A New Legal Theory to Test Executive Pay:
Contractual Unconscionability

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A NEW LEGAL THEORY TO TEST EXECUTIVE PAY:
CONTRACTUAL UNCONSCIONABILITY

Lawrence A. Cunningham

Abstract

Lucrative pay to corporate managers remains controversial yet continues to evade judicial scrutiny for legitimacy. Although many arrangements likely would pass the most rigorous scrutiny, it seems equally clear that some would not. Some agreements are not the product of arm’s-length bargaining, can rivet managers on short-term stock prices at the destruction of long-term business value, and can misalign manager–shareholder interests. Yet even such objectionable arrangements are immune from serious legal oversight. In theory, they are open to judicial review under corporate law, but shareholders challenging pay contracts face formidable procedural hurdles in derivative litigation and substantive obstacles from corporation law’s business judgment rule and the anemic doctrine of waste. A new legal theory would be useful to check board excesses in the population of clearly objectionable cases.

This Article explains why and how traditional contract law’s theory of unconscionability should be used to create a modicum of judicial scrutiny to strike obnoxious pay contracts and preserve legitimate ones. Under this proposal, pay contracts that are the product of managerial domination of the process and formed on terms massively favoring the executive will be stricken. This will follow direct shareholder lawsuits in state courts where the contract is made or performed and applying that state’s contract law. This new legal theory circumvents today’s dead-end route, where pay contracts are always upheld in derivative shareholder lawsuits applying corporate law that sets no meaningful limits on executive pay. This proposal creates new but modest pressure from sister states on Delaware to take greater responsibility for the effects its production of corporate law has nationally.

For those outraged by lopsided corporate executive compensation, this Article offers an appealing new legal theory of contractual unconscionability to police them. Those who see no or few problems with contemporary pay arrangements, or who are outraged by federal regulatory schemes like the Dodd–Frank Act, will welcome how this proposal is narrowly tailored using common law to address the most obnoxious cases.
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INTRODUCTION

Executive pay has skyrocketed in recent decades, stoked by stock-based components extolled under a three-pronged theoretical logic that proved problematic in practice. Law and economics’ optimal contracting theory promised that boards would fashion optimal pay arrangements, but practice showed limits on this ideal. Finance theory’s hypothesis of efficient markets, with stock price as a proxy for performance, overlooked gaps between short-term price and long-term results. Corporate legal theory’s agency model proposed that stock-based pay would align managerial incentives with shareholder interests, yet evidence shows that corporations can create perverse incentives departing from that model. Law fueled the engine: federal tax law encouraged stock-based pay; federal securities-disclosure law stimulated a ratcheting up as executives sought raises to beat their peers; and Delaware, free of competition from other states in setting the nation’s corporate laws, looked the other way.

Given these infirmities, reformers propose increased shareholder power to strengthen optimal contracting theory’s promise, redesigning contracts to focus on the long term, and diminishing the alignment rationale of stock-based pay in favor of an executive-retention

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1 See, e.g., Jeffrey N. Gordon, Executive Compensation: If There’s a Problem, What’s the Remedy? The Case for “Compensation Discussion and Analysis,” 30 J. CORP. L. 675, 687 (2005) (“[M]any believed that significant stock option grants would align shareholder and managerial interests . . . . Beliefs about the desirable effects of stock options proved to be, at best, only partly correct . . . .”); Usha Rodrigues, The Fetishization of Independence, 33 J. CORP. L. 447, 460–61 (2008) (noting that stock-based pay was to “align” managerial and shareholder interests but “[t]he success of these measures is debatable, at best”); Cynthia A. Williams, Icarus on Steroids, 94 GEO. L.J. 1197, 1226 (2006) (reviewing David Skeel, Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From (2005)) (“The theory of granting stock options is that they would align the interests of managers and shareholders . . . . to reduce agency costs. The reality has proven more problematic.”).


7 See Stephen M. Bainbridge, Caremark and Enterprise Risk Management, 34 J. CORP. L. 967, 981 n.129 (2009) (“In theory, stock options . . . . align manager and shareholder interests . . . . In practice . . . the differing time horizons of managers and shareholders may give rise to conflicts of interest.”); Larry E. Ribstein, The Uncorporation and Corporate Indeterminacy, 2009 U. ILL. L. REV. 131, 136 (stock options “may only roughly align pay with performance”).

8 See infra Part II.A.
rationale. To fill the legal lacuna, the Dodd–Frank Act of 2010 partially responded to these calls. It gave shareholders precatory votes on pay packages, enhanced the role of independent directors in setting compensation levels, and expanded disclosure to include the ratio of top pay to median pay and the relation of pay to firm performance. But the infirmities in executive pay design remain, and these incremental legal reforms still rely on longstanding corporate mechanisms that continue to insulate pay from judicial review for legitimacy. The contracts remain subject to legal evaluation solely through the lens of corporate law, whose conventional reposing of power in boards, along with boundless judicial deference, protects the arrangements from judicial scrutiny.

It is time for a fresh approach to this problem: applying the contractual unconscionability doctrine to test executive pay. This proposal is designed to appeal equally to those who believe that executive compensation poses a broad systemic problem requiring wholesale reform, and to those who believe that, at best, there are occasional excesses warranting targeted scrutiny. It will appeal to those who perceive a systemic problem because it has no effect on any other enacted or proposed reform. It will appeal to those who perceive only discrete problems because it is precisely tailored to target only those special cases. Testing pay contracts using contract law requires surmounting several hurdles that will assure a screening function so that only the most odious contracts are exposed. Those hurdles are surmountable without requiring any action of any legislative or regulatory body. The proposal requires only interested lawyers to identify a proper case and proceed as this Article elaborates.

It can be tempting to think of contractual unconscionability in terms of paternalistic impulses intended to protect vulnerable types, such as consumers and employees, from themselves and from predation at the hands of the unscrupulous. The standard modern illustration appearing in contracts casebooks protects an impoverished and uneducated single mother from a repugnant cross-collateral clause in a predatory consumer sales contract written in boilerplate legalese. It may be difficult for the contemporary legal mind to transplant that image to the rarified context of the corporate boardroom, where sophisticated directors advised by experts hammer out a deal with an equally sophisticated and advised executive.

