglitz, Professor, Columbia University, *Talk of the Nation: Economists Explain How to Save Capitalism*, (NPR radio broadcast Oct. 20, 2008), *available at* http://www.npr.org/templates/story/story.php?storyId=95906243.

claims that CEOs "reported high profits, gave big bonuses, big stock options, but in fact there were huge risks buried off-balance sheet and those chickens have now come home to roost."[4] Another Noble prize winning economist, Paul Krugman, states that "the subprime crisis and the credit crunch are, in an important sense, the result of our failure to effectively reform corporate governance after the last set of scandals."[5] These economists are hardly alone in their critique.[6] CEOs now exercise sufficient autonomy to devastate their firms through recognition of illusory profits and deferral (even burial) of lethal risks.[7] Given its staggering costs, the subprime crisis stands as the starkest indictment of our system of corporate governance.[8] The law is simply failing to contain agency costs in the U.S. public corporation.[9]

Even prior to the subprime fiasco, critiques of American corporate governance populated economic and finance literature.[10] High-profile legal

4. *Id.*

5. Paul Krugman, *Banks Gone Wild*, N.Y. TIMES, Nov. 23, 2007, at A37 (describing how the system of executive compensation encourages high-risk decision making).

6. *See, e.g.*, Rakesh Khurana & Nitin Nohria, *Management Needs to Become a Profession*, FIN. TIMES, Oct. 20, 2008, at 12, *available at* http://www.ft.com/cms/s/0/14c053b0-9e40-11dd-bdde-000077b07658.html (arguing that the financial crisis shows the need for professional standards for firm managers); Krishna Guha, *Fed Governor Urges Bankers Pay Reform*, FIN. TIMES, Feb. 26, 2008, http://www.ft.com/cms/s/0/5037f4c2-e40d-11dc-8799-0000779fd2ac.html (Federal Reserve Board Governor arguing that bankers' compensation encourages excessive risk).

7. James L. Bicksler, *The Subprime Mortgage Debacle and Its Linkages to Corporate Governance*, 5 INT'L J. DISCLOSURE & GOVERNANCE 295, 295 (2008) (showing that corporate governance failed to assure that CEO compensation was even "remotely" linked to performance).

8. The total cost of the subprime debacle is difficult to calculate. Nevertheless, as of this writing, the U.S. government has assumed $9.7 trillion in obligations in an effort to save the financial system. Mark Pittman & Bob Ivry, *U.S. Taxpayers Risk $9.7 Trillion on Bailout Programs*, BLOOMBERG.COM, Feb. 9, 2009, http://www.bloomberg.com/apps/news?pid=Washingtonstory&sid=aGq2B3XeGKok. Additionally, global equity markets suffered trillions more in losses associated with the subprime crisis. *See e.g.*, Press Release, Wilshire Associates, Dow Jones Wilshire 5000 Loses $6.9 Trillion in 2008: Worst Year Ever for Broad Market Index (Jan. 15, 2009), *available at* http://www.wilshire.com/Company/PressRoom/PressReleases/Article.html?article=WARelease091501.htm. Consequently, the subprime debacle amounts to a multi-trillion-dollar economic catastrophe.

9. This Article focuses on public corporation, traded on a national securities exchange and marked by dispersed ownership, rather than the private firm marked by concentrated ownership blocks. *See* Martin Gelter, *The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance*, 50 HARV. INT'L. L. J. 129, 130 (2009) (distinguishing between agency problems under dispersed ownership structures and hold-up problems arising from control exercised by concentrated shareholder ownership).

10. *See, e.g.*, D. QUINN MILLS, WHEEL, DEAL AND STEAL: DECEPTIVE ACCOUNTING, DECEITFUL CEOS, AND INEFFECTIVE REFORMS 183 (2003) ("CEOs have found a way to enormously increase their own wealth by a variety of means in a period in which shareholders have been losing their shirts . . . . [T]he core of the problem faced by investors today, as revealed by corporate scandals, is that investors must be better protected from CEOs."); Paul Gompers et

scholars joined these attacks.[11] I previously argued that corporate governance at public firms had devolved into CEO primacy,[12] and long warned that the current system would lead to financial instability,[13] historic macroeconomic disruptions,[14] and costly taxpayer bailouts of financial firms.[15] Sophisticated investors warned that corporate governance had undergone a "pathological mutation" away from shareholder capitalism and toward "managers' capitalism."[16] Persistent scandals, such as the failure of Enron and other high-profile firms in 2001–2002, suggested that CEOs simply exercised too much autonomy to line their pockets at the expense of shareholders and general

al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 145 (2003) (finding that potential gains from improvements in corporate governance "would be enormous"); Charles P. Himmelberg et al., *Investment, Protection, Ownership and the Cost of Capital* 38–39 (World Bank Policy Research, Working Paper No. 2834, 2002), *available at* http://ssrn.com/abstract=303969 (noting that "there is still substantial room for improvement in the design of the legal and regulatory environment for financial contracting and corporate governance" even in developed countries like the United States).

11. *See, e.g.*, LUCIAN A. BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFILLED PROMISE OF EXECUTIVE COMPENSATION 10 (2004) (stating that excessive compensation payments to CEOs result from excessive CEO power and impose costs beyond just the quantum of excessive payments, including costs associated with distorted incentives); Lisa M. Fairfax, *Spare the Rod, Spoil the Director? Revitalizing Directors' Fiduciary Duty Through Legal Liability*, 42 HOUS. L. REV. 393, 451 (2005) ("Enron suggests that the costs of eliminating [directors'] liability completely and thereby allowing corporate malfeasance to go unchecked are simply unacceptable."); Joel Seligman, *Rethinking Private Securities Litigation*, 73 U. CIN. L. REV. 95, 114 (2004) (stating that lax state fiduciary duties contributed to a "dramatic increase in the ratio of the compensation of the corporate CEO to that of the average corporate blue collar employee" from 42 to 1 in 1980 to 475 to 1 in 2000).

12. Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. ON REG. 313, 334 (2007) [hereinafter Ramirez, *The End of Corporate Governance Law*] ("CEO primacy is a direct outcome of the system of corporate governance law that devolved in the 1980s and 1990s into a dictatorship of management, by management, and for management.").

13. Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as well as the Frivolous*, 40 WM. & MARY L. REV. 1055, 1084 (1999) ("The . . . 'reforms' of private securities litigation are a betrayal of . . . the federal securities laws and expose our financial system to risks that are not fully appreciated. A more reactionary cycle could hardly have been imagined by the promulgators of the federal securities laws in the early 1930s.") [hereinafter Ramirez, *Arbitration and Reform*].

14. Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM. & MARY L. REV. 503, 561, 572–73 (2000) (stating that although the costs of lost investor confidence arising from lax securities laws and other corporate governance mechanisms may "come due only once a century, when they are paid, the viability of capitalism itself can be called into question").

15. Steven A. Ramirez, *The Chaos of 12 U.S.C. Section 1821(k): Congressional Subsidizing of Negligent Banks Directors and Officers?*, 65 FORDHAM L. REV. 625, 689 (1996) (predicting that dilution of the duty of care for bank directors would lead to more trillion-dollar bank bailouts and is "tantamount to telling taxpayers: 'Keep that checkbook open!'").

16. *See, e.g.*, JOHN C. BOGLE, THE BATTLE FOR THE SOUL OF CAPITALISM 28 (2005).

financial stability.[17] The options backdating scandals[18] suggested more reform was needed beyond the Sarbanes-Oxley Act of 2002 ("SOX").[19] Yet, the macroeconomic consequences of inferior corporate governance never before reached the staggering levels of lost output suffered beginning in 2007 and continuing through today.[20]

Global financial institutions now face a historic struggle to remain solvent.[21] The events of late 2008 illustrate the unprecedented magnitude of the problem. On September 7, 2008, the United States Treasury announced that the U.S. government was seizing control of Fannie Mae and Freddie Mac, two government sponsored entities that together guaranteed $5.4 trillion[22] in mortgage backed securities.[23] Secretary Paulson stated that if the government failed to take these steps, "great turmoil"[24] would follow in world financial

17. Douglas Guerrero, *The Root of Corporate Evil*, INTERNAL AUDITOR, Dec. 2004, at 37 (stating that with regard to the corporate failures of 2001–2002, "highly placed executives used their power . . . to achieve financial targets fraudulently, boost the stock price, and further enrich themselves via compensation schemes that rewarded those achievements").

18. *See* M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1601 (2007) (finding that backdated options at forty-eight sampled companies resulted in approximately $500,000 in extra compensation for executives while costing shareholders at each company $389 million in market capitalization). "Recent research has established that many executives exert both legal and illegal influence over their compensation." *Id.* at 1641. "[O]ur evidence suggests that managerial theft is not a zero-sum game, but involves huge dead-weight losses for the shareholders." *Id.*

19. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.).

20. The Congressional Budget Office is currently projecting a $2 trillion shortfall in GDP relative to potential GDP during 2009 and 2010, with no full recovery in sight until 2015. This would make the current contraction the most economically significant downturn since the Great Depression. *The State of the Economy and Issues in Developing an Effective Policy Response: Hearing Before the H. Comm. on the Budget*, 111th Cong. 1–2 (2009) (statement of Douglas W. Elmendorf, Director, Cong. Budget Office), *available at* http://www.cbo.gov/ftpdocs/99xx/doc9967/01-27-StateofEconomy_Testimony.pdf. Of course, it is impossible to determine the extent of losses exclusively attributable to flawed corporate governance.

21. Henry Meyer & Ayesha Daya, *Roubini Predicts U.S. Losses May Reach $3.6 Trillion*, BLOOMBERG.COM, Jan. 20, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aS0yBnMR3USk&refer=home (quoting New York University economist Nouriel Roubini that the U.S. banking system is "effectively insolvent").

22. Press Release, Fed. Hous. Fin. Agency, Statement of FHFA Director James B. Lockhart (Sept. 7, 2008), *available at* http://www.ft.com/cms/s/0/e30472a6-7e79-11dd-b1af-000077b07658,dwp_uuid=5db90a0e-4e6c-11dd-ba7c-000077b07658.html.

23. Press Release, U.S. Dep't of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://www.treas.gov/press/releases/hp1129.htm.

24. *Id.* In 2008, Fannie Mae and Freddie Mac accounted for nearly for 80% of the U.S. mortgage market. Press Release, Fed. Hous. Fin. Agency, Statement of FHFA Director James B. Lockhart (Sept. 7, 2008), *available at* http://www.treas.gov/press/releases/reports/fhfa_statement_090708hp1128.pdf.

markets.[25] On September 15, 2008, Lehman Brothers filed for bankruptcy, the largest ever.[26] This caused a virtual freeze in global credit markets and a destructive credit contraction.[27] On September 18, Treasury Secretary, Henry Paulson, and chairman of the Federal Reserve Board, Ben Bernanke, warned Congressional leaders of imminent economic meltdown without an immediate Wall Street bailout.[28] On October 4, 2008, the U.S. government committed to provide a $700 billion bailout of its largest banks—reflecting only a fraction of the likely total cost of saving insolvent banks.[29] These actions represent the most sweeping government interventions into the economy since the Great Depression.[30] Economist Nouriel Roubini of New York University noted the change: "Socialism is indeed alive and well in America; but this is socialism for the rich, the well connected and Wall Street. A socialism where profits are privatized and losses are socialized."[31] The costs of all these bailouts are not known, but the financial system as a whole has surely lost trillions.[32]

What is known is that the United States and the world are facing a major financial crisis and that it was triggered by home loans—subprime loans made to borrowers that really could not repay lenders.[33] The entire crisis has its

25. The takeover of Fannie and Freddie doubled the national debt. Krishna Guha et al., *Cost of US Loans Bail-Out Emerging*, FIN. TIMES, Sept. 9, 2008, http://www.ft.com/cms/s/0/e30472a6-7e79-11dd-b1af-000077b07658,dwp_uuid=5db90a0e-4e6c-11dd-ba7c-000077b07658.html.

26. Yalman Onaran & Christopher Scinta, *Lehman Files Biggest Bankruptcy After Suitors Balk (Update 1)*, BLOOMBERG.COM, Sept. 15, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=a6cDDYU5QYyw&refer=home.

27. David Goldman, *Credit Freeze: What Lehman Wrought*, CNNMONEY.COM, Nov. 16, 2008, http://money.cnn.com/2008/11/14/news/economy/two_months_since_lehman/index.htm.

28. Carl Hulse & David M. Herszenhorn, *Behind Closed Doors, Warnings of Calamity*, N.Y. TIMES, Sept. 20, 2008, at C5.

29. James Politi, *Global Financial Crisis: House Makes "Most of Bad Hand,"* FIN. TIMES, Oct. 4, 2008, at 2.

30. Deborah Solomon et al., *Mortgage Bailout Is Greeted with Relief, Fresh Questions*, WALL ST. J., Sept. 9, 2008, at A1.

31. Nouriel Roubini, *Comrades Bush, Paulson and Bernanke Welcome You to the USSRA (United Socialist State Republic of America)*, RGEMONITOR, Sept. 9, 2008, http://www.rgemonitor.com/roubini-monitor/253529/comrades_bush_paulson_and_bernanke_welcome_you_to_the_ussra_united_socialist_state_republic_of_america.

32. By late 2008, total worldwide losses from loans exceeded $1 trillion. Nancy Marshall-Genzer, *Marketplace: Global Bank Losses Total $1 Trillion* (American Public Media radio broadcast Dec. 18, 2008), *available at* http://marketplace.publicradio.org/display/web/2008/12/18/global_bank_losses/.

33. The subprime crisis is "[s]hocking because a pack of the highest-paid executives on the planet . . . managed to lose tens of billions of dollars on exotic instruments built on the shaky foundation of subprime mortgages." Shawn Tully, *Wall Street's Money Machine Breaks Down*, FORTUNE, Nov. 26, 2007, at 65 [hereinafter Tully, *Money Machine Breaks Down*]. The senseless subprime lending reached a fever pitch in 2007; less than one year later, loans originated in that year defaulted at a rate of 31.25%. Al Yoon, *US Prime Mortgage Defaults Worsen Faster than*

roots in such simple ideas that *Fortune* magazine ran a cover that asked, "What Were They Smoking?"[34] The financial turmoil sparked soaring unemployment, raising the specter of further mortgage defaults.[35] Economists suggested that as of late 2008, the government's prodigious effort to contain the catastrophe "seems to be failing."[36] By any measure, the subprime crisis has impaired the ability of world financial markets to channel capital to productive uses[37] and has cost the global economy trillions in forgone GDP.[38]

America's flawed system of corporate governance operated to allow CEOs to harvest huge compensation payments while offloading staggering risks upon their companies and the global economy generally.[39] Corporate governance in America simply continues to leave too much power in the hands of the CEO, and the subprime mortgage debacle empirically proves just how pernicious that can be.[40] The political power and wealth that CEOs control implies political

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Subprime, REUTERS, Aug. 22, 2008, http://www.reuters.com/article/marketsNews/idUSN2256391220080822.

34. *What Were They Smoking?*, FORTUNE, Nov. 26, 2007, at 66.

35. Sudeed Reddy & Kelly Evans, *Jobless Rate of 6.1% Fuels Economic Debate*, WALL ST. J., Sept 6–7, 2008, at A1, A4 ("[T]he job losses sparked concern that housing markets would continue to slide because more people would have trouble meeting mortgage payments . . . . [leading to a] 'negative feedback loop.'").

36. *See e.g.*, Paul Krugman, *The Power of De*, N.Y. TIMES, Sept. 8, 2008, at A23.

37. David Greenlaw et al., Leveraged Losses: Lessons from the Mortgage Market Meltdown (Feb. 29, 2008) (unpublished manuscript), *available at* http://www.chicagogsb.edu/usmpf/docs/usmpf2008confdraft.pdf (estimating total lost loan volume from subprime debacle to amount to $2 trillion, based upon an estimate of $900 billion in losses).

38. The IMF projects world GDP growth to be about 1.1 to 1.2% lower than 2007 in both 2008 and 2009; in a $60 trillion global economy that amounts to $1.2 trillion in forgone global output. INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK: HOUSING AND BUSINESS CYCLE 1–5 (Apr. 2008), http://www.imf.org/external/pubs/ft/weo/2008/01/ (calling the subprime debacle "the largest financial shock since the Great Depression"). More recently, the IMF projects essentially zero global growth, implying trillions more in forgone GDP. *Global Growth to Stall, IMF Says*, WASH. POST, Jan. 29, 2009, at D6 (growth is expected at 0.5% for 2009). The IMF also increased its estimate of total financial losses from the crisis to $2.2 trillion. *Id.*

39. A recent study of compensation for senior executives at Bear Stearns and Lehman Brothers found, for example, that while the top five executives at these firms pocketed billions from the sale of stock (as well as in salary) from 2000–2008, shareholders faced a total loss of investment. "As a result, the bottom line payoffs for these executives during 2000–2008 were not negative but decidedly positive." Lucian A. Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008*, YALE J. ON REG. (forthcoming 2010) (manuscript at 2), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1513522. Economists and other commentators suggest that flawed corporate governance contributed to the financial turbulence during the dotcom bubble and the lead-up to the Great Depression. ROY C. SMITH & INGO WALTER, GOVERNING THE MODERN CORPORATION: CAPITAL MARKETS, CORPORATE CONTROL, AND ECONOMIC PERFORMANCE 116–17 (2006).

40. I have argued that corporate governance in the United States was based upon CEO primacy, in that the law seemed to operate to place the interests of CEOs ahead of all other

distortions in the law of corporate governance, and today the world is paying the cost of the perverse incentives American corporate governance yields.[41] This Article posits that sound corporate governance must operate to stem CEO autonomy, even under conditions of financial stress. It further illustrates the means by which the legal infrastructure of American corporate governance could operate to prevent the kind of macroeconomic crisis that our nation now suffers through. The prime culprits in the subprime debacle are well known—a disproportionate amount of the losses can be traced to a handful of financial behemoths.[42] These financial behemoths include banks, insurance companies, thrifts, investment banks, and mortgage brokerages.[43] These companies transcend any one regulatory scheme, such as banking regulation or securities regulation—but they are all public companies listed in the United States, and as such, they all operated pursuant to American corporate governance standards.[44] State law primarily regulated some of these firms and federal

corporate constituents including the nominal firm owners—the shareholders. I also argued that the underlying political structure of corporate law needed to be reformulated to prevent serial crises spawned by flawed corporate governance. Ramirez, *The End of Corporate Governance Law*, *supra* note 12, at 358.

41. *Id.* ("At both the federal and state level, corporate governance outcomes seem best explained by special interest influence, accompanied by transient disruptions triggered by financial crises.").