But the unconscionability doctrine is not limited to the context of judicial paternalism for consumers and employees. It catches bargains that no fair-minded person would propose and no

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11 Id. §§ 951–953. For large banks, this Act is more directive, ordering federal regulators to adopt rules banning contingent executive compensation that yields excessive pay or generates material risk of loss to the bank. Id. § 956.
12 This new legal theory applies to all executive employment contracts used in the for-profit corporate form of business organization, including those providing compensation during employment and for severance upon termination of employment. Much of this Article’s analysis focuses on stock-based pay contracts because they (a) form the bulk of contemporary senior executive compensation and (b) present the most pernicious risks of overreaching. The contractual analysis applies equally to executive employment contracts used in other organizations not using stock-based pay, such as labor unions or not-for-profit corporations, though the doctrinal hurdles would differ considerably.
rational person would assent to.\textsuperscript{14} Absent from the boardroom are shareholders who often deserve greater protection from lopsided bargains than corporate law provides. Corporate law works well when boards act in shareholders’ interests, consistent with optimal contracting theory, or when boards depart from that model to violate corporate law duties stated in statutes or judicially developed fiduciary law. But corporate law breaks down when managerial power dominates board decision-making and results in executive pay contracts that are unconscionable; yet, such power evades judicial review because of the inherent limits of corporate law. Those inherent limits also pose several hurdles to testing executive pay by contractual unconscionability, which is readily overcome in a proper case.

The first hurdle is the internal affairs doctrine, a choice-of-law principle that can make the law of the state of incorporation applicable to a corporation’s internal arrangements.\textsuperscript{15} As with officer-incentive devices authorized by boards to align managerial incentives with shareholder interests, it is tempting to treat pay contracts as governed by the internal affairs doctrine. That means corporate law applies—Delaware’s corporate law for most large U.S. corporations. Under the doctrine of waste, even exorbitant pay contracts pass muster. But seeing executive pay as an internal affair is not inevitable. It is also increasingly clear that many pay contracts are not the internal alignment devices that they were once held out to be; rather, they are employment agreements designed for retention.\textsuperscript{16} And because they are not matters of internal affairs, they would be governed by the law of the state having the greatest interest.\textsuperscript{17}

Managers could name Delaware as the choice of law by contract and maintain Delaware’s quasi-monopoly that insulates the devices from judicial scrutiny. Yet contractual choice-of-law clauses are but one factor relevant to determining what law governs a contract.\textsuperscript{18} Other considerations include the contract’s place of formation and performance. In some cases, that choice of law would not be dispositive against an assertion of contractual unconscionability, since a declaration of contractual unconscionability can render all terms of a contract unenforceable.\textsuperscript{19} In addition, Delaware contract law shows incrementally greater willingness to police unconscionable bargains than its corporate law polices transactions amounting to waste.\textsuperscript{20}

\textsuperscript{14} E.g., Waters v. Min Ltd., 587 N.E.2d 231 (Mass. 1992).
\textsuperscript{16} Bebchuk & Fried, supra note 9.
\textsuperscript{17} See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 301 (1971). There is also considerable debate about the legal origins and legitimacy of the internal affairs doctrine. See infra notes 243–48 and accompanying text.
\textsuperscript{18} See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971) (stating that the enforceability of choice of law provision entails a two prong-test: (1) whether there is a reasonable relation between the contract and the jurisdiction’s law chosen, and (2) absence of tension with a fundamental policy of the state whose law would apply absent the clause).
\textsuperscript{19} See RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981) (explaining that courts faced with an unconscionable contract term “may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term . . . . ”); E. ALLAN FARNSWORTH, CONTRACTS 380–86 (2d ed. 1990) (noting judicial approaches to declarations that contracts are invalid as a matter of public policy and how courts sometimes refuse to enforce any part of a contract containing a repugnant clause along with mediating doctrines that enable striking the obnoxious clause while preserving others).
\textsuperscript{20} See infra Part IV.
Shareholder challenges to pay contracts are habitually classified as derivative under corporate law. This poses obstacles to judicial scrutiny. Boards have complete power to manage a corporation, including its litigation. Shareholders suing on the corporation’s behalf, in derivative cases, must first demand that a board redress the claim or show why it would be futile to seek demand. Boards committed to a pay contract can rebuff such demands, and corporate law’s test for demand futility defers to boards, thwarting shareholder claims. But just as treating pay contracts as internal affairs is not inevitable, shareholder challenges to them can be classified as direct. The primary remedy sought is rescission, and the theory of liability is that the corporation lacked legal power to enter into the contract. This is known as ultra vires in corporate law, and state corporate law statutes authorize these claims to be brought as direct actions. Even if treated as derivative, the ultra vires assertion justifies excusing shareholder demand on the corporation’s board as futile, and some challenges to executive-pay contracts reach the merits even though they are classified as derivative.

While these hurdles to enabling review of executive-pay arrangements under contract law are high, the route is simpler and incrementally more likely to succeed than the dead-end route of corporate law. The gauntlet should help persuade those who do not see executive pay as a serious systemic problem (or skeptics about judicial scrutiny of board decisions) to tolerate the prescription. Only the most egregious cases would qualify and be limited to this class of claims. Those cases warrant such rebuke. Furthermore, consistent with the hypotheses that managers respond to shareholder outrage and judicial shaming, even a few cases holding an

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21 See Feldman v. Cutaia, 951 A.2d 727, 728 (Del. 2008); Kramer v. W. Pac. Indus., Inc., 546 A.2d 348, 349 (Del. 1988); Bebchuk, supra note 3, at 779; Gordon, supra note 1, at 691 (“Suits challenging executive compensation were deemed to be derivative, not direct, because the injury of putatively excessive compensation was to the corporation itself or to all shareholders as a group.”); Charles M. Yablon, Overcompensating: The Corporate Lawyer and Executive Pay, 92 Colum. L. Rev. 1867, 1902–04 (1992) (reviewing Graef Crystal, In Search of Excess (1991)).

22 E.g., Del. Code Ann. tit. 8, § 141(a) (West 2006).


24 Ultra vires means beyond the power, and corporations are empowered to pursue lawful, but not unlawful, activities. Claims that a contract is unconscionable can constitute a claim that it is unlawful and therefore beyond the power of a corporation to form. See infra text accompanying notes 291–97.


27 See, e.g., In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 46 (Del. 2006); Brehm v. Eisner, 746 A.2d 244, 249 (Del. 2000). These cases are analyzed towards the end of this Article. See infra text accompanying notes 335–50. Trial court opinions have also sometimes treated demand as futile in derivative cases challenging executive compensation. E.g., In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106, 138 (Del. Ch. 2009); In re Viacom S’holder Derivative Litig., No. 602527/2005, 2006 N.Y. Misc. LEXIS 2891, at *2 (N.Y. Sup. Ct. June 23, 2006).