42. For example, Merrill Lynch, Citigroup, and Washington Mutual accounted for $120 billion in asset write downs and losses. *Hall of Shame*, ECONOMIST, Aug. 9, 2008, at 71. Compare that with total write downs of over $500 billion, as of August 2008. Yalman Onaran, *Banks' Subprime Losses Top $500 Billion on Writedowns (Update1)*, BLOOMBERG.COM, Aug. 12, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=a8sW0n1Cs1tY#.

43. Citigroup is the nation's largest bank. Tully, *Money Machine Breaks Down*, *supra* note 33, at 66. Merrill Lynch is the nation's largest securities brokerage firm. David Ellis, *Merrill Lynch Reports $4.9 Billion Loss*, CNNMONEY.COM, July 17, 2008. http://money.cnn.com/2008/07/17/news/companies/merrill_lynch/index.htm?postversion=2008071716. Washington Mutual was the nation's largest thrift. Drew Desilver et al., *End of WaMu: Feds Seize Seattle Thrift in Nation's Largest Bank Failure*, SEATTLE TIMES, Sept. 26, 2008, at A1. The key point is that the full array of financial institutions played major roles in the subprime debacle, suggesting that the problem is broader than any single regulatory scheme, and instead pointing to the one regulatory element they had in common—American corporate governance for public companies.

44. All companies that are publicly traded in the United Sates are subject to the federal securities laws. *See* Ramirez, *Arbitration and Reform*, *supra* note 13, at 1060 n.13. Unfortunately, in the mid-1990s, Congress eviscerated private enforcement under the securities laws pursuant to the Private Securities Litigation Reform Act and the Securities Litigation Uniform Standards Act. *Id.* at 1080 ("[The PSLRA] is a further move toward the risky strategy of financial deregulation. The original conception of federal securities regulation—that the nation needed federal regulation to create more stringent standards of conduct than those prevailing under state law—seems to have been lost in the shuffle."). Similarly, virtually all American public companies have eliminated any duty of care liability for their putative prime managers—the board of directors. Steven A. Ramirez, *The Chaos of* Smith, 45 WASHBURN L.J. 343, 359–60

agencies regulated others.[45] Yet virtually every firm that played a major role in generating[46] the crisis looked to the uniquely American system of corporate federalism for its corporate governance standards.[47] Consequently, corporate governance at public firms must be a primary area of inquiry and reform.

Part I of this Article will assess the best existing evidence addressing the appropriate level of CEO autonomy; this necessarily requires weighing the need for unified leadership and strategic vision against potential agency costs arising from excessive CEO autonomy. Part II will test that model against the stress of the subprime debacle. It will show that our system of corporate governance failed that test and that a central problem of the subprime debacle involved excessive CEO autonomy to fatten profits (and therefore, compensation payments) without regard to the risk of future losses absorbed by firms.[48] Part III will explain the political origins underlying flawed corporate governance standards applicable to American public firms. Essentially, corporate governance relies too much upon state law to optimize corporate governance standards, and state law is inherently riddled with a political structure that distorts incentives for the states, especially Delaware, to appropriately contain agency costs through corporate governance law. Part IV

(2006) (arguing that allowing directors to be "infinitely careless" through the virtual abolition of the duty of care is a "dangerous source of macroeconomic instability").

45. For example, AIG was the world's largest insurer, and because the federal government does not regulate insurance, its primary business was regulated by states, particularly by New York. *The Causes and Effects of the AIG Bailout: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 2 (2008) [hereinafter *AIG Hearings*] (statement of Eric Dinallo, Superintendent, New York State Insurance Department), *available at* http://oversight.house.gov/documents/20081007100906.pdf.

46. Although the subprime frenzy was made in America, many firms across the world suffered losses. *See, e.g.*, *Hall of Shame*, *supra* note 42, at 71. For the most part, these firms were investors in subprime mortgages and were not involved in originating subprime mortgages. *See, e.g.*, *AIG Hearings*, *supra* note 45, at 3. This Article does not address possible flaws in the corporate governance standards of any nation other than the United States, or the possible distortions in such standards arising from similar political dynamics. *See* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 52 (2004) (attributing lack of scrutiny applicable to manager decisions transnational to concerns that too much liability could make managers overly risk averse). In light of the global subprime crisis, it would seem that risk averse managers are hardly a concern.

47. Corporate federalism refers to the blended authority of states and the federal government over questions of corporate governance. William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619, 624 (2006). Under the internal affairs doctrine, the state that charters the corporation supplies the substantive law defining the duties owed by managers and directors of corporations. *Id.* at 624–25. The federal government periodically intervened to preempt state law with national governance standards, most prominently through the promulgation of the federal securities laws. *Id.* at 620.

48. Tully, *Money Machine Breaks Down*, *supra* note 33, at 66 (stating that the "fee engine" became so compelling that firms booked the income without regard to long term losses).

will address the shortcomings in our system of corporate governance revealed in this Article, with specific suggestions for reconfiguring the board of directors to curtail CEO autonomy. Corporate governance law needs to actually reduce agency costs rather than endow CEOs with unfettered autonomy over their firms, and implementation of these changes will require further federal intervention.[49] The ultimate conclusion is that the subprime mortgage crisis could have easily been prevented or mitigated through sound corporate governance.

Excessive CEO autonomy is a multi-trillion dollar problem. The American system of corporate governance has failed yet again to appropriately contain agency costs in the context of the publicly held corporation. As University of Chicago Finance Professor Raghuram Rajan states, "Unless we fix incentives in the financial system we will get more risk than we bargain for."[50] In this instance, this excessive risk proved highly toxic to public firms as well as the global economy.[51] Unless the legal system responds to these lessons, the world will continue to suffer from serial macroeconomic crises, as it has been since the advent of CEO primacy in American corporate governance. This Article seeks to optimize corporate governance applicable to public firms in terms of CEO autonomy, based upon the best evidence regarding appropriate levels of CEO power, as tested in the cauldron of the subprime debacle.

I. THE PROBLEM OF CEO AUTONOMY

Most states do not require the centralization of operational power in any particular officer, much less one called a CEO. Delaware serves as the prime example.[52] Delaware dominates the market for chartering public corporations.[53] Moreover, the approach that Delaware takes to the statutory

49. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) ("[I]t is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint."). The problem of agency costs within the corporation has bedeviled shareholders and scholars from the very inception of corporate power; in fact, agency costs are inherent to the issuance of corporate equity. *Id.* at 312–13. Controlling agency costs is key to the economic basis of the public corporation. *See id.* at 357.

50. Raghuram Rajan, *Bankers' Pay Is Deeply Flawed*, FIN. TIMES, Jan. 8, 2008, at 11 (noting the incentives for CEOs and financial managers to tolerate excessive risks that increase short term returns in order to receive immediate compensation).

51. *Supra* note 42.

52. R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 4.010 (3d ed. Supp. 2009) (stating that under Delaware law, a corporation need not have any particular officers and could give its officers any title including czar or potentate).

53. Lawrence A. Hamermesh, *Panel Three: Sarbanes-Oxley Governance Issues: The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1749 n.1 (2006) (noting that Delaware charters 60% of the Fortune 500 firms).

framework governing the powers of CEOs is not atypical. Delaware simply vests the power to manage the corporation in the board of directors.[54] The board may delegate operational authority to any agent it deems fit and may give that agent any title it deems appropriate.[55] Beyond that cursory legal framework, Delaware corporate law does little to delimit CEO power.

Federal law also governs public firms and provides additional restraint on managers, beyond state corporate law. For example, in 2002, SOX imposed a new regime to govern the audit function that diminishes CEO influence.[56] Shortly thereafter, similar mechanisms emerged pursuant to the listing requirements of the national securities exchanges, particularly the NYSE and the NASDAQ, to enhance the independence of the board generally, and the nominating committee and compensation committee in particular.[57] These listing requirements furnish the SEC a means of influencing corporate governance standards because all listing requirements are subject to SEC approval.[58] This framework reflects the American system of corporate federalism that directs corporate governance for public firms.[59] The remainder of this section will measure the efficacy of this framework against the best evidence regarding CEO autonomy.

Optimizing CEO autonomy requires balancing the risk of excessive agency costs against the costs of hamstringing CEO leadership. Former Federal Reserve chairman Alan Greenspan served as a director of numerous public firms.[60] Greenspan admits corporate governance devolved towards CEO primacy.[61] He recognizes that CEOs enjoy sufficient autonomy to enhance

54. DEL. CODE ANN. tit. 8, § 141(a) (2008) ("The business and affairs of every corporation . . . shall be managed by or under the supervision of a board of directors . . . .").

55. *Id.* §142(a) ("Every corporation . . . shall have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board . . . .").

56. Joel Seligman, *A Modest Revolution in Corporate Governance*, 80 NOTRE DAME L. REV. 1159, 1170–75 (2005) (detailing enhanced requirements for independent directors and the audit committee).

57. *Id.* *See also* ROY C. SMITH & INGO WALTER, GOVERNING THE MODERN CORPORATION: CAPITAL MARKETS, CORPORATE CONTROL, AND ECONOMIC PERFORMANCE 90 (2006) ("During the last two decades of the twentieth century, some institutional investors and corporate governance experts have tried to restrict excessive concentration of powers in management by increasing the power of non-executive directors.").

58. Robert B. Thompson, *Corporate Federalism in the Administrative State: The SEC's Discretion to Move the Line Between the State and Federal Realms of Corporate Governance*, 82 NOTRE DAME L. REV. 1143, 1180–86 (2007) (discussing the influence of the SEC and stock exchanges over corporate governance).

59. *Id.*

60. ALAN GREENSPAN, THE AGE OF TURBULENCE: ADVENTURES IN A NEW WORLD 424 (2007).

61. *Id.* ("[C]orporate governance moved from shareholder control to control by the CEO.").

their own compensation and harm their firms.[62] Despite such "obvious shortcomings," Greenspan concludes ("reluctantly") that "CEO control and the authoritarianism it breeds are probably the only way to run an enterprise successfully."[63] Greenspan argues that "[a] corporation can have only one strategy [and] [c]ompeting 'independent' voices . . . undermine the effectiveness of the CEO and the rest of the corporate board."[64] Chairman Greenspan articulates the central challenge addressed in this Article: The optimal contours of CEO autonomy.[65]

Despite the lack of any legal requirement for the position of CEO, the public firm in the United States evolved toward a uniform approach of centralizing all operational authority in the hands of a singular executive officer.[66] The concept of empowering CEOs to pursue opportunities quickly, without first achieving internal consensus, supported allowing dynamic leaders greater authority.[67] The emergence of the imperial CEO inspired a new norm in the boardroom—deference and support displaced real monitoring.[68] CEOs came to dominate boards by setting the agenda, controlling the flow of information, selecting board members, and hiring outside consultants and professionals.[69] For a period of time in the 1960s, firms with strong CEOs seemed to enjoy superior financial performance.[70] Such centralized power raised concerns regarding agency costs, but "most CEOs" exercised their power appropriately, and resisted the temptation to transfer wealth away from shareholders for their own benefit.[71] Current norms stress that directors should not "second guess management" and that a board should "support" the CEO,

62. *Id.* at 425 (stating that CEO primacy "spawned abuse").

63. *Id.* at 428–29.

64. *Id.* at 431.

65. Scholars Renée Adams and Daniel Ferreira model CEO incentives to share information with boards that monitor management with more intensity. Renée B. Adams & Daniel Ferreira, *A Theory of Friendly Boards*, 62 J. FIN. 217, 217–18 (2007). They conclude that CEOs may well respond to enhanced scrutiny by withholding information from the board that would necessarily diminish the value the board may add in its advisory as well as its monitoring capacity. *Id.* at 241–42.

66. SMITH & WALTER, *supra* note 57, at 99–111 (explaining the development of CEOs as the central operational authority).

67. *Id.* at 98 ("[T]ransferring more power to part-time independent board members may . . . nullify the authority of executives to act quickly and opportunistically in the shareholders' best economic interest. Boards may deny this authority to competent CEOs while they argue over [the] merits of particular actions and consider their personal liabilities.").

68. *Id.* at 110–11.

69. *Id.* at 111.

70. *Id.*

71. SMITH & WALTER, *supra* note 57, at 111, 113.

particularly with respect to operations.[72] The Corporate Director's Guidebook (promulgated by the Committee on Corporate Laws of the American Bar Association's Section of Business Law) suggests that while "directors are responsible for overseeing and directing the operation of the business and affairs of the corporation, most directors are not managers" and that the "challenge for outside directors is to oversee the corporation's activities effectively and make well-informed decisions without themselves usurping the role of management."[73] The current best practice for directors appears to be managerial deference in terms of operations.

Naturally, a CEO's influence on firm performance depends upon sufficient power to set the course for the firm. The proposition that more powerful CEOs exert a greater sway over performance enjoys abundant empirical support.[74] Similarly, scholars have demonstrated that the diversification of opinions implicit in more diffused group decision-making operates to stabilize returns.[75] Evidence suggests that group decision-making benefits from a diversity (cultural, racial, gender, and socioeconomic) of perspectives.[76] This evidence

72. SUSAN F. SHULTZ, THE BOARD BOOK: MAKING YOUR CORPORATE BOARD A STRATEGIC FORCE IN YOUR COMPANY'S SUCCESS 158, 162 (2001). *See also* RAM CHARAN, BOARDS THAT DELIVER: ADVANCING CORPORATE GOVERNANCE FROM COMPLIANCE TO COMPETITIVE ADVANTAGE 173 (2005) ("The best CEOs are powerful in the good sense of the word . . . [and that normally the board's job is to provide] coaching and support."); HARVARD BUSINESS REVIEW ON CORPORATE GOVERNANCE 188–89 (2000) ("Most directors and managers seem to agree that the objective is to make the board a more effective watch-dog without undermining management's ability to run the business.").

73. CORPORATE DIRECTOR'S GUIDEBOOK: COMMITTEE ON CORPORATE LAWS 2 (5th ed. 2007). "The Committee on Corporate Laws of the American Bar Association's Section of Business Law is composed of active or former practicing lawyers, law professors, regulators, and judges, with corporate expertise and from throughout the United States." *Id.* at ix.

74. *E.g.*, Renée B. Adams et al., *Powerful CEOs and Their Impact on Corporate Performance*, 18 REV. FIN. STUD. 1403, 1404 (2005) ("We find evidence that stock returns are more variable in firms in which the CEO has greater power to influence decisions.").

75. *See* Raaj K. Sah & Joseph E. Stiglitz, *The Quality of Managers in Centralized Versus Decentralized Organizations*, 106 Q.J. ECON. 289, 290 (1991) ("The overall effect of a greater centralization . . . is to induce a greater variability in the economy's managerial quality.").

76. *E.g.*, IRVING L. JANIS, GROUPTHINK: PSYCHOLOGICAL STUDIES OF POLICY DECISIONS AND FIASCOES 250 (2d ed. 1982) (undertaking intensive case studies and finding that group heterogeneity can stem "groupthink"); David A. Carter et al., *Corporate Governance, Board Diversity and Firm Value*, 38 FIN. REV. 33, 36 (2003) ("[D]iversity produces more effective problem solving. While heterogeneity may initially produce more conflict . . . the variety of perspectives that emerges cause decision makers to evaluate more alternatives and more carefully explore the consequences of these alternatives."); Poppy Lauretta McLeod et al., *Ethnic Diversity and Creativity in Small Groups*, 27 SMALL GROUP RES. 248, 252 (1996) (comparing quality and feasibility of the ideas of "Anglo" working groups and racially or ethnically diverse groups and concluding that culturally diverse workforces create competitive advantage through better decisions).

extends to diverse boards.[77] Indeed, a fundamental justification for the existence of a board of directors is the benefit of group decision-making.[78] A CEO-centric model of corporate decision-making thus benefits from some degree of logical support, but is associated with more variable returns as well as the loss of any decision-making benefit arising from the inclusion of diverse perspectives.

A CEO-centric model of corporate power also compromises efforts to control agency costs. For example, rational CEOs can be expected to exercise the largely unbridled power[79] that they enjoy to hand-pick directors to maximize expected payoffs.[80] One study suggests that powerful CEOs will engage in homosocial reproduction in the selection of board members.[81] This will naturally lead to higher compensation payments to the CEO[82] and less stringent monitoring.[83] As could be expected, research on affinity bias demonstrates that the payoffs from homosocial reproduction can be

77. Carter, *supra* note 76, at 51 ("After controlling for size, industry and other corporate governance measures, we find statistically significant positive relationships between the presence of women or minorities on the board and firm value . . . .").

78. As Professor Stephen Bainbridge states, "Because most board tasks entail the exercise of critical evaluative judgment . . . corporations are well-served by group decisionmaking at the top." Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 54 (2002).

79. *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 732 (2007) ("The shareholder franchise is largely a myth. Shareholders commonly do not have a viable power to replace the directors of public companies. Electoral challenges are rare, and the risk of replacement via a proxy contest is extremely low.").

80. Steven A. Ramirez, *Games CEOs Play and Interest Convergence Theory: Why Diversity Lags in America's Boardrooms and What to Do About It*, 61 WASH. & LEE L. REV. 1583, 1613 (2004) ("CEOs play the game of homosocial reproduction when selecting directors. Given our apartheid tradition, this means that the upper echelons of corporate America will be essentially the exclusive province of white males far into the future.") [hereinafter Ramirez, *Games CEOs Play*].

81. James D. Westphal & Edward J. Zajac, *Who Shall Govern?: CEO/Board Power, Demographic Similarity, and New Director Selection*, 40 ADMIN. SCI. Q. 60, 77 (1995) ("[When] CEOs are relatively powerful, new directors are likely to be demographically similar to the firm's incumbent CEO . . . ."). Westphal and Zajac's study is based upon data from "413 Fortune/Forbes 500 companies from 1986 to 1991." *Id*. at 61. They define demographic diversity in terms of age, educational background, tenure with the organization, and insider/outsider status. *Id*. at 63–65. The authors' premise is that "in-group bias" is "quite powerful" even when based upon irrelevant factors. *Id*. at 62. Therefore, it seems reasonable to extend their findings to factors such as race that have powerful social meaning in our society.

82. *Id.* at 79 ("[D]emographic similarity between CEOs and board members was positively related to subsequent increases in CEO compensation.").

83. Marleen A. O'Connor, *The Enron Board: The Perils of Groupthink*, 71 U. CIN. L. REV. 1233, 1240–41 (2003) (arguing that enhanced board diversity reduces the perils of groupthink).

significant.[84] Another study tends to show that CEOs will use their influence to bestow higher pay on directors in order to enhance their own pay prospects at the cost of firm performance.[85] Despite notable reforms recently, CEOs still influence board selections and America's corporate boards continue to be the near exclusive preserve of white males.[86] A CEO with power over board selection rationally will pursue board members with high affinity to the CEO in order to achieve higher compensation and more lax monitoring.