28 Other sometimes-controversial corporate decisions, such as merger and acquisition activity, are clearly within the internal-affairs doctrine and thus outside this Article’s prescriptive scope. See infra note 328.


30 See Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. Rev. 1009, 1103–04 (1997) (discussing how judicial shaming can constrain corporate managers to the interests of the
executive-pay contract unconscionable would influence contract design and courts evaluating their legality.

A well-known case involving The Walt Disney Company (“Disney”) illustrates both how corporate law handles such challenges and the incremental but potentially important differences that would result using contract law. The board of Disney, a Delaware corporation based in California, approved an employment contract with a top recruit following sloppy procedures that cast doubt on whether the board took its duties seriously. The contract was made, performed, and terminated in California. The executive worked for Disney for fourteen months before the board fired him. The termination triggered a $140 million payout with features that may have induced the executive to perform poorly, but not terribly, to receive the short-term windfall. The Delaware court observed that the contract did not involve the internal affairs doctrine, that board procedures were “casual if not sloppy and perfunctory,” and that the pay was “exceedingly lucrative, if not luxurious.” Despite the court calling the case “troubling,” shareholders ultimately lost the derivative suit.

Suppose instead that shareholders had sued the corporation and the executive in California, asserting unconscionability and seeking rescission. California contract law applies because the contract was made, performed, and terminated there. If classified as derivative, the case would proceed without demand, as it did in Delaware, and shareholders could even credibly assert the right to a direct action by stressing that they seek the remedy of rescission and portraying the contract to be so egregious as to be unlawful and beyond the corporation’s power to form. On substance, though $140 million may be a trifle in the dreamland of Hollywood or in a company Disney’s size, it shocked even the Delaware courts. Their difficulty was comparing the payout to the value of recruiting the executive, inducing the judges to defer under corporate law’s business judgment rule. Judges testing the contract from a contract-law perspective would not have been as inclined to hold their noses.

The Disney case usefully shows most of the differences between the corporate-law and contract-law approaches. But the primary reason for discussing the case is because it is among the very few cases challenging executive pay that surmounted the formidable corporate-law obstacles to generating an appellate opinion on the subject. That yields a further justification for this Article’s proposal. Currently, corporate law as it relates to executive compensation provides essentially no limits. Within the common law on the subject, all the cases point in one direction: more pay and on any terms managers can get boards to agree to. Most common-law subjects produce a pool of important and interesting cases that wrestle with the complexities of business


31 Brehm, 746 A.2d at 249.
32 Id.
33 When presenting a version of this paper to an audience that included many distinguished practicing lawyers representing plaintiffs in corporate litigation, one informed me that she had originally filed a claim in the Disney matter in California court that would have included claims of the kind I am describing. She reported that nearly simultaneously another firm had filed the Disney action in Delaware. Ensuing procedural and strategic jockeying among those and other interested law firms resulted in the Delaware case being pursued and the California case abandoned.
and social life. The pool enables discerning the boundaries between what is lawful and what is not.

However, this is not the case with the law of corporate-executive compensation or the doctrine of corporate waste. As a result, Disney is essentially the only contemporary corporate-law case with which to compare the proposed contract-law approach. That is true despite occasional compensation packages widely covered in the popular press that draw public outrage. Examples include both astonishingly high compensation despite dismal corporate performance and lavish executive severance pay in light of events ranging from deep business disappointment to the destruction of a company. It is possible to predict that some of these would fail the test of contractual legitimacy described in this Article and be declared unconscionable.

There is also a reported appellate opinion in the case of Richard Grasso, once the CEO of the New York Stock Exchange. He engineered a lavish, one-time payment of $140 million from the Exchange when it was a not-for-profit corporation subject to the jurisdiction of the office of the New York Attorney General. When that office challenged the payout, it did so relying heavily on corporate law principles set out in New York’s not-for-profit corporate statute. The New York Court of Appeals, adopting the corporate law viewpoint contained in that statute, found that the Attorney General lacked statutory authority to pursue the kinds of corporate law claims he asserted. Had the Attorney General and the court thought about the case from a contract law perspective, instead of taking a corporate law approach, the opposite result may have been possible.

Part I of this Article reviews the three-pronged theoretical logic that spawned the skyrocketing of executive pay, especially stock-based pay. It recounts the classical theories of optimal contracting, efficient markets, and incentive alignment, and then discusses limitations in all three. This synthesis of the literature justifies skepticism about the virtues of prevailing executive compensation practices. Part II explains how limited policing of pay contracts facilitated their exponential growth despite backfires. It then reviews the new reform agenda to fix these problems, identifying persistent shortcomings of the federal statutory and state corporate law approaches. Part III celebrates common-law approaches to these challenges, but

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34 Recent reported examples of astonishingly high executive compensation compared to performance include the following: (1) Sanjay Jha (Motorola, Inc.), $104.4 million annually during a year when the company’s stock price fell 71%; (2) Robert Iger (The Walt Disney Company), $51.1 million annually during a year when the company’s profits fell 5% and an amount twice the payment the previous year; and (3) Kenneth Chenault (American Express Company), $42.8 million annually during a year when the company’s profits fell 29%. See Kenneth R. Davis, Taking Stock—Salary and Options Too: The Looting of Corporate America, 69 Md. L. Rev. 419, 420–21 (2010).

35 Recent reported examples of lavish severance despite business destruction include: (1) Robert Nardelli (Home Depot, Inc.), $210 million, despite mediocre accomplishments during his stormy CEO tenure; (2) Stanley O’Neil (Merrill Lynch Co.), $160 million, during the period when 2008’s financial crisis destroyed this once-powerful brokerage firm, dooming it to a government-orchestrated takeover by Bank of America; and (3) Charles Prince (Citigroup Inc.), $68 million, the year after 2008’s financial crisis decimated the once-mighty financial institution as it relied on federal taxpayer bailouts to survive. See Davis, supra note 34, at 422, 460. In Prince’s case, a shareholder derivative lawsuit in Delaware challenging the payment as waste survived preliminary challenges and is pending. In re Citigroup Inc. S’holder Derivative Litig., 964 A.2d 106 (Del. Ch. 2009). If it follows corporate-law precedent, the shareholders will lose; if the contract-law analysis proposed in this Article is applied, they have a good chance of winning.

notes how corporate law’s waste doctrine is anemic compared to contract law’s unconscionability doctrine.