The conclusion that excessive CEO power leads to suboptimal decision-making and excessive agency costs seems well supported empirically.[87] For example, one study focused upon the prevalence of luck-based compensation.[88] The study found that CEO compensation is frequently tied to luck, such as CEOs in the oil industry achieving windfall paydays from increases in the price of oil—over which they have no control.[89] Luck-based compensation, however, arose most prominently in firms with weak corporate governance.[90] For instance, pay for luck diminishes significantly in firms with a large individual shareholder, who presumably has strong incentive to monitor management closely.[91] This suggests that compensating CEOs for luck is

84. *See* Michael E. Murphy, *The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis*, 5 BERKELEY BUS. L.J. 131, 160 (2008) (demonstrating that membership in a group creates preference for that group and against other groups, even when groups are defined based upon arbitrary and trivial factors).

85. Ivan E. Brick et al., *CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?*, 12 J. CORP. FIN. 402, 404, 421–22 (2006) (finding that higher director pay is associated with higher CEO pay and weaker financial performance, suggesting cronyism).

86. *E.g.*, DOUGLAS M. BRANSON, NO SEAT AT THE TABLE: HOW CORPORATE GOVERNANCE AND LAW KEEP WOMEN OUT OF THE BOARDROOM 179 (2007) ("Many boards are men's clubs, in which the members dress the same, have attended the same schools, and represent a single social class. Directors and the boards on which they sit tend to be isolated from what goes on in the society that surrounds them.").

87. *E.g.*, Jap Efendi et al., *Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors*, 85 J. FIN. ECON. 667, 703–04 (2007) (finding that financial misstatements are positively associated with CEOs that also chair the board, as well as CEOs that hold substantial amounts of in-the-money options).

88. Marianne Bertrand & Sendhil Mullainathan, *Are CEOs Rewarded for Luck? The Ones Without Principals Are*, 116 Q. J. ECON. 901, 901–02 (2001) ("Simple models of the contracting view generate one important prediction. Shareholders will not reward CEOs for *observable* luck. By luck, we mean changes in firm performance that are beyond the CEO's control. Tying pay to luck, therefore, cannot provide better incentives and will only make the contract riskier.").

89. *Id.* at 914 ("[T]he average firm rewards its CEO as much for luck as it does for a general movement in performance."). The study relied upon data on 792 firms from 1984 to 1991. *Id.* at 910.

90. *Id.* at 929.

91. *Id.* at 921, 929 ("Adding a large shareholder on the board, for example, decreased the pay for luck by 23 to 33 percent.").

suboptimal and that it is possible to filter out such pay.[92] It also suggests that if CEOs have sufficient power, they will subvert the compensation setting process by using that power to skim profits from shareholders.[93]

Another study assessed CEO centrality (defined by the CEO's share of aggregate compensation paid to a firm's top five executives) on firm performance and certain negative behavioral and performance markers.[94] The study concluded that CEO power is associated with lower firm value, negative market reactions to acquisition announcements, more luck-based compensation, and less CEO turnover, among other things.[95] This is consistent with evidence that award-winning CEOs use their enhanced stature to garner higher compensation while underperforming financially.[96] Other studies suggest that firm performance may be enhanced by limitations upon CEO autonomy.[97] It appears that the current corporate governance framework permits too much CEO autonomy.[98] Thus, in general, the concept of enhanced board monitoring to reduce CEO autonomy appears promising.[99] These

92. *Id.* at 929.

93. Bertrand & Mullainathan, *supra* note 88, at 929.

94. Lucian A. Bebchuk et al., *CEO Centrality* 1, 7 (Harvard John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 601, 2007), *available at* http://papers.ssrn.com/abstract=1030107 (CEO pay slice is computed using a sample data period of 1993–2004).

95. *Id.* at 34. The authors recognize the possibility that high CEO centrality could be optimal for low-value firms. *Id.* at 23, 34. Nevertheless, some of the other firm aspects tested are likely correlated to suboptimal decision-making, strengthening the inference that the correlation between high centrality and low firm value is the result of governance problems and agency costs. *Id.* Further, it is unclear why low firm value would be correlated to high CEO centrality. *See id.* at 34.

96. *See* James B. Wade et al., *Star CEOs: Benefit or Burden?*, 37 ORG. DYNAMICS 203, 207 (2008) (finding that after earning awards, CEOs garnered higher compensation but that firm value decreased 240 days after the award announcement).

97. Augustin Landier et al., Bottom-Up Corporate Governance 22 (May 21, 2007) (unpublished manuscript), *available at* http://www.econ.berkeley.edu/~sraer/bottomup.pdf (finding that firms with more independent officers—those not selected by the CEO—below the CEO, achieve higher financial performance).

98. A key element of the corporate governance framework which operates to entrench managers and encourage suboptimal conduct is state antitakeover legislation. Marianne Bertrand & Sendhil Mullainathan, *Enjoying the Quiet Life? Corporate Governance and Managerial Preferences*, 111 J. POL. ECON. 1043, 1046–47 (2003). The evidence suggests that these statutes allow CEOs to raise the wages paid to employees at the expense of more remote shareholders. *Id.* at 1072 (finding higher wages for workers following antitakeover statutes, but suggesting that these did not lead to higher productivity).

99. *See* Ivan E. Brick & N. K. Chidambaran, Board Meetings, Committee Structure, and Firm Performance 35 (Nov. 2007) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1108241 ("While we do note some positive effects of board monitoring on firm value, it is evident only in some of our regression specifications. We interpret our results to imply that firms are in equilibrium with respect to the level of board monitoring and

studies lend further support to the position that CEOs possess sufficient autonomy to enhance their compensation at the expense of their shareholders.

Excessive CEO autonomy also seems to distort certain elements of corporate behavior. Those companies that issue guidance regarding earnings, for example, are more likely to engage in myopic behavior.[100] Specifically, such firms will manage their earnings in various ways such as reducing research and development expenses to pump-up current earnings.[101] This earning management impairs long-term performance.[102] CEOs apparently meet their guidance through a variety of earnings management techniques that harm long term financial performance.[103] A similar dynamic pertains to high-cost acquisitions of other firms.[104] Apparently, "overconfident, very powerful, [or] very greedy"[105] CEOs will overpay for acquisitions in order to enhance their power, prestige, and, ultimately, their compensation.[106] CEO hubris associated with both harmful earnings management[107] as well as excessive payments for acquisitions[108] suggests that these areas are in need of diminished CEO autonomy. And more vigilant boards do, in fact, reduce the ability of CEOs to undertake acquisitions that harm shareholder wealth.[109]

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that the intense focus of political and regulatory attention has to some degree served to make boards more sensitive to firm performance and add to shareholder value.").

100. Mei Cheng et al., Earnings Guidance and Managerial Myopia 29 (Nov. 2005) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=851545. This study involved a sample of 989 companies across ten industries from 2001 to 2003. *Id.* at 11.

101. *Id.* at 29 ("[W]e document that dedicated guiders invest less in R&D . . . and have significantly lower [return on assets] growth than occasional guiders.").

102. *Id.*

103. Katherine Gunny, The Relation Between Earnings Management Using Real Activities Manipulation and Future Performance: Evidence from Meeting Earnings Benchmarks, 4 (Sept. 2005) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=816025&rec=1&srcabs=928182# ("[A]fter controlling for size, performance, level of accruals, industry and managerial intent real earnings management is associated with significantly lower future earnings and cash flows.").

104. *E.g.*, Matthew L. A. Hayward & Donald C. Hambrick, *Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris*, 42 ADMIN. SCI. Q. 103, 103 (1997) (finding that CEO hubris and power are associated with higher acquisition premiums).

105. *Id.* at 124.

106. *See* SMITH & WALTER, *supra* note 57, at 112–13.

107. Paul Hribar & Holly Yang, CEO Confidence, Management Earnings Forecasts, and Earnings Management 1 (July 2006) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=929731&rec=1&srcabs=817108 ("Taken together, our results suggest that overconfidence increases the optimistic bias in voluntary forecasts, leading to both a greater likelihood of missing management forecasts and increasing earnings management among firms issue management forecasts.").

108. Hayward & Hambrick, *supra* note 104, at 123–24.

109. *See id.* at 124.

Compensation in particular raises concerns regarding excessive CEO autonomy.[110] The concerns regarding CEOs incurring too much risk in order to maximize short-term payoffs during the subprime lending frenzy seem valid.[111] "CEOs who derived [a high level] of their pay from stock options generated more big losses than big gains . . . . and their ratio of big losses to big gains [exceeded] the corresponding ratios for CEOs who derived less of their pay from stock options."[112] The essential problem arising from options compensation is that CEOs benefit from upside moves in stock prices, but have zero exposure to downside price moves;[113] naturally, a CEO facing such incentive-based compensation will seek higher returns regardless of risk.[114] CEO autonomy over compensation practices transmogrified into the nefarious[115] options backdating scandals that came to light in 2006 through academic research that strongly suggested wrongdoing on a systemic basis.[116] This further demonstrates that CEOs too often manipulate the system of compensation to garner excessive payments, or worse.[117]

110. *E.g.*, Harley E. Ryan Jr. & Roy A. Wiggins III, *Who Is in Whose Pocket? Director Compensation, Board Independence, and Barriers to Effective Monitoring*, 73 J. FIN. ECON. 497, 499 (2004) ("[P]owerful managers use their positions to influence the directors' compensation to provide fewer incentives to monitor and simultaneously make their own compensation less sensitive to stock performance.").

111. *See, e.g.*, Wm. Gerard Sanders & Donald C. Hambrick, *Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance*, 50 ACAD. MGMT. J. 1055, 1076 (2007) (finding that CEOs will undertake excessive risks in order to maximize payoffs from stock option incentive compensation).

112. *Id.* at 1073.

113. SMITH & WALTER, *supra* note 57, at 114 (noting risks of options compensation arising from moral hazards facing CEOs whereby they benefit from profits but are not exposed to risks of loss).

114. Sanders & Hambrick, *supra* note 111, at 1076. *See also* Matt Bloom & George T. Milkovich, *Relationships Among Risk, Incentive Pay and Organizational Performance*, 41 ACAD. MGMT. J. 283, 292 (1998) (finding higher risk firms that relied upon incentive pay such as stock options performed worse than firms that did not rely on such compensation).

115. Charles Forelle & James Bandler, *Matter of Timing: Five More Companies Show Questionable Options Pattern*, WALL ST. J., May 22, 2006, at A1 ("It is stealing, in effect. It is ripping off shareholders in an unconscionable way.") (quoting former SEC chair Arthur Levitt). The options backdating scandal involved the use of fabricated documents so the managers could take advantage of lower stock prices when they exercised their right to buy shares. *Id.* at A10.

116. "We . . . estimate that 29.2% of firms at some point engaged in manipulation of grants to top executives between 1996 and 2005." Randall A. Heron & Erik Lie, *What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?*, 55 MGMT. SCI. 513, 524 (2009).

117. *See Federal Reserve's Second Monetary Policy Report for 2002: Hearing Before the Comm. on Banking, Housing, & Urban Affairs*, 107th Cong. 11 (2002) (testimony of Alan Greenspan, chairman, Board of Governors of the Federal Reserve System) (stating that lax boards had contributed to a CEO-centric corporate power structure that permitted senior executives to

Overall, empirical scholarship gives scanty clue regarding the optimal contours of CEO autonomy, at least with any degree of precision. It seems, though, that a strong case can be made that the present system of corporate governance fails to appropriately curb CEO power.[118] In general, reduced CEO power within an organization increases financial performance or firm value.[119] But the incomplete nature of the record counsels caution. Strong CEOs can potentially have a positive influence on firm performance.[120] While noted business leaders contest the notion of the CEO as firm savior or strategic visionary, stifling CEO autonomy may lower agency costs only at the cost of managerial excellence.[121] Corporate governance must search for the optimal balance between the containment of agency costs and the empowerment of CEOs to maximize profits.[122]

Unfortunately, there is a dearth of academic analysis on this seemingly basic point. But the question of appropriate CEO autonomy animates the basic reforms embodied in SOX. SOX focused primarily on limiting the ability of the CEO to subvert or manipulate the audit function.[123] SOX mandated independent audit committees.[124] It provided that auditors for public firms report to and be accountable to the independent audit committee.[125] SOX provided a specific, if modest, definition of "independent."[126] Finally, public firms must have one audit committee member with specific accounting

"harvest" gains through manipulation of share prices) *available at* http://www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm.

118. *See* SMITH & WALTER, *supra* note 57, at 113–16 (describing the incentives for CEO misbehavior within the current system).

119. *See* Ramirez, *The End of Corporate Governance Law*, *supra* note 12, at 337. In 2007, I surveyed much of the empirical evidence addressing optimal corporate governance, generally, and concluded that: "The current system of corporate governance law looks nothing like emerging corporate governance science" and that CEOs exercised far too much power. *Id.* at 346–47.

120. SMITH & WALTER, *supra* note 57, at 99–112.

121. *See generally* RAKESH KHURANA, SEARCHING FOR A CORPORATE SAVIOR: THE IRRATIONAL QUEST FOR CHARISTMATIC CEOS (2002).

122. *See* Ramirez, *The End of Corporate Governance Law*, *supra* note 112, at 316 n.23 ("Optimal corporate governance would consist of those laws, regulations, disclosure requirements, and contractual provisions that would serve to maximize benefits from the alignment of interests between investors and managers net of compliance, regulatory, and other transaction costs. Thus, optimal corporate governance would minimize net agency costs." (citing John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1160–61 (2005))).

123. *See generally* Sarbanes-Oxley Act of 2002, 15 U.S.C. § 78j-1 (2006).

124. *Id.* § 78j-1(m)(3)(A).

125. *Id.* §§ 78j-1(k), (m)(2).

126. *Id.* § 78j-1(m)(3)(B).

expertise (or an explanation regarding the lack of financial expertise).[127] All of this effectively stripped the CEO of autonomy over the audit function.

These SOX reforms seem successful, and independent audit committees are frequently associated with a lower cost of capital.[128] Business scholars suggest the SOX approach (as refined by SEC regulations) is "optimal" because it allows firms flexibility in defining the precise contours of the audit committee.[129] The reforms operate to enhance the quality of audits.[130] This is consistent with evidence showing that the market valued the SOX audit reforms and, since 2002, there has been less improper earnings management.[131] Moreover, it is noteworthy that in the context of the subprime mortgage crisis, audit failure has not materially contributed to the subprime crisis.[132] Taken together, these reforms appear to have enhanced the operation of corporate governance.

The empirical evidence suggests that curbing CEO autonomy over ancillary corporate functions—those functions more central to monitoring than business strategizing—is appropriate. The audit function, for instance, is a check on the performance of the CEO, and CEO domination of this function is difficult to justify. The CEO should not be permitted to control the production of financial statements as they are fundamentally a report on the performance of management. Moreover, an independent audit function does not impair the ability of the CEO to pursue any strategic vision the CEO may have. An independent audit function does not interfere with operational control. The empirical record regarding the efficacy of the SOX audit reforms thus appears to enjoy a sound basis in reason.

127. 15 U.S.C. § 7265 (2006). The SEC promulgated regulations implementing this section. 17 C.F.R. §§ 228, 229, 249 (2008).

128. *E.g.*, Ronald C. Anderson et al., *Board Characteristics, Accounting Report Integrity, and the Cost of Debt*, 37 J. ACCT. & ECON. 315, 340 (2004) (finding that independent audit committees are associated with a lower cost of debt).

129. Joseph V. Carcello et al., Audit Committee Financial Expertise, Competing Corporate Governance Mechanisms, and Earnings Management 32–33 (Feb. 2006) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=887512 (finding that independent audit committee members facilitate higher quality audits).

130. *See id.*

131. Daniel A. Cohen et al., Trends in Earnings Management and Informativeness of Earnings Announcements in the Pre- and Post-Sarbanes Oxley Periods 30 (Feb. 2005) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=658782 (finding less improper earnings management after SOX).

132. *See, e.g.*, Donald Nordberg, Waste Makes Haste: Sarbanes-Oxley, Competitiveness and the Subprime Crisis 21–23 (May 10, 2008) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1131674 (arguing that SOX posed an opportunity to reform corporate governance but not attributing any part of the subprime crisis to the SOX audit reforms).

The foregoing suggests that CEO autonomy should be limited to the freedom necessary to secure the unified leadership of the firm and the pursuit of a unified business strategy. The CEO should not have autonomy to harm the corporation through the subversion of the business monitoring function, the audit function, or the legal compliance function. Normatively, these functions are best secured without strong CEO autonomy. They only tangentially bear upon the core business mission of the firm, and the CEO is not inherently optimal institutionally to manage these functions. The next part of this Article summarizes the functioning of the American system of corporate governance for public firms in the specific context of the subprime fiasco. Testing corporate governance in that context supplements the empirical learning reviewed in this section by subjecting that evidence to a stress test.

II. CEO AUTONOMY AND THE SUBPRIME FIASCO

Perhaps the prime lesson of the subprime fiasco is that corporate governance law must be able to withstand exogenous shocks.[133] As previously stated, the subprime crisis arose from many complex factors far removed from corporate governance.[134] For example, the frenzy of subprime mortgage lending had its roots in an extended period of expansionary monetary policy beginning after the attacks of September 11, 2001, and the dot-com bust.[135] Deregulation in the financial sector, ranging from subprime lending practices to the degree of leverage permissible in the investment banking industry, exacerbated the effects of this easy money.[136] Even the structure of globalization contributed to the flow of cheap capital to fund consumption in

133. The costs of a breakdown in corporate governance for public firms can now be measured in the trillions. SMITH & WALTER, *supra* note 57, at 19. Thus, even a one percent chance of a major breakdown must be comprehended within any policy calculus regarding the risks of lax corporate governance. I have argued previously that the more demanding system of corporate governance prevailing from 1934 to 1987 supported durable stability for at least six decades. *See* Steven A. Ramirez, *Fear and Social Capitalism: The Law and Macroeconomics of Investor Confidence*, 42 WASHBURN L.J. 31, 60 n.168, 60–63 (2002) (arguing that the radical deregulation of director duties in the 1980s combined with the evisceration of private securities litigation in the 1990s permitted management and associated professionals to harvest excessive compensation while shareholders lost billions).

134. *E.g.*, MARK ZANDI, FINANCIAL SHOCK: GLOBAL PANIC AND GOVERNMENT BAILOUTS—HOW WE GOT HERE AND WHAT MUST BE DONE TO FIX IT 2 (updated ed. 2009) ("There's plenty of blame to go around.").

135. *Id.* at 3.

136. *Id.* at 4, 13. *See also* Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt, and Risk*, N.Y. TIMES, Oct. 3, 2008, at A1 (recounting suspension of net capital rule for investment banks that allowed Bear Stearns to leverage its debt to equity ratio to 33 to 1).

general and the housing market in particular.[137] Under these circumstances, a predictable mania fueled by debt took hold in financial firms.

Corporate governance did not respond well to these macroeconomic challenges.[138] Such challenges are far more frequent than corporate scholars generally assume.[139] As economist Hyman Minsky contended, "Periods of stability (or of tranquility) of a modern capitalist economy are transitory."[140] At the heart of this fundamental and permanent instability is the financing and investment function.[141] The corporation is central to this process because its infinite life permits matching assets with revenues generated from those assets over long periods of time, which, in turn, facilitates the financing of such assets.[142] And, as Minsky states, "[B]y and large, business corporations control capital assets and order investment output, the financial powers and practices of corporations are the starting points for policies to manage or contain instability."[143] The assessment of corporate governance, therefore, must be reconceived from its functioning under static or stable conditions to comprehend its performance under conditions of financial strain, stress, and instability.[144] The baseline assessment must assume conditions of instability,

137. ZANDI, *supra* note 134, at 3, 10. *See also* Mark Landler, *Dollar Shift: Chinese Pockets Filled as Americans' Emptied*, N.Y.TIMES, Dec. 26, 2008, at A1 ("In the past decade, China has invested upward of $1 trillion, mostly earnings from manufacturing exports, into American government bonds and government-backed mortgage debt. That has lowered interest rates and helped fuel a historic consumption binge and housing bubble in the United States.").

138. Alan Greenspan's famous admission of error, made as part of his congressional testimony, supports the thesis of this article that CEOs enjoy too much autonomy to harm their firms and line their own pockets: "I made a mistake in presuming that the self-interest of organizations, specifically banks and others, were such . . . that they were best capable of protecting their own shareholders and their equity in the firms." *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. of Oversight and Government Reform*, 110th Cong. 33 (2008) (preliminary transcript of testimony of Alan Greenspan), *available at* http://oversight.house.gov/documents/20081024163819.pdf.

139. *See* CHARLES P. KINDLEBERGER, MANIAS, PANICS AND CRASHES: A HISTORY OF FINANCIAL CRISES 220–21 (4th ed. 2000) ("Dismissing financial crisis on the grounds that bubbles and bust cannot take place because that would imply irrationality is to ignore a condition for the sake of a theory.").

140. HYMAN P. MINSKY, STABILIZING AN UNSTABLE ECONOMY, at ix (2008).

141. *Id.* at 327 ("[T]he inherent instability of capitalism is due to the way profits depend upon investment . . . and investment depends upon the availability of external financing. But the availability of financing presupposes that prior debts and the prices that were paid for capital assets are being validated by profits.").

142. *Id.* at 351–52 ("The corporation is a social instrument that is best suited to hold and operate expensive special-purpose capital assets whose expected life as an earner of quasi-rents is long.").

143. *Id.* at 349.

144. Minsky recognized that monetary and fiscal measures enabled the United States to avoid a repeat of the Great Depression. *Id.* at 328. He also maintained, however, that financial innovation coupled with a return of laissez-faire regulation could ignite a debt-deflation driven

and even comprehend severe financial crises, such as the subprime mortgage fiasco.

An overview of the history of corporate governance scholarship demonstrates that few authors contemplate such stress-testing.[145] Prior to the 1990s, most financial and economics scholars assumed that corporate governance must be optimal, having evolved under Darwinian market conditions and standing the test of time.[146] Today many scholars test various elements of corporate governance against financial or economic performance, permitting innovative insights into an optimal corporate governance regime.[147] The sample periods used for these empirical assessments generally are too short to permit any sort of stress test, and, in any event, are too frequently based upon periods of stability and prosperity.[148] This necessarily means that the extant scholarship testing for optimal corporate governance (or by extension appropriate levels of CEO autonomy) does not comprehend the complex of challenges leading up to the subprime fiasco or the macroeconomic wake left by the subprime debacle.

depression. Dimitri B. Papadimitriou, *Minsky's* Stabilizing an Unstable Economy: *Two Decades Later in* HYMAN P. MINSKY, STABILIZING AN UNSTABLE ECONOMY, at xvii–xviii (2008).

145. Recently apologists for the CEO-centric model of corporate governance took easy comfort in a study linking increased CEO pay to increases in market capitalization, as if the CEO alone among employees was inherently entitled to riskless equity returns. *See* Xavier Gabaix & Augustin Landier, *Why Has CEO Pay Increased So Much?*, 123 Q. J. ECON. 49, 50 (2008) ("The sixfold increase in CEO pay between 1980 and 2003 can be attributed to the sixfold increase in market capitalization of large U.S. companies during that period."). Of course, recently stock market prices have collapsed; there is little indication that CEO compensation is poised to suffer a similar collapse. *See* Lynn Thomasson, *Morgan Stanley Says S&P 500 to Drop 25%, Cuts Outlook*, BLOOMBERG.COM, Mar. 13, 2009, http://www.bloomberg.com/apps/news?pid=20601103&sid=aUX5fDy9mtbQ&refer=us (noting that U.S. equities have fallen 52% in 17 months and that some analysts predict another 25% drop).

146. *See, e.g.*, Stacey Kole & Kenneth Lehn, *Deregulation, the Evolution of Corporate Governance Structure, and Survival*, 87 AM. ECON. REV. 421, 421 (1997) (stating that, as of 1997, "[m]uch of the literature on corporate governance" took a "Darwinian view" in that surviving firms are presumed to have optimal governance structures leading to an absence of evidence regarding optimal governance structures).

147. *E.g.*, Lucian A. Bebchuk et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009) (concluding that managerial entrenchment is negatively correlated with firm performance and stock returns); Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 108–11 (2003). Superior corporate governance is associated with higher market valuations and using an index of corporate governance consisting of twenty-four factors of corporate governance. The authors broke these factors down into five groups: (i) factors associated with delaying hostile threats to corporate control; (ii) factors associated with voting rights; (iii) factors designed to protect officers and directors from liability or termination; (iv) other anti-takeover protections; and (v) state laws bearing upon takeovers. *Id.* at 111.

148. *See, e.g.*, Lawrence D. Brown & Marcus L. Caylor, *Corporate Governance and Firm Valuation*, 25 J. ACCT. & PUB. POL'Y 409 (2006) (finding that correlation between certain corporate governance elements as of February 1, 2003 and performance in 2002).

Yet, by any reasonable assessment, the U.S. system of corporate governance allowed agency costs to run amok during the relevant time period associated with the subprime crisis, and allowed CEO misconduct in particular to destroy firms and crash the global economy.[149] The International Monetary Fund assessed the magnitude of the subprime mortgage crisis and identified the subprime classes of 2006 and 2007 as the most problematic in terms of delinquency rates; in fact, within months of origination, loans from the class of 2006 suffered a delinquency rate of over 35%, and the class of 2007 outpaced the class of 2006.[150]

The following five firms were very active in the subprime mortgage sector during those problematic years: Countrywide Financial;[151] Citigroup;[152] Merrill

149. Finance Professor James Bicksler conducted a partial review of empirical reality in terms of the link between corporate governance and the subprime fiasco: "In sum, these executive compensation payments were big time wealth transfers from the common shareholders of Countrywide Financial, Citigroup, and Merrill Lynch to the CEOs of these respective companies." James L. Bicksler, *The Subprime Mortgage Debacle and Its Linkages to Corporate Governance*, 5 INT'L J. DISCLOSURE & GOV. 295, 297 (2008) (showing that corporate governance failed to assure that CEO compensation was even "remotely" linked to performance). Professor Bicksler argues that his sample of Countrywide, Citigroup and Merrill Lynch reflects a broader problem: "a seemingly large disconnect between actual corporate performance and corporate executive compensation" that infected a number of mortgage firms, and that plagues American corporate governance generally. *Id.* at 298.

150. *See* INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: FINANCIAL STRESS AND DELEVERATING 12 fig.1.8 (Oct. 2008), *available at* http://www.imf.org/external/pubs/ft/gfsr/2008/02/pdf/text.pdf.

151. Countrywide originated over $57 billion in subprime mortgages in 2006 and 2007. I INSIDE MORTGAGE FINANCE PUBLICATIONS, INC., THE 2008 MORTGAGE MARKET STATISTICAL ANNUAL 12 (2008). It serviced in excess of $231 billion in subprime mortgages. *Id.* at 241. In addition, it packaged for resale (as underwriter or issuer) to investors in excess of $106 billion in mortgage backed securities (MBS) consisting of subprime mortgage pools. II INSIDE MORTGAGE FINANCE PUBLICATIONS, INC., THE 2008 MORTGAGE MARKET STATISTICAL ANNUAL 149–50 (2008). Countrywide was the nation's largest mortgage lender. Gretchen Morgenson, *Inside the Countrywide Lending Spree*, N.Y. TIMES, Aug. 26, 2007, at BU1.

152. Citigroup sold at least $63 billion in subprime backed MBS as issuer or underwriter between 2005 and 2007. II INSIDE MORTGAGE, *supra* note 151, at 149–50. As will be discussed below, on November 4, 2007, Citigroup announced it had $55 billion in subprime exposure that resulted in significant losses. Press Release, Citigroup, Citi's Sub-Prime Related Exposure in Securities and Banking (Nov. 4, 2007), *available at* http://www.citigroup.com/citi/press/2007/071104b.htm. Much of this exposure arose from Citigroup's sales of mortgage pools for fees, but which included a provision that allowed buyers to resell them to Citigroup if liquidity for the instruments dried up—these were hence termed "liquidity puts" and they were not disclosed to Citigroup's shareholders until November 4, 2007. Floyd Norris, *Bank Profits Had Whiff of Suspicion*, N.Y. TIMES, Nov. 16, 2007, at C1. Before the subprime meltdown, Citigroup was the nation's largest bank. Jonathan Stemple, *J.P. Morgan Passes Citigroup as Largest U.S. Bank*, REUTERS, Nov. 4, 2007, http://www.reuters.com/article/businessNews/idUSTRE49F45Q0081016.

Lynch;[153] AIG;[154] and Washington Mutual.[155] Combined, these firms bear significant responsibility for the subprime fiasco. Each of these firms was subject to different regulatory regimes. All were publicly held, and their shareholders absorbed massive losses as a result of subprime exposure.

Countrywide Financial originated, serviced, and packaged more subprime loans than any other firm.[156] And throughout, Countrywide was engaged in reprehensible lending practices. In fact, Countrywide ultimately settled allegations of predatory lending asserted by eleven states for over $8 billion—the largest such settlement in history.[157] The states alleged that Countrywide lied about its "no closing cost loans," misled consumers with respect to hidden fees, structured loans with risky features, paid brokers more to sell more risky loans, and frequently lent based upon inflated borrowers' income (without borrower involvement).[158] The *New York Times* interviewed former employees[159] who corroborated (and documented) many of these allegations.[160] The profits generated through lax lending standards and high fees were so

153. Merrill Lynch securitized $95 billion in subprime mortgages through 2006 and 2007. II INSIDE MORTGAGE FINANCE, *supra* note 151, at 149–50.

154. AIG invested "hundreds of billions in mortgage-related assets." In addition, AIG was a key player in the credit default swap market and guaranteed an unknown amount of unknown obligations. AIG also invested heavily in hedge funds. Thus, its "collapse would be as close to an extinction–level event as the financial markets have seen since the Great Depression." Michael Lewitt, *Wall Street's Next Big Problem*, N.Y. TIMES, Sept. 16, 2008, at A29. Among the obligations AIG guaranteed were $80 billion in mortgage securities, including subprime mortgages. Carol J. Loomis, *AIG: The Company that Came to Dinner*, FORTUNE, Jan. 19, 2009, at 76. When those securities defaulted, AIG was downgraded by the credit rating agencies, a move that ultimately led to a run on the financial conglomerate that once was the world's largest insurance company. *Id.*

155. WaMu originated $32 billion in subprime mortgages in 2006 and 2007. INSIDE MORTGAGE FINANCE, *supra* note 151, at 215. It securitized nearly $35 billion. II INSIDE MORTGAGE FINANCE, *supra* note 151, at 149–50 (noting that WAMu was once the nation's largest savings and loan, also known as a thrift).

156. David Olive, *Corporate Rewards for Failure*, THESTAR.COM, Feb. 1, 2008, http://www.thestar.com/columnists/article/299415 (reporting that Countrywide CEO sold $400 million in stock between 2005 and 2008).

157. Gretchen Morgenson, *Countrywide to Set Aside $8.4 Billion in Loan Aid*, N.Y. TIMES, Oct. 6, 2008, at BU1.

158. *Id.*

159. Morgenson, *supra* note 151, at BU8 ("Such loans were made, former employees say, because they were so lucrative—to Countrywide. The company harvested a steady stream of fees or payments on such loans and busily repackaged them as securities to sell to investors.").

160. *Id.* ("One document, for instance, shows that until last September the computer system in the company's subprime unit excluded borrowers' cash reserves, which had the effect of steering them away from lower-cost loans to those that were more expensive to homeowners and more profitable to Countrywide.").

substantial that Countrywide continued its reckless lending,[161] even after delinquency rates soared.[162] Accordingly, as the *Times* noted, "the company is Exhibit A for the lax and, until recently, highly lucrative lending that has turned a once-hot business ice-cold and has touched off a housing crisis of historic proportions."[163]

Anthony Mozilo, Countrywide's CEO, garnered outrageous compensation for leading the firm into the subprime pit.[164] In 2006, Mozilo's compensation amounted to $102 million, which included a bonus of $20.5 million for increasing earnings at Countrywide from $4.11 per share in 2005 to $4.62 per share.[165] In 2007, Mozilo exercised stock options, hauling in $127 million, just prior to the July 24, 2007 announcement that Countrywide would write down $388 million in loan losses.[166] That year, Mozilo earned an additional $102 million in salary and $30 million in options compensation.[167] He retired in 2008 with a $58 million benefit package.[168] But during 2007, Countrywide lost $704 million, as 33% of its subprime mortgages were found to be delinquent.[169] Shareholders lost over 80% of the value of their shares relative to their value before the credit crisis.[170] Ultimately, as their fortunes tumbled, Countrywide was acquired by Bank of America—where its subprime portfolio inflicted $33 billion in additional loan losses.[171]

Back in 2007, Citigroup CEO Chuck Prince recognized that if liquidity dried up "things will be complicated," but decided "as long as the music is playing you've got to get up and dance."[172] Citigroup worked to keep the

161. *Id.* ("The company would lend even if the borrower had been 90 days late on a current mortgage payment twice in the last 12 months, if the borrower had filed for personal bankruptcy protection, or if the borrower had faced foreclosure or default notices on his or her property.").

162. *Id.* ("One reason these loans were so lucrative for Countrywide is that investors who bought securities backed by the mortgages were willing to pay more for loans with prepayment penalties and those whose interest rates were going to reset at higher levels.").

163. Morgenson, *supra* note 151, at BU8 ("[T]he profit margins Countrywide generated on subprime loans that it sold to investors were 1.84 percent, versus 1.07 percent on prime loans. A year earlier, when the subprime machine was really cranking, sales of these mortgages produced profits of 2 percent, versus 0.82 percent from prime mortgages.").

164. Olive, *supra* note 156.

165. Bicksler, *supra* note 149, at 296.

166. *Id.* at 296–97.

167. *Id.* at 297.

168. *Id.*

169. Roddy Boyd, *Countrywide: From Bad to Worse*, CNNMONEY.COM, Jan. 8, 2008, http://money.cnn.com/2008/01/29/news/companies/boyd_countrywide.fortune/.

170. *Bank of America and Countrywide: Fingers Crossed*, ECONOMIST, June 28, 2008, at 82.

171. *Bank of America Faces Lingering Financial Woes from Countrywide: Report*, MARKETWATCH, Feb. 8, 2009, http://www.marketwatch.com/news/story/bank-america-faces-lingering-financial/story.aspx.

172. David Wighton, *Prince of Wisdom*, FIN. TIMES, Nov. 4, 2007, http://www.ft.com/cms/s/0/fce88e10-8b12-11dc-95f7-0000779fd2ac.html.

music playing by including "liquidity puts" in its securitized pools of subprime mortgages it sold to investors.[173] The liquidity puts required Citigroup to repurchase interests in subprime mortgages if the bank ran into any financial turbulence.[174] Thus, when the road became rough in late 2007, Citigroup publicly disclosed for the first time that it had $55 billion in subprime mortgage exposure and anticipated losses between $8 billion to $11 billion.[175] Prince resigned shortly thereafter.[176] In December of 2007, Citigroup announced it would assume $58 billion of debts that had been carried by structured investment vehicles (SIVs) it had sponsored—the SIVs had invested in long term assets (including mortgage related assets) with short term funding.[177] The risks of these losses went undisclosed to shareholders.[178]

Ultimately, the U.S. government was forced to bail out Citigroup, injecting $45 billion in capital and guaranteeing $306 billion in asset values.[179] During 2007, Citigroup's shareholders had lost 45% of their value.[180] Its stock traded at $55 per share in 2006, and in early 2009 it traded at less than $4 per share.[181] Recently, Citigroup shares have traded at below $1 per share.[182] CEO Chuck Prince fared much better: his compensation amounted to $66.8 million over his last three years, and he was paid a "bonus" of $10.4 million for his last ten months of work, which were marked by staggering losses.[183] He exited Citigroup with $40 million in severance pay.[184]

Shareholders attempted to hold management responsible for the billions in losses and for the excessive compensation paid to CEO Prince in a derivative

173. Carol J. Loomis, *Robert Rubin on the Job He Never Wanted*, FORTUNE, Nov. 26, 2007, at 69.

174. *Id.*

175. *Id.*; Tully, *Money Machine Breaks Down*, *supra* note 33, at 68.

176. Loomis, *supra* note 173, at 69. *See also* Tim Bowler, *The Rise and Fall of Citigroup*, BBC, Jan. 16, 2009, http://news.bbc.co.uk/2/hi/business/7746077.stm ("If the bank had been allowed to collapse, it could have caused financial havoc around the globe, seizing up fragile lending markets and causing untold losses among institutions holding debt and financial products backed by the company.").

177. Shannon D. Harrington & Elizabeth Hester, *Citigroup Rescues SIVs With $58 Billion Debt Bailout (Update1)*, BLOOMBERG.COM, Dec. 14, 2007, http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=aS0Dm.iV5BCI.