That sets the stage for Part IV’s new legal theory of contractual unconscionability to promote judicial review of pay contracts. It encounters and surmounts all the hurdles to show how applying contract law to pay contracts, rather than corporate law, would therapeutically and incrementally expand the population of contracts that fail the test of judicial legitimacy. This new legal theory would thus add considerable value to a field where both federal and state laws have failed. In this limited and narrow way, state courts around the country applying their contract laws could even add a small but much-needed bit of pressure on Delaware courts to heed interests that its traditional corporate law may overlook.

I. THREE PILLARS AND THEIR DIMINISHMENT

Executive compensation, especially stock-based components, has skyrocketed since the 1990s thanks to a three-pronged theoretical model whose limits were revealed beginning in the early 2000s. Part I.A reviews the three theories, and Part I.B demonstrates their limits.

A. CLASSICAL THEORY

The three-pronged theoretical model supporting growing executive compensation, especially stock-based components, consisted of a vision of corporate boards forming optimal contracts with managers, an assumption that stock market prices are good indicators of managerial performance, and a belief that stock-based pay would better align managerial incentives with shareholder interests.

1. Optimal Contracting

In optimal contracting theory, shareholders are treated as principals and corporate managers as agents. The theory notes how interests of principals and agents diverge. The costs of controlling divergence and of the part that cannot be controlled are called agency costs. In corporate contexts, agency costs are limited by markets, including the labor, capital, product and corporate control markets. Divergence of interests between managers and shareholders can be reduced by: (a) investing in monitoring devices, such as oversight, auditing, and internal controls; (b) using bonding devices, such as commitments not to take certain actions; and (c) creating interest-aligning incentives for agents, such as stocked-based pay contracts. In theory, boards of directors, acting for shareholders and being accountable to them, can be counted on to reduce agency costs. Compensation contracts that align manager incentives with shareholder interests are one method.

2. Efficient Markets

39 Jensen & Meckling, supra note 37.
To enable boards to reduce agency costs by arrangements that align manager incentives with shareholder interests, scholars searched for a proxy to express the shareholder interest and then tie manager incentives to it. For centuries, shareholders have been seen as interested in maximization of firm profits and managerial performance was evaluated in those terms. Beginning in the 1960s, it became fashionable to look beyond those terms to see stock market price as a proxy for both the shareholder interest and firm value. This shift arose when theorists developed a hypothesis that stock price incorporates all public information about a corporation, reflecting profits and value.40

The principal–agent model and optimal contracting theory thus found a valuable cognate.41 This efficient market hypothesis suggested stock prices reflect corporate performance so as to provide a report card on managerial stewardship. Higher stock prices signal better management.42 This assertion pointed to stock-based pay as an incentive device to induce managers to focus on stock price, a barometer of their performance.43 Stock-based pay could reward long-term investor wealth increases, even when focused on current stock price, because “stock prices reflect the entire future stream of expected payments to shareholders, discounted to present value.”44 They could extend managerial time horizons to coincide with shareholders’ horizons.45

3. Incentive Alignment

The idea that stock-based pay may align manager incentives with shareholder interests dates back to the 1950s.46 But theories of optimal contracting and market efficiency that jelled by the 1980s enabled an intensification of this assertion a decade later. This achievement is marked by an influential paper by Michael Jensen and Kevin Murphy encouraging stock-based pay.47 While recognizing that agency costs are high and many devices, both market and contractual, are available to contain such costs, these scholars argued that stock-based pay is most effective to align manager incentives and shareholder interests.48

41 Fox, supra note 4, at 2101.
46 See Arthur H. Dean, Employee Stock Options, 66 Harv. L. Rev. 1403, 1404 (1953).
Professors Jensen and Murphy were more concerned with compensation form than amounts. Before they stimulated a shift, cash was the currency of executive compensation, not stocks or options. They observed that cash compensation varied little with corporate performance, as measured by stock price. They thought this a problem reflected in the agency-cost model, showing manager–shareholder interests diverging. To limit divergence, and reduce agency costs, Jensen and Murphy sought to link pay with performance, measured by stock price. That meant making managers into shareholders, and CEOs into substantial shareholders. Stock options and other stock-based pay were the solution.

Deeper theory supposes managers are more risk averse than shareholders. That is because managers have human capital (their earnings potential) tied up in their corporation, and human capital is hard to diversify. Public shareholders have no human capital in the corporation and can diversify financial risks by holding investments in many firms. Diversified shareholders may prefer managers to pursue risky projects. So portrayed, shareholders have a stronger risk appetite than managers, and some aggressive alignment mechanism, like stock-based pay, was the device to close that divergence.

Managers may also place greater weight on factors that put human capital at risk than on financial rewards accompanying successful execution of risky projects. If so, the incentives must be sufficiently strong to meet that asymmetric managerial orientation. The prescription was to mirror that orientation with asymmetrical payoffs—alignment devices that affirmatively “reward[] success” and avoid “penalizing failure.” Stock options that make managers win big on the upside and lose little on the downside became a virtue, providing the asymmetrical payoffs their asymmetrical risk appetites warranted.

Most legal scholars avoided overstating the alignment case, noting stock-based pay as one device among many to align managerial interests “more closely” with shareholder interests. They could help align these interests, but imperfectly. Of course, everyone knows

50 See *Jensen & Meckling, supra* note 37.
54 *Id.* at 40 (explaining that their representative analysis of the comparative risk appetites of shareholders and managers meant prescribing “a sufficiently large amount of stock options to offset inclinations to be too risk-averse”).
55 *Id.* For some qualification on this prescription, see Randall S. Thomas, *Should Directors Reduce Executive Pay?*, 54 *Hastings L.J.* 437, 450 (2003).
that agency costs cannot be reduced to zero. Stock-option contributions to agency-cost reduction cannot be assured, and costs of stock-based pay can exceed the agency-cost reductions they achieve. For example, stock options on exercise require share issuances that dilute claims of other shareholders. It was understood that stock-based pay could solve some incentive problems but create others.