178. In fact, not even the Chair of the Citigroup Executive Committee comprehended the risks from these instruments. Loomis, *supra* note 173, at 69.

179. Evan Thomas & Michael Hirsh, *Rubin's Detail Deficit*, NEWSWEEK, Dec. 8, 2008, at 45.

180. Bicksler, *supra* note 149, at 297.

181. Bowler, *supra* note 176.

182. Jonathan Stemple, *Citigroup Stock Falls Below $1 for First Time*, REUTERS, Mar. 5, 2009, http://www.reuters.com/article/bondsNews/idUSN0532847720090305.

183. Bradley Keoun, *Citi Cost-Cutters Skip Offices, Staff for Ex-CEOs Prince, Reed*, BLOOMBERG.COM, Feb. 17, 2009, http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=a.MJ0tBKx67w.

184. Bicksler, *supra* note 149, at 297.

action.[185] Citigroup, however, had inserted an exculpatory provision into its charter which effectively allowed management to insulate itself from liability for violation of the duty of care under Delaware law.[186] Moreover, the court stated that "bad faith is a necessary condition to director oversight liability."[187] Further, the court applied Delaware precedent to find that a board is permitted the protection of the business judgment rule to assure the firm does not sue them derivatively.[188] With respect to claims regarding the excessive compensation paid to CEO Prince, the court permitted this claim to proceed.[189] But history suggests that such a claim is not promising.[190] Merrill Lynch CEO Stanley O'Neal garnered $91 million in compensation for 2006, a year in which Merrill reported record earnings.[191] In October 2007, when Merrill recognized $14.1 billion in subprime losses, O'Neal retired.[192] His severance package totaled $160 million.[193] According to the allegations of securities fraud claims asserted by Merrill's shareholders, 2006 also marked the beginning of a multiyear effort by management to mislead investors about the nature and magnitude of Merrill's subprime mortgage exposure.[194] On January 16, 2009, Merrill Lynch announced it had reached an agreement with the shareholders' counsel to settle such claims for $550 million.[195]

Merrill Lynch also worked hard to keep the music playing, and when customers stopped buying securities backed by subprime mortgages, Merrill

185. *In re* Citigroup Inc. Shareholder Derivative Litig., 964 A.2d 106, 114–15 (Del. Ch. 2009).

186. *Id.* at 124–25 (citing DEL. CODE ANN., tit. 8, § 102 (b)(7) (2009)).

187. *Id.* at 120 (citing Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006)).

188. *Id.* at 121–22 (finding that "[d]emand is not excused solely because the directors would be deciding to sue themselves" and instead plaintiff must show "egregious" misconduct).

189. *Id.* at 140.

190. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 34 (Del. 2006) (ruling for defendants in a case involving payment of severance pay of $130 million for fourteen months service). *See also* Marc I. Steinberg & Matthew D. Bivona, *Disney Goes Goofy: Agency, Delegation, and Corporate Governance*, 60 HASTINGS L.J. 201, 231 (2008) (arguing that Delaware gives CEOs too much autonomy that is likely to diminish the effectiveness of independent directors, and suggesting that Delaware may be willing to jawbone directors but is not likely to enforce sound corporate governance standards through money damages).

191. Bicksler, *supra* note 149, at 297.

192. *Id.*

193. *Id.*

194. Matthew C. McNally, *Merrill Lynch Reveals $475M Deal to Settle Subprime Fraud Suit*, 14 SEC. REG. & LITIG. REP. 19 (2009), *available at* http://news.findlaw.com/andrews/bf/scl/20090121/20090121_merrill.html ("The defendants, allegedly motivated by millions of dollars in cash bonuses and stock award grants tied to the company's performance, only gradually revealed the true extent of Merrill's mortgage-related losses in a series of statements beginning in October 2006.").

195. Merrill Lynch & Co., Inc., Current Report (Form 8-K), at 2 (Jan. 16, 2009), *available at* http://www.sec.gov/Archives/edgar/data/65100/000095012309000815/y74071e8vk.htm.

purchased billions of dollars in its own products, which customers did not want—particularly collateralized debt obligation (CDOs) based upon subprime mortgages.[196] The probable reason: "Merrill became addicted to the fees that flowed from financing CDOs, which reached $700 million in 2006."[197] Merrill lost $27.61 billion in 2008, and was taken over by Bank of America, which received $45 billion in government bailout funds as well as asset guarantees of $118 billion.[198] Merrill shareholders lost $30 billion between the date of the announced Bank of America takeover and the closing of the merger.[199] Moreover, Merrill Lynch racked up nearly $40 billion in losses in its last few quarters.[200]

American International Group, or AIG, once the world's largest insurance company, apparently lost more than any other firm.[201] On March 2, 2009, AIG announced the largest quarterly loss in all of corporate history, totaling $61.7 billion.[202] AIG was subject to a patchwork of regulatory regimes, ranging from the Office of Thrift Supervision (OTS),[203] to the New York State Department of Insurance, and various other international and domestic agencies.[204] The AIG Financial Products unit, which caused the catastrophic

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196. *See* Tully, *Money Machine Breaks Down*, *supra* note 33, at 76.

197. *Id.*

198. Jonathan Stempel, *Merrill Q4 Loss $15.84 Bln, Has Material Weakness*, REUTERS, Feb. 25, 2009, http://uk.reuters.com/article/hotStocksNewsUS/idUKTRE51N6YA20090225.

199. Jonathan Stempel, *Bank of America/Merrill Merger Wins Shareholder OK*, REUTERS, Dec. 8, 2008, http://www.reuters.com/article/bankingFinancial/idUSN0529675320081208.

200. Dan Fitzpatrick et al., *In Merrill Deal, U.S. Played Hardball*, WALL ST. J., Feb. 5, 2009, at A1.

201. Hugh Son & Margaret Popper, *AIG's CEO Says Insurer Can Still Repay Taxpayers*, BLOOMBERG.COM, Mar. 2, 2009, http://www.bloomberg.com/apps/news?pid=20601103&sid=ahykOmEesvWk&refer=us. AIG underwrote $450 billion of credit default swaps that obligated it to pay on pools of securities in the event that the primary obligees failed to pay. Lilla Zuill & Kristina Cooke, *AIG Failure Would Be Disastrous for Global Markets*, REUTERS, Mar. 2, 2009, http://uk.reuters.com/article/stocksAndSharesNews/idUKLNE52101620090302?pageNumber=1&virtualBrandChannel=0. As of March 2, 2009, the government had pumped $200 billion into AIG, but it still had $300 billion in credit default swap exposure. *Id.*

202. See Son & Popper, *supra* note 201.

203. *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 12 (2009) [hereinafter *OTS Statement*] (statement of Scott M. Polakoff, Acting Director, Office of Thrift Supervision) (stating that losses occurred in the unregulated AIG Financial Products unit and that the OTS only regulated the AIG Federal Savings Bank unit and the AIG holding company), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=01e2f009-eb49-45db-9 349-99174a45da32.

204. *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 2 (2009) (statement of Eric Dinallo, Superintendent, New York State Insurance Department) (stating that the State of New York was the primary regulator of only 10 of 71 AIG insurance subsidiaries and that AIG operated in 130 countries through 176 operating

losses, was unregulated—but was backed by the full credit and guarantee of the parent company.[205] Fed chairman Ben Bernanke maintains that AIG "exploited a huge gap in the regulatory system" and operated as an unregulated hedge fund that "made huge numbers of irresponsible bets."[206] Treasury Secretary Timothy Geithner concurred, calling AIG a hedge fund that grew "without any adult supervision."[207] The Treasury Secretary and the Fed chairman speak with particular authority since they engineered the bailout of AIG, which left the United States as the owner of nearly 80% of the firm.[208]

AIG's losses arise from credit default swaps (CDS), whereby the firm assumed the risk of loss on pools of subprime related securities.[209] Essentially, the firm acted as credit insurer; yet, the credit default swaps were not insurance, and AIG assumed these risks through an unregulated subsidiary, meaning it did not have to reserve fully against future losses nor carry any capital to fund potential losses.[210] The fees generated from the credit default swaps were consequently free income with little associated expense.[211] AIG literally gambled its viability away in the name of short-term profits.[212] When

subsidiaries), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=8ee655c8-2aed-4d4b-b36f-0ae0ae5e5863.

205. *OTS Statement*, *supra* note 203, at 5.

206. *Economic and Budget Challenges for the Short and Long Term: Hearing Before the S. Budget Comm.*, 111th Cong., 3 (2009) (statement of Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System).

207. *President's Fiscal Year 2010 Budget Overview: Hearing Before the H. Comm. on Ways and Means*, 111th Cong., 3 (2009) (statement Timothy Geithner, secretary, U.S. Treasury), *available at* http://waysandmeans.house.gov/hearings.asp?formmode=view&id=7849.

208. Joint Press Release, Board of Governors of the Federal Reserve System and U.S. Department of the Treasury, U.S. Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan (Mar. 2, 2009), *available at* http://www.federalreserve.gov/newsevents/press/other/20090302a.htm.

209. *See* Michael Lewitt, *Wall Street's Next Big Problem*, N.Y. TIMES, Sept. 16, 2008, at A29. One money manager defined credit default swaps as a credit insurance contract in which one party pays another party to protect it from the risk of default on a particular debt instrument: "The insurer (which could be a bank, an investment bank or a hedge fund) is required to post collateral to support its payment obligation, but in the insane credit environment that preceded the credit crisis, this collateral deposit was generally too small." *Id.*

210. *See id.*

211. Stephen Taub, *New York: Credit-Default Swaps=Insurance*, CFO.COM, Sept. 22, 2008, http://www.cfo.com/article.cfm/12285201. Ironically, shortly after AIG's federal bailout, New York determined that credit default swaps would be regulated as if they were contracts of insurance, meaning that firms would have to hold capital reserves to secure the obligations. *Id.*

212. *See* Gretchen Morgenson, *A.I.G., Where Taxpayers' Dollars Go to Die*, N.Y. TIMES, Mar. 8, 2009, at BU1, BU2. AIG obligated itself to assume up to $440 billion in credit default swaps, which was more than twice its total market value of $200 billion. "That means the geniuses at A.I.G. who wrote the insurance were willing to bet more than double their company's value that defaults would not become problematic. That's some throw of the dice. Too bad it came up snake eyes for taxpayers." *Id.*

the market for subprime securities crashed, AIG absorbed huge losses in the form of obligations to subprime investors.[213] The short-term profits were used to fund a $600 million bonus pool for the officers in charge of the unit that underwrote the credit default swaps.[214] The CEO who managed AIG into this subprime mess was paid $47 million in severance pay when discharged.[215] The U.S. government effectively seized control in late 2008, at a cost of billions to U.S. taxpayers.[216]

The essential problem at AIG involves a failure of risk management. The firm's management simply concluded that the risks of ever being obligated to pay under the credit default swap agreements were so remote that little risk management was needed. AIG never hedged its exposure to credit default swaps, and only limited its exposure after it had entered into hundreds of billions in agreements.[217] The OTS leveled criticisms regarding "risk management, corporate oversight, and financial reporting, culminating in [a] Supervisory Letter issued by OTS in March 2008, which downgraded AIG's examination rating."[218] The firm's auditors found similar problems and alerted the firm to material weaknesses in risk management.[219] In particular, the firm suffered from severe liquidity risk and was unable to meet collateral calls in accordance with the CDS agreements;[220] in fact, the OTS "in hindsight" now maintains that if the liquidity risks of the CDS agreements had been properly assessed, AIG would have been ordered to reduce its CDS exposure.[221] This risk mismanagement cost shareholders dearly: the shares of AIG traded as high

213. By the end of 2007, AIG had lost $61.7 billion due to its subprime related securities. David Glovin & Joel Rosenblatt, *Maurice Greenberg Sues AIG Over 'Inflated' Shares*, BLOOMBERG.COM, Mar. 2, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aHDoc7YcjQZI&refer=home.

214. Lilla Zuill, *NY AG Says Targeting Exec Pay at AIG, Elsewhere*, REUTERS, OCT. 22, 2008, http://www.reuters.com/article/newsOne/idUSTRE49L6I420081022?pageNumber=1&virtualBrandChannel=0.

215. *Id.* It is not clear how much of compensation will ultimately be paid to the AIG executives because their pay is being challenged by the Attorney General of New York. *Id.* ("It is not just compensation, but incentives—perverse incentives for executives to produce (short-term) profit rather than long-term growth,' said Cuomo . . . . ") (quoting New York Attorney General Andrew Cuomo).

216. *See* Brady Dennis, *AIG Posts $61.7 Billion Loss, Faces Grim Future*, WASH. POST, Mar. 3, 2009, at D1.

217. Robert O'Harrow Jr. & Brady Dennis, *Downgrades and Downfall*, WASH. POST, Dec. 31, 2008, at A1.

218. *OTS Statement*, *supra* note 203, at 6.

219. O'Harrow & Dennis, *supra* note 217.

220. *Id.*

221. *See OTS Statement*, *supra* note 203, at 6.

as $70 per share in 2007, and, as of its latest bailout, the shares traded for less than $2.[222]

Washington Mutual (WaMu) was the nation's largest thrift, until it became the nation's largest bank failure.[223] Four elements of Washington Mutual's business epitomized reckless lending: First, "WaMu gave mortgage brokers handsome commissions for selling the riskiest loans, which carried higher fees, bolstering profits and ultimately the compensation of the bank's executives;" second, "WaMu pressed sales agents to pump out loans while disregarding borrowers' incomes and assets;" third, "The bank set up what insiders described as a system of dubious legality that enabled real estate agents to collect fees of more than $10,000 for bringing in borrowers, sometimes making the agents more beholden to WaMu than they were to their clients;" and fourth, "WaMu pressured appraisers to provide inflated property values that made loans appear less risky, enabling Wall Street to bundle them more easily for sale to investors."[224] It suffered mortgage-related losses in excess of $11 billion in 2008.[225] Washington Mutual's CEO received a total of $88 million in pay between 2001 and 2007.[226] Yet, the losses from loans wiped out all of its earnings from 2005 and 2006, as well as three months worth of profits generated in 2004.[227] When the profits disappeared, the CEO still kept his "performance" compensation.[228]

In all, "Executives at seven major financial institutions that have collapsed, were sold at distressed prices or are in deep to the taxpayer received $464 million in performance pay since 2005."[229] But these same firms recognized $107 billion in losses, and shed $740 billion in shareholder wealth since 2007.[230] The seven firms include American International Group, Bear Stearns,

222. Matt Krantz, *AIG: Removal from Dow Index Is the Least of Your Worries*, USA TODAY, Oct. 6, 2008, http://www.usatoday.com/money/perfi/columnist/krantz/2008-10-06-aig-stock-dow_N.htm; Jonathan Stempel & Lilla Zuill, *AIG Has $61.7 Billion Loss, New US Aid May Not Be Last*, REUTERS, Mar. 2, 2009, http://www.reuters.com/article/ousiv/idUSN0134457520090302.

223. *See* Jon Talton, *WaMu's Loyal Shareholders Left Holding the Empty Bag*, SEATTLE TIMES, Nov. 9, 2008, http://seattletimes.nwsource.com/html/jontalton/2008368307_biztaltoncol09.html.

224. Peter S. Goodman & Gretchen Morgenson, *Saying Yes to Anyone, WaMu Built Empire on Shaky Loans*, N.Y. TIMES, Dec. 28, 2008, at A1. The *New York Times* interviewed twenty-four former employees and others who did business with WaMu, who portrayed the thrift's business in a manner consistent with 89 confidential witnesses from a shareholders suit against WaMu management. *Id.*

225. *See id.*

226. *Id.*

227. Gretchen Morgenson, *Gimme Back Your Paycheck*, N.Y. TIMES, Feb. 22, 2009, at BU1.

228. *Id.*

229. *Id.*

230. *Id.*

Citigroup, Countrywide Financial, Lehman Brothers, Merrill Lynch, and Washington Mutual, each of which were central players in the subprime catastrophe.[231] Thus, the CEOs of these firms were compensated based upon illusory profits—profits, in fact, that very soon transmogrified into staggering losses—yet, faced no liability or obligation to repay their "performance pay" when the losses sunk their firms.[232] According to Amy Borrus, deputy director at the Council of Institutional Investors, "Poorly structured pay packages encouraged the get-rich-quick mentality and overly risky behavior that helped bring financial markets to their knees and wiped out profits at so many companies. . . . yet many of these C.E.O.'s have pocketed enormous compensation.'"[233]

One telling feature of the subprime mortgage debacle involves the use of leverage—i.e., debt—to enhance short-term profits.[234] Debt can be used to amplify the profitability of an investment so long as the cost of borrowing is less than the rate of return on the asset. But the opposite is also true: Investing with borrowed funds can inflict greater losses if things go wrong.[235] The subprime fiasco marks a high point in the use of leverage to generate higher earnings. Indeed, the investment industry as a whole solicited a major change in SEC regulation: The SEC eliminated the net capital rule for the nation's largest investment banks and allowed the banks to use as much leverage as their CEOs desired.[236] This leverage turned toxic and resulted in huge losses when securities backed by subprime mortgages declined in value.[237] Fire sales ensued as firms sought liquidity to unwind debt obligations.[238] This excessive leverage could be expected to explode, as it has, in a system where CEOs benefit from short term profits and are insensitive to risk.

231. *Id.*

232. Morgenson, *supra* note 227, at BU7.

233. *Id.* (quoting Amy Borrus, deputy director at the Council of Institutional Investors).

234. Anil K. Kashyap et al., Rethinking Capital Regulation 39 (Sept. 2008) (unpublished paper available through the Federal Reserve Bank of Kansas City), *available at* http://www.kc.frb.org/publicat/sympos/2008/KashyapRajanStein.09.15.08.pdf ("Our analysis of the current crisis suggests that governance problems in banks and excessive short-term leverage were at its core.").

235. *See* Floyd Norris, *Credit Crisis? Just Watch What Happens with Corporate Bonds*, N.Y. TIMES, Dec. 28, 2007, at C1.

236. Labaton, *supra* note 136, at A1.

237. *See Worse than Japan*, ECONOMIST, Feb. 14, 2009, at 81, 82 ("Rapid deleveraging . . . also means that cleaning up banks' balance-sheets may not break the spiral that is driving down asset prices and stalling financial markets . . . . [F]inancial-sector debt was the fastest-growing component of private-sector debt in recent years. Many of those excesses are being unwound at warp speed.").

238. *See id.*

The options backdating scandal that came to light in 2006 should have triggered substantial reforms.[239] It manifested a fundamentally flawed system of corporate governance.[240] Essentially, CEOs lined their pockets through fraud and imposed huge deadweight losses upon shareholders.[241] The subprime debacle repeated this dementia on a grander scale with greater losses to the American economy and the global financial system.[242] At the bottom, CEOs systematically overreached for immediate compensation without regard to the welfare of shareholders, or systemic risk.[243] These episodes demonstrate a compelling need to curb CEO autonomy.[244]

The next part of this Article explains the deep sub-optimality of American corporate governance law. CEO autonomy over the public corporation reflects CEO political and economic power. In particular, state law (especially Delaware) fails to reduce CEO autonomy to acceptable levels because the

239. *See* Stephanie Saul, *Study Finds Backdating of Options Widespread*, N.Y. TIMES, July 17, 2006, at C1 ("More than 2,000 companies appear to have used backdated stock options to sweeten their top executives' pay packages . . . .").

240. *See* Charles Forelle & James Bandler, *Matter of Timing: Five More Companies Show Questionable Options Pattern*, WALL ST. J., May 22, 2006, at A1 (quoting former SEC Chair Arthur Levitt, options backdating is essentially "stealing" through the use of fabricated documents, unless fully disclosed).

241. M.P. Narayanan et al., *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1641 (2007) ("[O]ur evidence suggests that managerial theft is not a zero-sum game, but involves huge dead-weight losses for the shareholders.").

242. *See* Maria Bartiromo, *Nell Minow on Outrageous CEO Pay—and Who's to Blame*, BUS. WK., Feb. 19, 2009, http://www.businessweek.com/magazine/content/09_09/b412101545 7000.htm ("Enron, and WorldCom seemed very localized . . . . [b]ut in this case, because the problem seems so systemic and there has been no indication that anyone has done anything illegal, that has fueled a level of rage I have never seen before.") (quoting corporate governance expert Nell Minow).

243. *See The Bonus Racket*, ECONOMIST, Jan. 31, 2009, at 81 ("In effect, executives and employees were given a call option on the markets by the banking system. They took most of the profits when the market was booming and shareholders bore the bulk of the losses during the bust."). In the last three years, Bear Stearns paid $11.3 billion in bonuses while the shareholders were wiped out in bankruptcy; Lehman Brothers paid $21.6 billion and went bankrupt; finally, Merrill Lynch paid bonuses of $45 billion while its shareholders got $9.6 billion in Bank of America stock. *Id.*

244. Steven A. Ramirez, *The Special Interest Race to CEO Primacy and the End of Corporate Governance Law*, 32 DEL. J. CORP. L. 345, 367 (2007) ("The mere fact that this kind of scam was occurring at publicly traded companies at all, suggests that corporate governance is not operating to reduce CEO autonomy (and thus agency costs) to acceptable levels.") [hereinafter Ramirez, *The Special Interest Race*]. "[S]ecret backdating, which was generally illegal, was unlikely intended to serve shareholders' interests. However, each type of secret option backdating boosted and camouflaged managerial pay. Secret backdating thus provides further support for the view that managerial power has played an important role in shaping executive compensation arrangements." Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 886 (2008).

political structure governing state corporate governance standards will evolve only in accordance with the interests of managers—not shareholders or the interests of the economy generally. Thus, major federal intervention is necessary.

III. DELAWARE'S INFERIORITY

The political dynamics of corporate governance yields suboptimal results and retards its evolution towards optimality.[245] These political dynamics manifest themselves across federal[246] and state jurisdictions,[247] as well as within agencies such as the SEC.[248] Indeed, senior SEC officials openly acknowledge the sway of special interests upon SEC policy.[249] The most prominent domicile of public firms, Delaware, long ago declared its policy of promulgating pro-corporate laws.[250] In the past, I have addressed the need to restructure the legal and regulatory framework governing corporate

245. Ramirez, *The Special Interest Race*, *supra* note 244, at 367 (reviewing the evolution of corporate governance law in the 1980s and 1990s and concluding that it had "devolved . . . into a dictatorship of management, by management, and for management" under the current system of corporate federalism). *See generally* Lucian A. Bebchuk & Zvika Neeman, *Investor Protection and Interest Group Politics*, REV. FIN. STUD. (forthcoming) (articulating a model of sub-optimal corporate governance based upon lobbying resources and incentives and concluding that a CEO primacy model is consistent with extant empirical evidence).

246. There is powerful evidence that the dilution of investor remedies under the federal securities laws (pursuant to the PSLRA) was the product of special interest influence. See Ramirez, *Arbitration and Reform*, *supra* note 13, at 1087 n.156, for evidence that lobbying and campaign contributions fueled the political effort to eviscerate private securities litigation.

247. For example, Delaware essentially abolished the duty of care for directors of public firms in 1987, through the passage of Delaware General Corporation Law (DGCL) section 102 (b)(7). The synopsis of the bill indicated that the legislature was animated by the concerns of the insurance industry. *See* Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 43 (1989). This is odd given that the market value of such insurance companies rose significantly after the *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), decision. *Id.* at 73–74. It appears insurance companies were able to use the decision to enhance their premium revenues with little real additional risk. *Id.*

248. *See* ARTHUR LEVITT, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW 106–15 (2002) (recounting how "the business lobby" and "CEOs" successfully used Congress and the SEC to thwart reform efforts, such as those by the Financial Accounting Standards Board to require that options be expensed on corporate income statements).

249. Professor Lynn Turner, former SEC Chief Accountant, asserts that the Bush Administration kept Former SEC Chairman Harvey Pitt on in order to further the goals of special interests and to minimize the impact of SOX. Tim Reason, *Did the SEC Gut Sarbanes-Oxley?*, CFO MAGAZINE, Mar. 2003, at 1 ("It's becoming more and more clear to investors that the Administration kept Pitt in place to get done what the special interests wanted, which was to minimize Sarbanes-Oxley as much as possible.").

250. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 663 (1974).

governance to reduce its susceptibility to special interest influence.[251] I have also suggested that before any fundamental reform can occur, sufficient political and economic power must be marshaled to support such reform.[252] The current economic crisis is conducive to fundamental reform, and this Article seeks to articulate an optimal vision of CEO autonomy in light of the lessons of the subprime fiasco.[253]

Some scholars suggest that the current system of corporate governance tends towards optimality.[254] Essentially they posit that states are incentivized to create ever more refined corporate governance standards to attract corporate franchise tax revenues.[255] The empirical support for this vision of optimal corporate governance law is sketchy at best.[256] Other scholars point out that firms seem to pursue the protection of anti-takeover legislation rather than any concept of optimal corporate governance, which entrenches management and destroys shareholder wealth.[257] Recently, several scholars have settled upon

251. *See* Ramirez, *The End of Corporate Governance Law*, *supra* note 12, at 347–58 ("[T]he fact that every change seems to operate to entrench the power of management and enhance the sway of the CEO over the corporation suggests that corporate federalism is ideally suited to the exercise of special interest influence . . . .").

252. *See* Ramirez, *Games CEOs Play*, *supra* note 80, at 1585 ("Interest convergence theory holds that reform occurs when the interests of the racially oppressed align with the interests of the people who have the power to bring about reform.").

253. *See id.* at 1606 (stating that the key to reform "is to exploit opportunistically events and political pressure").

254. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 14–17 (1993) (stating that empirical evidence shows that choice among jurisdictions for incorporation "benefits rather than harms shareholders").

255. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 276 (1977) ("So far as the capital market is concerned, it is not in the interest of management to seek out a corporate legal system which fails to protect investors, and the competition between states for charters is generally a competition as to which legal system provides an optimal return to both interests.").

256. Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1820–21 (2002) (finding that empirical evidence does not support the conclusion that state competition for incorporations yields optimal corporate law outcomes). *Compare* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 527 (2001) (finding evidence that Delaware corporations had higher firm value), *with* Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 57 (2004) ("Delaware's trajectory over the past 12 years is more consistent with the predictions of the race to the bottom view.").

257. Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 387 (2003) ("[A]ntitakeover protections are correlated with success in the incorporation market; adding antitakeover statutes significantly increases the ability of states to retain their local firms and to attract out-of-state incorporations."). The "overwhelming majority" of event studies show that antitakeover protections have either no effect on shareholder value or harm shareholder value. *Id.* at 404–05 (citing, *inter alia*, GRANT A. GARTMAN, STATE ANTI-

the view that rather than competing for corporate charters, Delaware is a monopolist, far more concerned with maintaining its privileged position than optimizing corporate law standards.[258] Naturally, a monopolist will act to extract monopoly rents rather than to serve the nation's interest in appropriate corporate governance standards.[259]

Whatever the underlying causes, Delaware corporate law, combined with flaws at the federal level, is deeply suboptimal. After the parade of scandals in 2001–2002, scholars questioned the optimality of corporate governance standards yielded by the current system of corporate federalism.[260] In a 2007 article, I argued that the gap between the emerging science of corporate governance and the reality of corporate governance belied any competition among jurisdictions toward optimality.[261] I instead posited that public choice and collective action problems explained the evolution of corporate governance law for public firms;[262] by virtue of their positions, CEOs of public firms command concentrated economic resources and suffer no substantial collective action problems to impede their ability to organize because of their small numbers.[263] These political dynamics took hold of corporate governance law at the state level as well as the federal level.[264]

TAKEOVER LAW (2000)). In addition, there is empirical evidence that such statutes operate to increase agency costs. *Id.* at 405.

258. *See* Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?*, 22 J.L. ECON. & ORG. 1, 13 tbl.2 (2006). *See generally* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002) (discussing Delaware's superiority in attracting corporations and maintaining its monopoly). Ninety-seven percent of America's public firms are incorporated in either Delaware or the firm's home state. Robert Daines, *The Incorporation Choices of IPO Firm*s, 77 N.Y.U. L. REV. 1559, 1562 (2002).

259. For example, Professor Renee Jones argues that Delaware courts imposed "stricter judicial scrutiny" over management, in a possible effort to preserve Delaware's position as the primary source of charters for public companies, after the fall of Enron. Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 643–63 (2004).

260. *See id*. at 663 (stating that the spate of corporate corruption in 2001–02 "reveals flaws in modern federalist arguments denouncing national-level regulation").

261. Ramirez, *The Special Interest Race*, *supra* note 240, at 379–83 ("The science of corporate governance shows that there is no market pressure for optimal corporate governance; there is only market pressure for indulgent pro-management corporate governance law.").

262. *Id.* at 383–84, n.223 (citing MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION 2, 11, 165 (rev. ed. 1971) (stating that very large groups will not pursue organization to influence public goods like law because rational actors will instead assume that they can free ride on the efforts of others); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 343 (1974) (stating the economic theory of regulation rejects the use of the term "capture" as "inappropriately militaristic," but recognizes that private interests may subvert regulation).

263. *See id.* at 383–91.

264. *See id*. at 391–92.

Implicit in this vision of special-interest-driven corporate governance law is an inherently retarded evolutionary course for corporate governance law. It could be expected to evolve in pro-management directions, but it would not evolve in ways that constrain the power of management, particularly with respect to CEO autonomy. Thus, the duty of care would evaporate.[265] Private securities litigation would be eviscerated.[266] Anti-takeover legislation and similar impediments to hostile takeovers would thrive.[267] Courts would be very reluctant to question compensation.[268] Management would continue to monopolize the corporate proxy machinery.[269] Even SOX did little to disrupt the power of the CEO beyond the audit function.[270] All of this fits the collective action and public choice model of corporate governance lawmaking.[271]

265. *See* Marc I. Steinberg, *The Evisceration of the Duty of Care*, 42 SW. L.J. 919, 927–28 (1988) ("An eradication of fiduciary duties . . . would likely occur, however, if Delaware elects to amend its statute in order to incorporate the more lax provisions enacted by some states.").

266. *See* Douglas M. Branson, *Running the Gauntlet: A Description of the Arduous, and Now Often Fatal, Journey for Plaintiffs in Federal Securities Law Actions*, 65 U. CIN. L. REV. 3, 6 (1996) ("In forty federal securities law decisions, the Court decided thirty-two cases for defendants and, in almost every one, significantly narrowed the reach of federal securities laws.").

267. *See generally* Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005) ("Staggered boards, which a majority of U.S. public companies have, substantially insulate boards from removal in either a hostile takeover or a proxy contest.").

268. Linda J. Barris, *The Overcompensation Problem: A Collective Approach to Controlling Executive Pay*, 68 IND. L.J. 59, 100 (1992) ("With the massive compensation now being awarded, courts have the perfect opportunity to find specific plans are unreasonable and unfair to shareholders, instead of shielding excess compensation practices with the business judgment rule."); Mark J. Loewenstein, *Reflections on Executive Compensation and Modest Proposal for (Further) Reform*, 50 SMU L. REV. 201, 214 (1996) (stating that while some law suggests courts will enforce outer limits regarding compensation "in publicly-held corporations, in fact the courts just do not reach the merits of a claim of excessive compensation" because of difficult procedural hurdles).

269. *See generally* Amy Borrus, *SEC Reforms: Big Biz Says Enough Already*, BUS. WK., Feb. 2, 2004, at 43 (detailing the efforts of corporate managers to stifle proxy reform); Amy Borrus & Mike McNamee, *A Legacy That May Not Last*, BUS. WK., June 13, 2005, at 38 (discussing business lobbying efforts to frustrate proxy reform). Consequently, the entire SOX reform effort, including associated reforms in corporate governance at the New York Stock Exchange and the NASDAQ Marketplace, has left CEOs in virtual unfettered control of the machinery of so-called corporate democracy. *See generally* Thomas W. Joo, *A Trip Through the Maze of "Corporate Democracy": Shareholder Voice and Management Composition*, 77 ST. JOHN'S L. REV. 735, 767 (2003) ("For all the current talk of corporate governance reform, corporate democracy remains a myth.").

270. *See* Steven A. Ramirez, *Fear and Social Capitalism: The Law and Macroeconomics of Investor Confidence*, 42 WASHBURN L.J. 31, 63–65 (2002) (concluding that SOX may be a "political fraud" because it failed to restore private litigation as one means of containing agency costs).

271. Illustrative of management's facile autonomy over Delaware law is a recent Delaware innovation that allows managers to dispense with meeting face-to-face with shareholders. In

The flip side of this vision of evolution in favor of CEOs is the total lack of any legal or regulatory innovation that would cabin CEO autonomy.[272] In fact, Delaware is specifically structured to assure that no legislative modification of the corporation law could succeed without the support of management interests; the Delaware constitution prohibits changes to the corporation act without two-thirds approval in the legislature.[273] Given the key role that the corporate bar plays in the Delaware legislative process,[274] any amendment to the corporation code in Delaware simply must have management support.[275] Moreover, Delaware is concerned with maintaining its preeminent position, but has little concern over controlling agency costs or assuring that its corporate law either maximizes the financial performance of the public firm or that the public firm is macroeconomically optimized.[276] So Delaware looks to federal

2000, the Delaware corporation law was amended to provide for "virtual annual meetings." Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1779–80 n.136 (2006) (citing DEL. CODE ANN., tit. 8, § 211(e) (2006)). Shareholder advocates protested this innovation. *Id.* (citing Olga Kharif, *Let's Take an E-Meeting*, BUS. WK., July 31, 2000, at 8 (quoting Nell Minow that with the "virtual meeting" managers "never have to look [the] shareholders in the eye again")).

272. Professor Hamermesh has provided a first-hand account of what motivates the attorneys who draft any changes to Delaware's corporate code:

> It is a sufficient response to Cary at this point, in any event, to assert merely that today's drafters of the DGCL do not devote an iota of conscious effort to make that statute more friendly to management and less protective of stockholders. To the contrary, as explained below, we favor a much more conservative approach that seeks to maintain whatever balance currently exists, and we are distinctly uncomfortable with any change that alters that balance in either direction.

Hamermesh, *supra* note 271, at 1763–64.

273. DEL. CONST. art. IX, § 1 (1897).

274. Hamermesh, *supra* note 271, at 1755 ("[T]he function of identifying and crafting legislative initiatives in the field of corporate law has been performed by the Corporation Law Section of the Delaware State Bar Association.").

275. *See id.* at 1755–56 (discussing the process of crafting corporation legislation in Delaware and the pro-management parties involved).

276. Professor Hamermesh could not be clearer that Delaware simply does not care about managing agency costs, assuring that its law reflects empirical learning with respect to optimal corporate governance, or that the public firm serves the macroeconomic interests of the United States. He lists the following policy concerns that drive Delaware law:

> [P]olicymakers are attentive to, and respond to, interstate competitive threats as well as potential federal expansion in the field of corporate law. Within those very broad limits, however, these policymakers act on conventional notions of (1) enhancing flexibility to engage in private ordering; (2) deferring to case-by-case development of the law, and avoiding legislation that is prescriptive and proscriptive; (3) avoiding impairment of preexisting contractual relationships and expectations; and (4) most importantly, avoiding legislative change in the absence of clear and specific practical benefits. Above all, Delaware corporate law is conservative.

Id. at 1752. The only conclusion to draw from Professor Hamermesh's inside account of corporate lawmaking in Delaware is that it is simply not the job of Delaware to get corporate law to control agency costs and to optimize the corporation from a financial and macroeconomic perspective.[277] It is hardly Delaware's fault that corporate governance in America is so deeply suboptimal; the blame lies squarely with the federal government because only the federal government is institutionally suited to impound the learning from economics, finance, and accounting, as well as the nationwide economic costs of allowing agency costs to fester.[278]

To be fair, these narrow interests admit to their influence and claim that they leave the parochial interests of their clients out of their secret deliberations.[279] But even those sympathetic to Delaware law recognize that management exercises influence over incorporations and that Delaware is keenly interested in maintaining its position as the leader in the market for corporate charters.[280] Professor Lawrence Hamermesh has provided an insider's account of how corporate law is made in Delaware, and the portrayal he provides is tailor-made for the exercise of special interest influence.[281] First, all amendments to the Delaware corporate law are crafted by the corporate bar, consisting of twenty-one Delaware attorneys.[282] Second, these individuals meet in secret with no record of their discussions.[283] Third, the

governance right; instead they depend upon federal law to optimize corporate governance. *See id.* ("Delaware can do and will do little if anything to stand in the way of [federal] responses.").

277. Professor Hamermesh managed to write an entire law review article addressing the policy foundations of Delaware law with nary a mention of the term "agency costs." *See id*.

278. Professor Hamermesh states that when a legislative initiative to amend the DGCL is presented to the legislature, it moves "very promptly" to a vote. *Id.* at 1754. Additionally, Professor Hamermesh suggests that the legislators "have not taken on any significant role" in crafting legislation. *Id.* In light of these facts, hearings with testimony from experts seemingly gum up the works in Delaware. *Id*. at 1753–56.

279. Hamermesh, *supra* note 271, at 1758.

280. *See id.* at 1753–54 ("Revenue from the state corporate franchise tax alone has in recent years constituted over twenty percent of the state's budget, a fact of which Delaware legislators are intensely aware.").