Even so, there was exuberance among influential corporate law scholars to rivet managers on stock price and make it the talisman of corporate performance—and stock-based pay was a leading way to do it.\(^{58}\) There was also little doubt among prescribers that the primary purposes of stock-based pay were to “motivate management” and to “align” recipient—shareholder interests.\(^{59}\) Some said such pay extends managers’ time horizons beyond their retirement, a value to the extent shareholder horizons are long.\(^{60}\) Though the exact alignment function was uncertain, it was always riveted on stock price, creating incentives to “get stock prices up.”\(^{61}\) This motivation feature did not differ greatly from the alignment thesis, at least so long as shareholders shared the ambition to “get stock prices up.”\(^{62}\)

**B. Reality Check**

Beginning in the late 1990s and intensifying through the first decade of the twenty-first century, reality exposed weaknesses in all three pillars of stock-based pay theory, and concerns about skyrocketing executive pay emerged. The optimal contracting model and agency—principal accounts work wonderfully in theory, but corporate governance realities make them often inaccurate descriptions of the actual state of affairs. Managerial power can be too great in some modern U.S. corporations to rely on the model’s envisioned contracting exercises.

The efficient market hypothesis, likewise elegant in theory, is an idealized picture of market operation, different from reality. Stock markets produce prices that deviate in sustained


\(^{58}\) E.g., Daniel R. Fischel, The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s Corporation Law, 76 NW. U. L. REV. 913, 919 (1982) (“Various compensation packages such as stock option plans, which cause managers to share the risk bearing function with shareholders, provide managers with an incentive to maximize shareholders’ wealth and keep stock prices high.”).

\(^{59}\) Carney, *supra* note 44, at 416.

\(^{60}\) Id.

\(^{61}\) Thomas & Martin, *supra* note 53, at 37–38; see also Fischel, *supra* note 58, at 919 (discussing how market mechanisms, such as stock-option plans, are designed to incentivize managers to “keep stock prices high”).

\(^{62}\) Stock option theory relied heavily not only the theory of efficient markets but also on other aspects of the larger body of modern finance theory of which market efficiency is a part. In particular, proponents relied upon a tool of modern finance theory to measure stock option value, the famous Black-Scholes option-pricing model. It says option values increase in proportion to volatility of stock prices which, in turn, were thought a reliable measure of fundamental business risk. Proponents prescribed that managers think about how risky their businesses were in terms of how volatile its stock price was—and using stock options to increase their incentives to increase that volatility.
and substantial ways from any useful expression of underlying corporate performance. These theory–practice discrepancies diminished confidence that stock-based pay would align manager incentives with shareholder interests—at least of long-term shareholder interests. They created perverse incentives. Any one of these discoveries alone raises doubt about the efficacy of stock-based pay; their combined effect compounds the problem not only for stock-based pay but for the amounts of executive compensation in all forms.

1. Suboptimal Contracting

Managerial power often proved too great for optimal contracting theory to work in practice. True, market constraints, contracting devices, stock-exchange voting rules, and regulatory and media oversight constrain managerial power to increase agency costs and extract lucre from corporations. Managers abusing power to wrest excessive stock-based pay can produce shareholder outrage. Shareholder outrage can lead to punishing misbehaving managers and using the market for corporate control to oust them, by tender offer or proxy contest. Managers may wish to avoid those consequences to protect reputations and associated human capital (their earnings potential).

But managers have tools to camouflage misconduct, including thorough control of board compensation committees, managing public disclosure, and other obfuscation. This point is not new, of course. Professor Eisenberg highlighted the problem when stock-option alignment enthusiasm incubated, along with optimal contracting and the efficient market theory. He explained that only in theory are compensation decisions made by independent committees acting on independent outside expert advice. A corporation’s chief executive officer always has a role in picking directors and supporting advisors and can dismiss noncompliant participants. The CEO has a clear interest in increasing her or his compensation and that of lieutenants. It looks like a governance process at work, but that can be an illusion.

Boards may honestly wish to align managerial incentives with shareholder interests and think that stock-based pay does so, tying all to stock price and amounting to a valid exercise of business judgment. Boards may likewise follow academic models and grant large numbers of options intended to overcome what theory says is a significant difference in manager–shareholder risk appetites. But Professors Bebchuk, Fried, and Walker warn of enduring illusion in this possibility. Boards do not always negotiate with senior executives over these matters. Optimal contracting theory assumes boards bargain with managers, acting for shareholder interests to get optimal contracts. But those assumptions are sometimes wrong.

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63 E.g., Bainbridge, supra note 7, at 981 & n.129 (“Because shareholders have a long-term investment horizon, they would prefer risk-return policies that produce sustainable share price appreciation . . . . [S]tock options may give management a short term investment horizon [to boost share price in non-sustainable ways].”)
64 See BEBCHUK & FRIED, supra note 29, at 61–79.
65 Eisenberg, supra note 56, at 1491–92.
66 Id.
68 Bebchuk, Fried & Walker, supra note 3 at 833.
Many scholars credit Professors Bebchuk and Fried with revealing contemporary limits of the classical theory of stock-based pay as a solution to the classic agency-cost problem. For example, Professor Stephen Bainbridge, reviewing their book, notes the traditional story recounted above calling for reducing agency costs by aligning manager incentives with shareholder interests, usually with stock-based pay. Bainbridge acknowledges that Bebchuk and Fried made a good case that those schemes may not work, demonstrating how “managerial influence over the board . . . taints the process” and how the system supposed to reduce agency costs is itself deeply infected with “agency costs.” Professor Eisenberg reviews the same account, noting stock-based pay as the routine prescription to give managers incentives that align with shareholder interests. He adds that Bebchuk and Fried showed that resulting compensation is not linked to performance and concurs about why: “incumbent CEOs often set their own compensation behind a screen of compliant consultants, compliant compensation committees, and compliant boards, all largely engaged in blowing smoke.”

Not all are convinced by Bebchuk and Fried’s argument that their managerial-power thesis is a better way to explain observed practices than optimal contracting theory. Critics say there may be good reasons, within optimal contracting theory, for executive compensation to result in pay unrelated to business performance. Other scholars observe that the managerial-power thesis leaves room for the optimal contracting theory to explain much of observed practice. Some empirical research identifies data suggesting that boards do engage in meaningful bargaining with managers. In response, Bebchuk and Fried emphasize two points: (1) the managerial-power thesis supplements, rather than displaces, optimal contracting theory; and (2) there should be no presumption that optimal contracting theory is correct so that any rival must disprove it to warrant recognition. On balance, there is at least some reason to doubt optimal contracting theory’s utility in practice.

2. Inefficient Markets

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71 Id. at 1662.
73 Id. at 175.
75 Gordon, supra note 1, at 676.
Another limit of the classic story is the difference between the efficient-capital-market theory and actual stock-market practice. Even Judge Richard Posner, a longtime, staunch and enduring devotee of the efficient-market theory, recognizes considerable limitations on the model, which have particularly deleterious effects on stock-based pay. In discussing stock-based pay, Posner observed that “capital markets are not as efficient at pricing securities as the best estimate of their companies’ discounted present value as economists and finance theorists used to think.” While still believing that efficient-market theory has “substantial explanatory value,” Posner reviews insight from behavioral finance casting “profound” doubt on its efficacy concerning evaluating executive compensation, especially stock options.