281. *Id.* at 1755 ("[F]or decades now the function of identifying and crafting legislative initiatives in the field of corporate law has been performed by the Corporation Law Section of the Delaware State Bar Association. In particular, it is the governing body of the Corporation Law Section—its Council—that develops such initiatives.").

282. *Id.* at 1755. ("The Council currently consists of twenty-one members . . . . [S]even of the large commercial law firms in Wilmington have nominated two members each; the other members practice in smaller firms (or in my case, teach), all in Wilmington."). These twenty-one Wilmington attorneys are unelected, unaccountable to the American body politic, and apparently unconcerned with controlling agency costs within public firms; it would be difficult to imagine a less democratic or more economically pernicious means of making corporate law which incontestably affects the well-being of every American. Professor Hamermesh provides the allocation of Council positions among the Wilmington corporate firms. *Id*. at 1755 n.23.

283. *Id.* at 1757 ("For better or worse—and Council members would almost certainly say for better—the work of the Council proceeds in private. There is a strongly held tradition that preliminary or potential legislative proposals are not to be discussed with or disseminated to persons outside the firms represented on the Council.").

group is heavily tilted towards attorneys representing management interests.[284] Finally, there is virtually no partisan debate regarding amendments.[285] Professor Hamermesh suggests this makes for "conservative" lawmaking.[286] I suggest that Delaware law simply cannot evolve in a direction that restrains the power of managers.[287] I have previously remarked upon the chasm between the best empirical learning regarding corporate governance and standards prevailing in Delaware.[288] And Professor Hamermesh articulates a lawmaking framework that explains this chasm.[289]

Parts II, III, and IV all lead to the same conclusion: The current system of corporate federalism for public firms in the United States fails to curb agency costs, leaves too much autonomy in the hands of CEOs, and permits CEOs to pursue short-term profits without regard to risks. The next part of this Article articulates a rationalized framework for controlling CEO autonomy within the public firm. It will draw upon the lessons learned from the subprime meltdown as well as the empirical learning on CEO power discussed in Part II, above. It will suggest major federal intervention to curb CEO autonomy in light of the above discussion regarding Delaware corporate law. Specifically, I propose a legal restructuring of the board of directors with the specific goal of creating a substantial brake on CEO autonomy without impairing CEO operational power.

IV. METHODS OF CONTROLLING CEO AUTONOMY

The remainder of this Article responds to the unfortunate reality that CEO autonomy is politically rigged to be suboptimal by articulating appropriate corporate governance organs that would operate to retether managerial power

284. Hamermesh, *supra* note 271, at 1756 ("[T]he members of the Council include a number of lawyers—a small minority, to be sure—whose litigation practice is dominated by representation of shareholder plaintiffs.").

285. *Id.* at 1753 ("[V]oting on amendments to the DGCL is almost invariably unanimous. Plainly, then, the Delaware General Assembly has not perceived the content of the DGCL as an appropriate subject for partisan controversy.").

286. *Id.* at 1752.

287. Professor Hamermesh suggests that Delaware is not pro-management because it protects minority shareholders against freeze-out mergers better than other states and its anti-takeover legislation is not as protective of management as some states. *Id.* at 1763 n.60. But it seems very unlikely that managers would wish to eliminate takeovers through state law because managers want to pursue takeovers to enhance their power. *Id.* And managers rarely have any interest in freezing-out minority shareholders—that is, typically something that benefits majority shareholders. *Id.*

288. Ramirez, *The End of Corporate Governance Law*, *supra* note 12, at 347 ("The science of corporate governance shows that there is no market pressure for optimized corporate governance—there is only market pressure for indulgent pro-management corporate governance law .").

289. *See* Hamermesh, *supra* note 271, at 1779.

to a rationalized system of legal restraint. The basic approach is to respond to the patent shortcomings of corporate governance as revealed during the subprime crisis, summarized in Part III. At the same time, this new proposal for a system of rationalized restraint will seek to vindicate the empirical learning summarized in Part II. Finally, these proposals will respond directly to the failure of corporate governance law, largely promulgated in Delaware, to evolve in a manner that responds to the fundamental need to control agency costs within the public firm. Simply put, this section will respond to the vacuum created in corporate law by Delaware's domination.

A. Corporate Governance and Risk Management

At the center of the subprime mortgage crisis, a tradeoff between short-term profits and risks festers, driven by compensation incentives for senior managers.[290] The subprime fiasco rose from one of the "worst miscalculations in the annals of risk management."[291] There is little basis for leaving risk management exclusively in the hands of the CEO, and the flaws revealed during the subprime crisis highlight the shortcomings of leaving too much risk management power in the hands of the CEO.[292] CEOs are too willing to rack up income and compensation today with little regard for risks down the road. This suggests more vigorous efforts to properly control risk at the public firm are appropriate. Increasingly, financial experts and economists shoulder the science of risk management.

The science of risk management suggests certain basic points.[293] Enterprise-wide risk management (ERM) seeks to control risk and limit excessive risks across the entire business enterprise.[294] As such, ERM seeks to

290. Even the banks admit now that short-term compensation problems contributed to the subprime crisis. *See* Michael Maiello, *Paying Bankers Smartly*, FORBES.COM, Feb. 19, 2009, http://www.forbes.com/2009/02/19/paying-bankers-smartly-leadership-compensation_wall_street.html.

291. Tully, *Money Machine Breaks Down*, *supra* note 33, at 75. According to Professor Stephen Bainbridge, "The financial crisis of 2008 revealed serious risk management failures on almost systemic basis throughout the business community." Stephen M. Bainbridge, Caremark *and Enterprise Risk Management*, 34 J. CORP. L. 967, 978 (2009).

292. *Confessions of a Risk Manager*, ECONOMIST, Aug. 9, 2008, at 72, 73. ("Most of the time the business line would simply not take no for an answer, especially if the profits were big enough.").

293. *See generally* Betty Simkins & Steven A. Ramirez, *Enterprise-Wide Risk Management and Corporate Governance*, 39 LOY. U. CHI. L.J. 571, 591–94 (2008) (articulating new disclosure mechanisms for encouraging the application of enterprise wide risk management techniques to public firms).

294. *Id.* at 581 ("Currently, many organizations still continue to address risk in 'silos,' with the management of insurance, foreign exchange risk, operational risk, credit risk, and commodity risks each conducted as narrowly-focused and fragmented activities. Under ERM, all risk areas function as parts of an integrated, strategic, and enterprise-wide system.").

avoid "risk silos" and instead bring a diversity of views and perspectives to bear on risk management in a holistic fashion—meaning that no department or business discipline monopolizes the risk management functions.[295] Instead, risk is controlled, calibrated, and coordinated across the entire business enterprise, with a view towards enhancing short-term and long-term shareholder value.[296] According to rating agencies, favorable risk management practices encourage active involvement of the board of directors.[297] Institutional investors have also embraced the fundamental value of ERM, suggesting that firms that pursue the best risk management practices will enjoy a lower cost of capital.[298] This supports empirical evidence suggesting that ERM adds firm value.[299] As ERM continues to evolve, it should contribute further to firm value.

Professor Betty Simkins and I previously proposed a new disclosure regime regarding ERM practices for public firms.[300] We suggested that the SEC issue interpretive guidance regarding risk management systems so that capital markets could impound risk management into investment decisions.[301] This proposal predated the depths of the subprime mortgage meltdown.[302]

295. The Committee of Sponsoring Organizations of the Treadway Commission ("COSO") defines enterprise-wide risk management as: "[A] process [a]ffected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives." *Id.* at 581–82 (quoting COMM. OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMM'N, ENTERPRISE RISK MANAGEMENT–INTEGRATED FRAMEWORK 2 (2004), *available at* http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf).

296. *Id.* at 582, 583.

297. *Id.* at 584 (citing Moody's Investors Service, *Moody's Findings on Corporate Governance in the United States and Canada: August 2003–September 2004* (Oct. 5, 2004), *available at* http://www.moodys.com/moodys/cust/research/MDCdocs/05/2003000000429471.pdf).

298. *Id.* at 583–84; Robert E. Hoyt & Andre P. Liebenberg, *The Value of Enterprise Risk Management: Evidence from the U.S. Insurance Industry* 1 (Jan. 31, 2008) (unpublished paper from the 2008 ERM Symposium, "Risk in the Age of Turbulence"), *available at* http://www.ermsymposium.org/2008/pdf/papers/Hoyt.pdf.

299. Hoyt & Liebenberg, *supra* note 298, at 14 (finding that in the U.S. insurance industry ERM practices are associated with a 17% premium in firm value for public firms). The authors searched a variety of databases for signals of ERM activity including the existence of a "Risk Management Committee." *Id.* at 2. Despite the fact that there is a good reason to conclude that ERM adds value, surveys consistently show that overall firms lag in the implementation of ERM. Bainbridge, *supra* note 291, at 970–73. Moreover, Delaware is unlikely to use fiduciary duty law to encourage the adoption of ERM. *Id.* at 990.

300. Simkins & Ramirez, *supra* note 293, at 591–94.

301. *Id.* at 593.

302. The referenced article was completed in early 2008. *See generally id.* The proposal, therefore, did not benefit from the full revelations of corporate wrongdoing summarized in Part III.

Nevertheless, based upon the empirical record as it stood in 2008, we argued that firms should provide detailed disclosure of their risk management efforts, and that the SEC had issued similar interpretive guidance with respect to far less compelling issues.[303] In early 2008, information regarding the scale of wrongdoing within public firms, or the resulting massive losses was not common knowledge.[304] Therefore, I now propose a mandatory and independent risk management committee. This call for a more demanding regime for ERM is based upon the manifest costliness of risk management failures on a systemic basis.

The subprime mortgage experience teaches that much more needs to be done to assure rationalization of the risk management function, particularly within firms involved in financial innovation.[305] Citigroup, for example, apparently failed to comprehend the risks of liquidity puts and SIVs—even Vice-Chairman of the Board, Robert Rubin, admitted these risks escaped his attention—and lost billions as a result, even as its CEO received millions in compensation.[306] The Basel Core Principles for Bank Regulation provide that "Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior-management oversight) to identify, measure, monitor and control all . . . material risks and, where appropriate, to hold capital against these risks."[307] I posit that in light of the problems of regulatory arbitrage, such a requirement is

303. *Id.* at 593 (citing Disclosure of the Impact of Possible Fuel Shortages on the Operation of Issuers Subject to the Registration and Reporting Provisions of the Federal Securities Laws, Exchange Act Release Nos. 33–5447, 34–10569, 3 SEC Docket 249 (Dec. 20, 1973) and Statement of the Commission Regarding Disclosure of Year 2000 Issues and Consequences, Exchange Act Release Nos. 33–7558, 34–40277, 67 SEC Docket 1437 (July 29, 1998)).

304. One commentator has suggested, apparently without jocularity, that the widespread use of antidepressants in the wake of 9/11 contributed to the recklessness on Wall Street. Peggy Noonan, *There's No Pill for this Kind of Depression*, WALL ST. J., Mar. 14, 2009, at A9 ("The sale of antidepressants and anti-anxiety drugs is widespread. In New York their use became common after 9/11. It continued through and, I hypothesize, may have contributed to, the high-flying, wildly imprudent Wall Street of the '00s."). As difficult as it is to explain the behavior of the CEOs of the firms at the center of this crisis, it could simply be old fashioned greed combined with easy money and the Minsky credit cycle. *See supra* notes 98–115. Either way, this Article proposes controls on CEO autonomy so that no individual (on drugs or otherwise) will have the power to sabotage public firms while attaining huge paydays. *See supra* Part IV.

305. Fed chairman Ben Bernanke has already suggested more rigorous regulation of the risk management function and has explicitly endorsed ERM practices, as a means of addressing the deficiencies revealed by the subprime meltdown. Ben S. Bernanke, Chairman, Bd. of Governors, Fed. Reserve Sys., Remarks Before the Council on Foreign Relations, Financial Reforms to Address Systemic Risk (March 10, 2009) (transcript available at http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm).

306. *See supra* Part II.

307. Basle Committee on Banking Supervision, Core Principles for Effective Banking Supervision 5–6 (Sept. 1997), *available at* http://www.bis.org/publ/bcbs30a.pdf?noframes=1.

particularly sensible for financial firms.[308] Every financial firm that is publicly held should now be required to have an independent risk management committee, comprised of experts in some field of risk management; indeed, this corporate governance innovation makes sense for all public firms of sufficient size to face serious losses from the mismanagement of risk.[309] Given that the options backdating fiasco transcended the financial sector, and given the reality that many elements of public entities like AIG's derivatives trading subsidiary largely escape regulatory scrutiny, it is clear that a rationalized risk function is needed across public firms.

In general, firms should be required to have an independent risk management committee as part of its board structure.[310] This suggestion is patterned upon and could be implemented like the SOX approach to independent audit committees.[311] Although I take issue with the SOX definition of "independent," the basic statutory approach of SOX is sound—the committee should be mandated and composed of independent members.[312] The committee should have the power to retain experts or even appoint a chief risk officer.[313] It should also have ultimate control over risk management policies.[314] While operating within risk policies would continue to be under the operational control of the CEO, the risk management committee should have minimal expertise requirements.[315] SOX responded to a crisis triggered

308. Fed chairman Bernanke has called for "consolidated supervision of all systemically important financial firms" so that no element of systemic risk escapes regulatory scrutiny. Bernanke, *supra* note 305. The proposal that all public firms have an independent risk management committee would be a significant move in that direction, as all of the financial firms at the center of crisis are publicly held firms. *Id.*

309. Risk mismanagement is pervasive across all types of firms. *See* Simkins & Ramirez, *supra* note 293, at 573–77.

310. Since most of the problems with the subprime crisis arise from large public firms, exemptions intended to contain compliance costs at smaller firms may be deemed appropriate. The SEC exempted certain issuers from the independent audit committee requirements promulgated under SOX under this rationale. *See* 17 C.F.R. § 240.10A-3(b)(iv) (2008).

311. *See* Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m) (2006).

312. *See id.* § 78j-1(m)(1), (3).

313. *See id.* § 78j-1(m)(5).

314. *See id.* § 78j-1(m)(4).

315. *See* Sarbanes-Oxley Act of 2002 § 407, 15 U.S.C. § 7265 (2006). Expertise requirements vindicate the premises of ERM which seeks to avoid risk silos based upon different departments having different capabilities within the firm. It also would be a significant step towards professionalizing the board of directors. I argued in favor of a comprehensive professionalization regime for corporate directors in 2005. *See* Steven A. Ramirez, *Rethinking the Corporation (and Race) in America: Can Law (and Professionalization) Fix "Minor" Problems of Externalization, Internalization, and Governance?*, 79 ST. JOHN'S L. REV. 977, 1008–09 (2005). Recently, in light of the subprime fiasco, commentators are calling for further professionalization. Rakesh Khurana & Nitin Nohria, *Management Needs to Become a Profession*, FT.COM, Oct. 20, 2008, http://www.ft.com/cms/s/0/14c053b0-9e40-11dd-bdde-

by audit failure; risk management failure as evidenced in the crisis of 2007–2009 warrants a similar response, specifically, a mandated and independent risk management committee.

The mandate for more sophisticated risk management within the public firm seems unlikely to cost much in light of the evidence thus far, suggesting that ERM enhances firm value. It has the potential to greatly mitigate the problems associated with excessive CEO autonomy through more appropriate monitoring rather than any disruption of the CEO's operational control.

B. The Qualified Legal Compliance Committee

Unlike audit reform, the SOX initiative to reform the legal compliance function failed insofar as its effort to encourage the use of Qualified Legal Compliance Committees (QLCC) is concerned.[316] SOX imposed federal rules of professional responsibility upon attorneys appearing before the Securities and Exchange Commission (SEC) and directed the SEC to promulgate regulations to implement this mandate.[317] The SEC rules basically require attorneys "appearing and practicing before" the SEC[318] to report certain material violations up the corporate ladder,[319] all the way to the board if necessary to secure an appropriate response to any such report.[320] Under the SEC rules, an attorney also has the option of reporting a material violation to the SEC.[321] As part of its regulatory scheme implementing SOX, the SEC created a new corporate organ termed the Qualified Legal Compliance Committee.[322] Firms could create a QLCC and avoid risks of disclosing

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000077b07658.html (arguing that the financial crisis shows the need for professional standards for firm managers).

316. Robert Eli Rosen, *Resistances to Reforming Corporate Governance: The Diffusion of QLCCS*, 74 FORDHAM L. REV. 1251, 1252 (2005) (finding that as of September 30, 2005, only about 2.5% of all public firms had adopted the optional Qualified Legal Compliance Committee).

317. Section 307 of SOX directed the SEC to promulgate minimum standards of professional responsibility for attorneys appearing or practicing before the SEC. Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C. § 7245 (2006). In promulgating such standards, the SEC created a new innovation—the QLCC. *See* Standards of Professional Conduct for Attorneys, 17 C.F.R. §§ 205.2(k), 205.3(c) (2008).

318. "Appearing and practicing" before the SEC is broadly defined to include any attorney advising a public firm with respect to disclosure of any information, transacting business with the SEC, or representing any issuer before the SEC. 17 C.F.R. § 205.2(a).

319. A material violation is a violation of state or federal securities law, a violation of a fiduciary duty, or a similar violation. *Id.* § 205.2(i).

320. *Id.* § 205.3(b).

321. *Id.* § 205.3(d)(2).

322. Professor Rosen defines a QLCC as:

> [A committee] composed of independent directors, one of whom must be a member of the audit committee. It receives and investigates reports from attorneys working for the company who have credible evidence of material violations of laws, regulations, or

certain legal violations by the firm's counsel as well as costs associated with counsel, weighing whether the firm has responded appropriately to a report of misconduct.[323] Thus, the SEC encouraged the formation of a QLCC, but did not mandate its adoption.[324] Few firms responded to the SEC's encouragement.

The linchpin for managing legal and reputational risk is the QLCC.[325] There is no requirement that a CEO be an attorney, nor should there be such a mandate. The CEO, consequently, is not institutionally suited for managing legal risk. The subprime mortgage crisis involved severe and pervasive violations of law; most notably, Countrywide paid a record amount to settle allegations of predatory lending, and Merrill Lynch paid $550 million to settle claims of securities fraud arising from its subprime securities activities.[326] CEOs incurred huge legal risks while receiving huge compensation payments. Certainly, more allegations of illegality are yet to come. Nevertheless, the record is clear now that there is too much CEO autonomy to violate the law and earn millions while firms and the general economy are destroyed. This presents a powerful theoretical and empirical case that CEOs should be stripped of exclusive autonomy over legal risks.

Using the SOX reform of the audit function as a model, I suggest that an independent QLCC, comprised only of qualified attorneys, should be mandatory for public firms.[327] Such a committee should have a broad mandate to hear complaints from broadly protected whistleblowers,[328] as well as

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> breaches of fiduciary duties. The QLCC makes recommendations to the entire board, the chief executive officer ("CEO"), and the general counsel or chief legal officer ("CLO"). A QLCC institutionalizes at the board level the company's responsibility to obey the law.

Rosen, *supra* note 316, at 1251 (citing 17 C.F.R. § 205.2(k) (2005)).

323. 17 C.F.R. § 205.3(c).

324. *Id.*

325. Steven A. Ramirez, *Legal Risk Post SOX and the Subprime Fiasco: Back to the Drawing Board*, *in* ENTERPRISE RISK MANAGEMENT: TODAY'S LEADINGS RESEARCH AND BEST PRACTICES FOR TOMORROW'S EXECUTIVES (J. Fraser and Betty Simkins, eds. 2010) [hereinafter *Legal Risk*].

326. *See supra* Part II.

327. The SEC's QLCC design inexplicably fails to include any requirement of legal expertise. *See generally* 17 C.F.R. §§ 205.1–205.7 (2008). Yet, requiring legal expertise to manage legal risk is sensible and would facilitate the further professionalization of board directorships. This could spur other beneficial developments—such as limiting the number of directorships assumed or splitting the position of chair from the position of CEO—in firms where such innovations may add value. *See* Lynne L. Dallas, *The Multiple Roles of Corporate Boards of Directors*, 40 SAN DIEGO L. REV. 781, 818–20 (2003).

328. SOX provides very limited protections to whistleblowers. Mary Kreiner Ramirez, *Blowing the Whistle on Whistleblower Protection: A Tale of Reform Versus Power*, 76 U. CIN. L. REV. 183, 188 (2007) ("SOX does little to change the hazardous path whistleblowers must tread."); Leonard M. Baynes, *Just Pucker and Blow?: An Analysis of Corporate Whistleblowers, the Duty of Care, the Duty of Loyalty, and the Sarbanes-Oxley Act*, 76 ST. JOHN'S L. REV. 875,

attorneys, and to manage all material legal risks.[329] Thus, my proposal to optimize the management of legal risk would require making the QLCC mandatory and enhancing it to respond to the reality of the subprime fiasco. A robust QLCC, including some minor enhancements and extensions, should be associated with superior financial performance over the long term by removing legal and reputational risk from the exclusive control of the CEO, placing it instead in a more institutionally suited organ of corporate governance.[330] Unfortunately, public firms still fail to follow the law in an acceptable manner, and the subprime mortgage crisis demonstrates the pernicious economic effects of the lawlessness of just a few firms.[331] Corporate governance mechanisms should at least operate to achieve a level of compliance commensurate with reasonable shareholder protection.

C. Board Nominations

Management dominates the process of director nominations and elections.[332] Shortly after SOX was passed, and again in 2007, the SEC proposed new regulations intended to expand the ability of shareholders to nominate directors to the board of public firms.[333] Intensive lobbying efforts unfotunately short-circuited these reform initiatives and ultimately, the SEC

896 (2002) ("[T]he corporate whistleblower cannot just pucker and blow. She has to use a great deal of thought to whether and how she may want to blow the whistle."). One major problem is that SOX protections only apply to allegations of securities violations made to a relatively narrow class of persons. Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C. § 1514A(a)(1) (2006). Thus, for example, this provision would provide no protection for any putative Countrywide employee that chose to blow the whistle on the firm's multi-billion dollar predatory lending racket. *See supra* notes 157–61 and accompanying text. Consequently, I propose expanding protection for blowing the whistle to the QLCC regarding any material violation of law.

329. This is a major improvement over the SEC's more limited vision of the role of a QLCC. The SEC's vision is actually focused upon compliance with the securities laws. My approach recognizes that legal risk in the form of predatory lending damages is as dangerous as legal risk from securities fraud damages. *See* 17 C.F.R. § 205.2(i) (2008).

330. *See* Simkins & Ramirez, *supra* note 293, at 587–88 (arguing that CEOs are not institutionally optimal for exclusive risk management).

331. *See supra* Part III. Even before the subprime meltdown, scholars noted the large costs of white-collar crime and the weak incentives for enforcement in this arena. *See e.g.*, Ramirez, *supra* note 325, at 226–27.

332. Bebchuk, *supra* note 79, at 732. Shareholders have scored recent successes in their efforts to expand voting powers; but shareholders still lack the power to nominate directors short of launching an expensive proxy context—and this would key efforts to impose non-accountability on management. Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L.J. 1259, 1307–08 (2009).

333. *See* Security Holder Director Nominations, 68 Fed. Reg. 60,784 (proposed Oct. 23, 2003) (not codified); Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. 70,450 (proposed Dec. 11, 2007) (not codified).

declined to reform proxy voting.[334] The American Law Institute suggests an independent nominating committee for board selections as a best practice.[335] The NYSE required in 2003 that listed firms maintain independent nominating committees.[336] Commentators show that current practice permits substantial CEO involvement and influence over board selections.[337] As Professor Jeffery Gordon points out, CEOs continue to fight "tooth and nail" against shareholder nominations.[338]

Nevertheless, evidence supports the proposition that boards selected without CEO input enhance firm value.[339] The evidence is mixed with respect to the efficacy of mere outside directors (i.e., those not otherwise employed by the firm), but boards with greater independence from the CEO are likely to have loss affinity to the CEO and will therefore be less likely to fall prey to unconscious bias in favor of the CEO.[340] Further, firms with boards that have weaker CEO control and less entrenched management enjoy higher market

334. The SEC's 2003 shareholder access proposal, which might have facilitated a limited degree of explicit shareholder influence over the selection of board members, was successfully opposed by the Business Roundtable. *See* Lucian A. Bebchuk, *The Case for Shareholder Access: A Response to the Business Roundtable*, 55 CASE W. RES. L. REV. 557, 557 (2005).

335. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 3A.04 cmt. c (1994).

336. NYSE, INC., LISTED COMPANY MANUAL § 303A.04 (2009). NASDAQ's rules require either a nominating committee or a practice under which nominations are made by the independent directors of the board. NASDAQ STOCK MARKET INC., BY-LAWS ARTICLE III § 3.1 (1998).

337. Murphy, *supra* note 83, at 148–49 (citing evidence that even independent nominating committees, subject to full disclosure requirements regarding their practices, do not nominate shareholder selections for the board).

338. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1499 (2007).

339. *E.g.*, Anil Shivdasani & David Yermack, *CEO Involvement in the Selection of New Board Members: An Empirical Analysis*, 54 J. FIN. 1829, 1852 (1999) (finding a higher stock market valuation when the CEO is not involved in the director selection process than when the CEO is involved). Significantly, Shivdasani and Yermack distinguish between outside directors who have close links to the CEO versus more independent outsiders. *Id*. at 1831.

340. *Compare* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233 (2002) (finding no linkage between the proportion of outside directors and various measures of performance), *with* Ronald C. Anderson et al., *Board Characteristics, Accounting Report Integrity, and the Cost of Debt*, 37 J. ACCT. & ECON. 315, 317 (2004) (finding that firms with more outside directors enjoy a lower cost of debt). Professor Antony Page recently reviewed the social science evidence regarding in-group (or affinity) bias and its operation in the context of culturally monolithic boards. Antony Page, *Unconscious Bias and Director Independence*, 2009 U. ILL. L. REV. 237, 248–49. I have long argued in favor of more cultural diversity in break down homosocial reproduction. Ramirez, *Games CEOs Play*, *supra* note 80, at 1600–12.

valuation.[341] Professor Jonathan Macey suggests that the focus on independent directors is misguided, because even independent directors are not immune from capture by management.[342] Instead, Macy suggests that only actively dissident directors are likely to mount challenges to management.[343] In the end, there is wide agreement (other than by management) that the board selection process must be open to a wider array of candidates than just those selected by management in order to disrupt CEO domination of the board, break down affinity bias, and open the door to greater diversity in the boardroom.

A key issue underlying board capture is compensation. The more the CEO controls the board, the more evidence there is of excessive compensation.[344] Thus, the reforms of the director selection process are associated with lower compensation.[345] As highlighted in Parts II and III, above, compensation practices contributed to the entire financial system gorging on risk, particularly leverage.[346] Management may harbor legitimate concerns about having dissidents on a board, unqualified directors, and board conflicts with CEOs that

341. When directors are selected without management involvement, closed-end mutual funds trade at higher valuations relative to net asset value. Raj Varma, *An Empirical Examination of Sponsor Influence over the Board of Directors*, 38 FIN. REV. 55, 75 (2003) (finding that closed-end mutual fund sponsors capture boards and that the market values boards selected without sponsor involvement). Professor Lucian Bebchuk summarizes the empirical record with respect to insulation that operates to entrench managers, and concludes that "the evidence indicates clearly that current levels of board insulation are costly to shareholders and the economy." Bebchuk, *supra* note 79, at 714.

342. JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 90 (2008).

343. *Id.* at 90–91.

344. *See, e.g.*, Eliezer M. Fich & Lawrence J. White, *CEO Compensation and Turnover: The Effects of Mutually Interlocked Boards*, 38 WAKE FOREST L. REV. 935, 947–50 (2003) ("[T]he number of mutual director interlocks is found to be significant and positively associated with total compensation.").

345. *E.g.*, Vidhi Chhaochharia & Yaniv Grinstein, CEO Compensation and Board Structure 2 (Sept. 10, 2008) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=901642&rec=1&srcabs=220851. Firms that complied with new independence requirements and did not comply with those requirements prior to the reforms "significantly decreased CEO compensation in the period after the rules went into effect" relative to firms that complied all along. *Id.* "The decrease is on the order of 17%, after taking into account performance, size, time-varying shocks to different industries during that period, firm fixed effects, and other variables affecting compensation that changed during that time." *Id.*

346. The market capitalization of the financial sector recently contracted beyond the contraction of technology stocks after the tech bubble burst. "That the financial sector's value could evaporate as quickly and as ruthlessly as the technology sector did demonstrates just how ephemeral the gains were, built on excessive leverage and business strategies that amount to little more than gambling." David Gaffen, *Collapse of the Financial Sector Harder, Deeper Than Tech Wreck*, WALL ST. J., Mar. 9, 2009, at C5.

could lead to impaired monitoring.[347] Still, the subprime fiasco supports the notion that right now, CEOs have too much autonomy over the composition of their board, and are able to use that power to gain distored compensation arrangements.

Perhaps a solution to the problem is to give shareholders a choice between nominees selected by incumbent management through a fully independent nominating committee and those nominated by shareholders and approved by the independent nominating committee.[348] Contested elections in corporate America are not unprecedented.[349] In fact, one large institutional investor permitted contested elections for several decades, and found that it resulted in "vitality and energy" at the board level and could lead to new ideas or fresh talent in the boardroom.[350] According to one CEO of the firm, its performance during the period of contested elections was "extraordinary."[351] So, the concept of contested elections has been tested, to some extent.[352]

This proposal that management include shareholder nominees in its proxy builds upon recent reforms.[353] It could finally give meaning to corporate

347. *See* John H. Biggs, *Shareholder Democracy: The Roots of Activism and the Selection of Directors*, 39 LOY. U. CHI. L.J. 493, 494–96 (2008) (cataloging objections to direct shareholder nominations and elections of board directors, including that: board members could turn the boardroom into a political battleground, the entrepreneurial spirit of American business could be diminished, adverse directors may damage board dialogue, and such boards may be too focused on compliance issues rather than enhancing shareholder value).

348. TIAA-CREF, a large institutional investor serving professors, allowed contested elections since its founding through a policyholders nominating committee that essentially allowed shareholders to nominate directors. *Id.* at 503. The policyholders nominating committee was appointed by the full board of trustees. *Id.*

349. Over a period of sixty-six years, sixty-nine policyholder nominees prevailed in contested elections, which attracted a large percentage of proxy participation—up to thirty percent. *Id.* at 502, 503.

350. *Id.* at 504–05.

351. *Id.* at 504.

352. In 1942, the SEC staff proposed the inclusion of shareholder nominees on management's proxy. Murphy, *supra* note 337, at 136. Five years later, the Commission adopted the present rule governing access to management's proxy—and denied access for director elections. *Id.* (citing Securities Exchange Act of 1934, 12 Fed. Reg. 8768, 8770 (Dec. 24, 1947)). The present rule is now at 17 C.F.R. § 240.14a-8(i)(8) (2008). *Id.* at 136 n.21.

353. Disclosure Regarding Nominating Committee Functions, Exchange Act Release No. 34–48,825, 68 Fed. Reg. 66,992, 66,998 (Nov. 28, 2003) (requiring disclosure of nominating committee's policy regarding shareholder nominees). A number of other scholars propose similar incremental reforms. *See, e.g.*, Jeffrey N. Gordon, *Proxy Contests in an Era of Increasing Shareholder Power: Forget Issuer Proxy Access and Focus on E-Proxy*, 61 VAND. L. REV. 475, 475 (2008) (proposing the use of technology to facilitate shareholder nominations to the board). As Professor Gordon highlights, for a variety of cost and liability reasons, the key to facilitating shareholder nominations is access to management's proxy. *Id.* at 479–82.

democracy and the proxy ballot.[354] Shareholders could have access to the nomination process and could even attain board representatives.[355] Yet current management would act as screen on shareholder nominations to assure that capable and nonhostile shareholder nominees would appear on the ballot.[356] Only otherwise unaffiliated shareholders could nominate directors, or shareholding managers (or close associates) could subvert the shareholder right to nominate.[357] Such directors must have no substantial social or economic relationship with current management.[358] No doubt, detailed regulations would be needed to address these and a plethora of other issues.[359] Nevertheless, the basic approach is simply to give shareholders an expanded voice on board selections with minimal interference with legitimate managerial prerogatives.[360]

In fact, that is the common thread to all of the reforms discussed above. Management power to manage the firm operationally is left intact. Yet, those corporate governance elements charged with monitoring the CEOs performance and pay are enhanced. Risk is monitored by the board, subject to the operational authority of the CEO. Similarly, legal risk would be operationally monitored by the board, but initially controlled by the CEO; the

354. This proposal ideally would be accompanied by other reforms of corporate democracy that would enhance the franchise rights of shareholders without impairing the ability of management to operate the business with a view to maximizing financial performance. *See* Joo, *supra* note 269, at 758–60, 767 (listing impediments to shareholder franchise rights and concluding that "corporate democracy remains a myth").

355. Biggs, *supra* note 347, at 502–03.

356. This screening mechanism vitiates the primary objection of management interests in greater shareholder access to the nominating process—the prospect that board seats will go to persons uninterested in shareholder value. *See* Bebchuk, *supra* note 334, at 563–65, 566–68.

357. As Jonathan Macey points out, there are powerful social mechanisms at work in the boardroom through which CEOs can effectively capture their boards. MACEY, *supra* note 342, at 51–68. To meaningfully break down this complex of norms and conventions, independence must be more robustly defined.

358. The nominating committee would have final say identifying the contestants for board seats. Thus, it is important to expand the modest definition of "independent" that has been used so far by the SEC or the NYSE and the NASDAQ. As I have pointed out before, a college roommate could satisfy these definitions of independent. *See* Ramirez, *Games CEOs Play*, *supra* note 80, at 1584 n.3 (citing David Enrich, *Capital Federal Financial Director Reynolds to Resign*, DOW JONES CORP. FILINGS ALERT, Dec. 30, 2003, WL 12/30/03 FEDFILE 19:42:00).

359. Professor Bebchuk's proposal for reform of the proxy system addresses many of the issues I have in mind. He proposes, *inter alia*, that shareholder votes be by secret ballot. Bebchuk, *supra* note 79, at 704–06. Such a reform would be necessary to give full effect to the contested elections approach I advocate here.

360. On June 10, 2009, the SEC proposed new proxy reforms that would greatly expand shareholder power to nominate board directors. Facilitating Shareholder, Director Nominations, 74 Fed. Reg. 29,024 (proposed June 10, 2009). This proposal is consistent with the thrust of the proposal herein.

main emphasis would be to assure legal compliance and that management should be stripped of the ability to pursue profits today at the expense of legal sanctions absorbed by the firm tomorrow. Finally, the CEO's power to select the monitors—the board—is curtailed with no impact on operational control. Theoretically and empirically, there is good reason to think that these innovations would enhance the financial performance of the board while reducing agency costs.

CONCLUSION

Excessive CEO autonomy played a central role in the subprime mortgage crisis that continues to grip the U.S. economy. Specifically, corporate governance law in the United States permits CEOs of public firms to generate current income to enhance their own compensation without regard to risk. The cost of this excessive autonomy reaches into the tens of trillions of dollars, across the globe. Although many factors coalesced to create the subprime fiasco, most all of the misconduct flowed through public corporations in the United States. At the very least, corporate governance standards failed to mitigate the subprime fiasco in any meaningful manner and probably exacerbated the economic maelstrom through its perverse incentives for top managers and its failure to reduce agency costs. In the end, the power of CEOs to accumulate income while crashing their firms, unfettered by the rule of law, proved disastrous.

Corporate governance law must be reformed. The reforms must comprehend that corporate governance must function during periods of crisis as well as periods of stability. Financial crises are inherent to modern capitalism and corporate governance must be designed with recognition of inherent instability. The subprime mortgage crisis demonstrates the inferiority of U.S. corporate governance to withstand stress and contain agency costs. While it is hard to imagine an economic crisis more severe than the present disruption, left undisrupted, CEOs will eventually see the profits they might garner by imposing huge risks tomorrow in exchange for huge compensation today. Delaware law (and by extension, state law generally) will not evolve in a manner that curtails CEO autonomy; in fact, Delaware law seems oblivious to controlling agency costs. Thus, federal law must respond to the subprime crisis and create a system of corporate governance for public companies that mitigates agency costs.

Reforms must address the perverse incentives imposed upon CEOs by the current system of corporate federalism. CEOs are the new potentates, with power to crash global capitalism and rake in millions for the favor. The rule of law must reassert itself. CEO power must be diminished. At the very least, the power of CEOs to manipulate risk, to stack the board with their own clones, and to skirt legal compliance must be diminished. The current system of CEO primacy has proven itself crisis prone and macroeconomically dangerous. There is no sound reason to continue to indulge CEO power, only political reasons. We can ill afford a continuation of CEO primacy. The cost of failing to address the costs of CEO primacy now must be counted in the trillions. Surely the law stands for more than the infinite enrichment of the CEOs of the largest financial institutions in the world.