The as-if rationality that efficient-market theory supposes does not hold when investor deviations from model behavior are systematic rather than random. Examples of systematic departures from rationality include biases like loss aversion, manifested in greater reluctance to sell losing than winning stocks, and demanding a larger risk premium to hold stocks compared to bonds than risk models of investment diversification justify. They include excessive trading and trading based on perceived stock price patterns. These systemic biases even plague professional money managers. Sophisticated arbitrageurs cannot eliminate them since there are not always good substitutes for mispriced stocks and there is no assurance that market errors will be corrected before an arbitrage position must be closed out.

The result is sustained deviations between stock price and business value. Even if the efficient market theory makes more modest claims, like price impounds public information, the reality of market behavior impoverishes stock-based pay as a way to tie managerial pay to managerial performance or to align managerial incentives with shareholder interests. True, as Posner stresses, the force of these deviations is debated and their policy implications contestable. But as Poser concludes, existing knowledge supports criticism about the prevailing structure, and amount, of executive compensation.

Evidence shows how stock price movements that determine compensation “may not be reliable estimates of underlying values, and hence of CEOs’ contribution to those values.”

These infirmities in efficient-market theory underscore the difference between the short term and long term. The model supposes there is no difference because short-term stock prices, impounding all public information, represent a reliable proxy for long-term business value. But that is contestable when stock prices are fueled by speculative optimism. Short-term prices can

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78 Id. at 1028–29.
79 Id. at 1036.
83 Posner, supra note 79, at 1036–38.
84 Id. at 1041. Posner adds that the “insidious effect” of this problem was acute in the 2008 financial crisis after managers were encouraged to ride the preceding market bubble through its bursting, preferring short-term high stock prices to medium- or long-term business value. Id.
be inflated compared to long-term business value. Based on the technology bubble of the late 1990s, there is a case that problems with the efficient-market theory make stock-based pay problematic, apart from the relative accuracy of optimal contracting theory versus the managerial-power thesis. It is possible, amid inefficient market bubbles, that shareholder interests are so riveted on short-term stock price that short-term, stock-based pay perfectly aligns shareholder–manager interests—though short-term price and long-term value differ.

But what of shareholders not interested in short-term price drops compared to long-term business value? There may be a stalemate between proponents of the classical theories supporting stock-based pay and those emphasizing reality checks. Proponents still hold out hope for tenets such as optimal contracting and efficient markets while skeptics stress the inherent limits of these models. Assuming shareholder interest promotion is the goal, it is vital whether the contending position can even agree about which shareholder interests matter. Shareholders may be arrayed on a highly delineated range of time horizons, from minute-to-minute short-term day traders fastened on price fluctuations to long-term devotees of fundamental value. The populations may vary with different corporations and economic climates. With efficient markets, this short-term–long-term dichotomy would not exist. But with imperfectly efficient markets, the difference can be vast.

That difference, along with managerial incentives to fasten on short-term price, rather than long-term value, has spawned three problems, which will be analyzed in the next Subpart as evidence of misaligned incentives: inclining managers to speculative short-term projects that sacrifice long-term investment, encouraging earnings manipulation and accounting fraud, and overdoing stock repurchases as opposed to paying cash dividends. None of those should be possible if stock markets are efficient, where stock price reflects all public information and are proxies for corporate or managerial performance. Even erstwhile, champions of stock-based pay, and the efficient-market theory used to justify it, see that stock prices can be inflated. Accordingly, it is no longer correct to say that stock-based pay pinned to the short term gives managers incentives to increase shareholder or corporate value; rather, it gives them incentives to increase short-term stock price.

3. Misaligned Incentives

It seems relatively widely recognized that stock-based pay does not always work as well to align manager incentives with shareholder interests as the theory predicted. It creates three

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86 Id. Professor Bolton’s paper explains that this problem is exacerbated by how corporate fiduciary duties run to current, not future, stockholders, a point made earlier by others, including me. See Cunningham, supra note 82.
perverse incentives for managers not aligned with the interests of shareholders other than speculative short-term ones. The first and most-cited problem is that stock-based pay rivets manager attention on current stock price, not long-term business value. In contrast, the interests of most shareholders focus on long-term business value, not short-term stock price. Second, the result of that fixation is managerial temptation towards manipulation and distorting financial records and accounting, thus skewing information in ways antagonistic to most shareholder interests. Third, the incentives also slant managers away from paying cash dividends to stockholders and towards stock repurchases because dividends are not paid on stock options and cash repurchases drive up stock price. That likewise may be an interest shared by some, but not all, shareholders.

These problems arise in part because of poor pay contract design. For example, misalignment occurs when stock options make managerial upside potential enormous and downside risk minimal. Stock options either pay off big or expire worthless, costing managers little on the downside and encouraging greater risk taking than many shareholders prefer. Even when stock prices fall below set exercise prices, the once-common board practice of cutting the exercise price—or issuing new options—creates value for option-holding managers not available to any shareholder. That undercuts manager–shareholder-interest alignment.

Options vest within a few years and can be exercised upon vesting for up to ten years, and managers tend promptly to liquidate them within the short term. The shorter the time until stock options vest and become exercisable, the shorter managerial focus becomes. At brief intervals, options “turbocharge” managerial fixation on short-term price that can misalign manager–shareholder interests on time horizons and, worse, induce pathological managerial obsession with stock price. That tempts managers not only to succumb to financial misreporting and slanted capital allocations but creates incentives for them to manipulate the timing of disclosure to shareholders—disclosing news likely to reduce stock price right before exercise prices are set and disclosing news likely to increase stock price right before exercising.

Several categories of costs arise from these misalignments. First, stock-based pay is more costly than an equivalent amount of cash for a corporation. To a manager, the choice between one million dollars in cash and stock options with an estimated value of one million dollars is

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92 Bratton, supra note 87, at 81.
94 Posner, supra note 79, at 1027.
96 Melone, supra note 93, at 559–60; Thomas, supra note 55, at 450.
easy—take the cash, since it offers liquidity and a certain value while the stock option is illiquid and of uncertain value. Second, the devices shift claims on corporate value from shareholders to managers, evidenced by the dilution of other shareholders when managers exercise options for shares. Third, any resulting financial misreporting, fraud, or disclosure manipulation risks capital misallocations. Fourth, pay contracts can inject volatility into stock market prices, skewing what could be a useful signal of corporate performance, as under efficient-market theory.97

Accordingly, it is difficult to embrace the alignment thesis of stock-based pay contracts. That is due to design that rivets managerial attention on the short-term and skewed incentives towards financial manipulation. It is also difficult because it is impossible to delineate a particular sort of shareholder with which any alignment prescription can be made.

II. FROM NEGLECT TO REFORM

Executive pay has skyrocketed along with stock-based components. From the 1980s to early 2000s, there was essentially no bulwark against excess. With the empirical discovery of limitations on the model, the new reform agenda offers many proposals to fill this gap. The following reviews the historical lack of oversight and highlights some approaches to providing it, including partial reforms appearing in the Dodd–Frank Act of 2010, prescribing independent director oversight of top pay contracts, enhanced disclosure, and periodic but nonbinding shareholder votes on them.

A. LIMITED HISTORICAL POLICING

Academics on balance supported growth in executive pay, especially stock-based components, with only a minority of scholars raising serious doubt.98 Many boards of directors became supine and compliant, increasingly relying upon outside executive-compensation consultants and benchmarking against peers in exercises that ratcheted up executive pay, especially stock option components.

At best, state corporate law, in Delaware99 or elsewhere,100 provided limited supervision. Delaware, in particular, had shifted its standard for judicial review of executive compensation

97 That is partly because stock options are often valued using a cognate of efficient market theory, which says stock options increase in value in proportion to the volatility of the underlying stock price—a model that, if managers believe it, gives them incentives to increase stock price volatility. See Thomas & Martin, supra note 53, at 41 (“Valuing a stock option requires using the Black-Scholes formula and is not an intuitive process.”): supra note 62. In theory, stock options should increase managerial risk appetites and that can be measured by how volatile the stock price is, which in turn, increases the estimated stock option value. But if stock price volatility may not be a function of underlying business activity or value, then the incentive is merely to inject price fluctuations into the stock market without regard to the corporation’s risk profile. It is difficult to see how that is in the interest of most shareholders.
98 For a review of some of the highlights of the literature, see supra Part I.A.
99 E.g., Pogostin v. Rice, 480 A.2d 619 (Del. 1984) (noting that the plan awarded interests over a five-year period, vesting then, with valuation based on market price of common stock then), overruled on other grounds, Brehm v. Eisner, 746 A.2d 244 (Del. 2000); Michelson v. Duncan, 407 A.2d 211, 219–22 (Del. 1979) (holding that the shareholder’s ratification of their stock option plan was enough to sustain directors’ cancellation and reissue of options following sharp stock price drop).
100 E.g., Cohen v. Ayers, 596 F.2d 733, 735–43 (7th Cir. 1979) (finding that the board’s decision to terminate and reissue overpriced options did not constitute waste).
from something resembling serious examination to the most deferential position possible. This relaxed waste standard, combined with the business judgment rule, veneration of formal board independence, and the endorsement of special litigation committees in derivative litigation, took Delaware courts and corporate law largely out of the policing picture. This relaxation coincided with growing recognition that Delaware no longer competed with other states in the market for corporate charters, so that its production of corporate law was not necessarily constrained by competition from other states.

At the federal level, securities regulators’ efforts resulted only in mandating more disclosure (a feature continued in the Dodd–Frank Act of 2010). While potentially useful, some of these rules, such as requiring comparisons of compensation at peer companies, made the practice of benchmarking more tempting and contributed to pay ratcheting up. Tax policy, though occasionally ambivalent, created additional incentives for corporations to use stock-based pay, rather than perform any policing function. Even the Sarbanes–Oxley Act, responding to scandals of the early 2000s with some link to stock-based pay, did nothing to address problems of misaligned incentives arising from inefficient markets and suboptimal contracting. Though some scholars contend that the declining competition for Delaware from other states has been replaced by an enduring threat of preemption from the federal government, these modest incursions are slight, and Delaware retains enormous leeway in designing corporate law for national use.

As stock-based pay began to proliferate, it was an accident of accounting history that standards did not require stock options to be treated as an expense on an income statement. That treatment contributed to corporate America’s appetite for using this form of compensation. In response, accounting standard setters sought to require recording option compensation as expenses, but business interests and politicians in Congress resisted mightily. After a decades of fighting and the passage of the Sarbanes–Oxley Act, standard setters achieved some reporting transparency. But that happened after stock-based pay had penetrated corporate culture so pervasively that the measures were too little too late to offer much of a policing function. As a group, auditors did not keep up with the inherent risks of earnings management that stock-based pay created. Many were co-opted by management.

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101 See Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 1997) (tracing the rise and decline of the doctrine of waste to police pay contracts).
102 Part III elaborates these points, noting the occasional but partial and limited judicial rebuke.
109 Cunningham, supra note 107.
With no legal oversight of executive compensation, the combination of public outrage, media pressure, and financial crisis that began in 2008 conspired to sharpen attention on the question. That induced some market correction, suggested by evidence of changes in stock-based-pay practices at some companies.\textsuperscript{112} Examples include increased used of contract provisions requiring disgorging amounts later deemed excessive under so-called “claw-back” provisions.\textsuperscript{113} Some see the incremental shift in board practices as a sign of a self-correcting governance program.\textsuperscript{114} Some scholars discern a flicker of a move within Delaware corporate law in response,\textsuperscript{115} focusing on officer fiduciary duties, though this remains inchoate.\textsuperscript{116} As discussed next, a new reform agenda emerged from this public outrage, leading to a few new provisions addressing executive compensation in the Dodd–Frank Act of 2010, but leaving much of the agenda incomplete and sustaining, rather than resolving, the debate.

**B. The New Reform Agenda**

The three-pronged theoretical logic that promoted skyrocketing executive compensation, including its stock-based components, is under renovation. Optimal contracting theory retains supporters who believe that boards are self-correcting, though others prescribe greater disclosure or expanding shareholder voice in corporate governance. Most seem to agree that there are differences between short-term price and long-term value, and that stock-based pay should be redesigned to emphasize the latter. Many still believe in the possibility of using stock-based pay to align manager incentives with shareholder interests. But that prospect’s dubiousness opens up new ways to justify the device. An alternative is that stock-based pay can be valuable to corporations to attract and retain scarce executive talent. The following discusses leading aspects of each point, drawing two implications. The first is whether the surgery on stock-based-pay redesign will prove worthwhile or whether a better prescription is to abolish it.\textsuperscript{117} The second, recognizing abolition as unlikely both practically and politically, is the continuing absence of judicial scrutiny of stock-based pay, to which Part III of this Article turns.

1. Reoptimizing Contracting

An early prescription to police stock-based pay was offered by Greaf Crystal, a compensation expert, who suggested corporate boards use independent consultants and compensation committees staffed with fully informed independent directors.\textsuperscript{118} Though scholars continue to debate whether observed pay practices comport with optimal contracting theory or

\begin{footnotesize}
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\item \textsuperscript{112} Bebchuk & Fried, \textit{supra} note 9.
\item \textsuperscript{114} See, e.g., JEFFREY D. BAUMAN, ALAN R. PALMITER & FRANK PARTNOY, \textit{CORPORATIONS LAW AND POLICY} 814–15 (6th ed. 2007). The increased appearance of clawback provisions is some evidence of some ongoing self-correction. See Cherry & Wong, \textit{supra} note 114.
\item \textsuperscript{115} See Thomas & Wells, \textit{Executive Compensation in the Courts}, \textit{supra} note 69. (discerning that signs exist, especially in Delaware trial courts, of increased policing of executive compensation when officers participate on the corporation’s behalf in setting their own).
\item \textsuperscript{116} The prescription to police executive compensation by focusing on officer duties is not novel. See Douglas C. Michael, \textit{The Corporate Officer’s Independent Duty as a Tonic for the Anemic Law of Executive Compensation}, 17 J. CORP. L. 785 (1992).
\item \textsuperscript{117} E.g., Melone, \textit{supra} note 93, at 559–60.
\item \textsuperscript{118} See Estreicher, \textit{supra} note 49, at 609 (discussing GRAEF CRYSTAL, \textit{IN SEARCH OF EXCESS} (1990)).
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the managerial-power thesis, there is little doubt that merely having such consultants and committees does not promote an air-tight arrangement in which actual bargaining occurs. It is not obvious that continuing to emphasize board independence in a formal legal sense promotes serious arm’s-length contracting, given the variety of structural, cognitive, and other biases that make directors more sympathetic and accountable to senior executives than to public shareholders. Accordingly, new provisions in the Dodd–Frank Act of 2010 prescribing independent-board-committee oversight of top-executive pay, while potentially incrementally helpful, are not highly likely to succeed.

Reinvigorating the optimal contracting story requires intensifying the accountability of directors engaged in compensation setting. They must have incentives, aligned with stockholder interests, to conduct arm’s-length bargaining. That leads to a standard prescription to increase shareholder voice in the boardroom. The Dodd–Frank Act of 2010 takes an incremental step of requiring periodic shareholder votes on top pay, though these are expressly not binding and do not expressly alter board fiduciary duties. While this process may increase visibility of pay and intensify board oversight, the precatory nature of the vote and its infrequency may dull its teeth.

Enhanced disclosure is the standard approach to reforming securities regulation generally and executive compensation practices in particular. The Dodd–Frank Act increases disclosure to address academic criticism and public outrage concerning executive compensation. Regarding academic criticism, Dodd–Frank requires disclosure relating executive pay to enterprise performance, a clarion cry of pay critics for a decade. Regarding public outrage, the Act requires stating and relating in a ratio the amounts of the CEO’s pay to the pay of the company’s

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119 E.g., Lawrence A. Cunningham, Rediscovering Board Expertise: Legal Implications of the Empirical Literature, 77 U.CIN.L.REV. 465 (2008) (reviewing how the idea of director independence is a standard response to corporate crisis and how it rarely provides a reliable solution to perceived problems); Rodrigues, supra note 3.

120 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 952, 124 Stat. 1376, 1900–03 (2010). The Act directs the SEC to require stock exchanges to prohibit listing securities of most issuers unless they have a compensation committee staffed solely by independent directors. Id. § 952(a)(2). The SEC must direct the exchanges to define independence in this context taking into account how directors are compensated, whether they do consulting work for the issuer, and whether any other affiliations exist. Id. § 952(a)(3). The committee’s advisors, in turn, must be independent taking into account similar factors, Id. § 952(b)(1), as the SEC further delineates according to examples the statute gives, id. § 952(b)(2). The committee is to have the power to retain qualifying consultants and be directly responsible for hiring, paying and overseeing them—none of this, the Act says, intended otherwise to prescribe committee actions or judgments. Id. § 952(c)(1). Similar provisions apply to committee retention of legal and other advisors. Id. § 952(d). The SEC is likewise directed to tell exchanges they can’t list securities of issuers not complying with these provisions. Id. § 952(f)(1).

121 Id. § 951. At least tri-annually, public companies already required to disclose top pay packages must put top pay packages to a shareholder vote for approval. Id. § 951(a). At least every six years, they must let shareholders vote on whether those approval votes should be taken annually, bi-annually, or tri-annually. Id. § 951(b). When doing any major business-combination transaction requiring a shareholder vote, disclosure must include, “in a clear and simple form,” any deals made with top officers triggering additional pay. Id. § 951(b)(1). If there is anything like that, shareholders also must vote on it (unless already covered by a previous shareholder vote). Id. The statute makes clear that these votes are not binding and cannot overrule a board decision, affect board fiduciary duties, or alter shareholder rights to make their own proposals on executive compensation. Id. § 951(c). Financial intermediaries holding and voting shares in these procedures must disclose to their investors how they vote. Id. § 951(d).


123 Dodd-Frank Act § 953(a).
median worker.¹²⁴ Companies also must disclose whether top executives owning company stock are allowed to hedge against declines in the stock price.¹²⁵ This is important because even stock-based pay designed to induce optimal incentives can be circumvented with hedges.

This tried-and-true approach to corporate regulation using disclosure is heralded by some.¹²⁶ Indeed, there has long been extensive disclosure of pay contracts and other executive-compensation arrangements, including the terms of stock-option plans. But these can be buried in dense documents or reams of paper that only a handful of market professionals digest. That may be enough to make the information public within the meaning of efficient-market theory and reflected in stock price. But disclosure serves additional functions, including as a check on board and management, generating outrage when pay is exorbitant and thus deterring excess.¹²⁷ A new disclosure rule in the Dodd–Frank Act expressing the ratio of top to median pay at a company may inflame public outrage and may provide that check.¹²⁸

Or the rule could backfire. For example, spotlighting the ratio of top-to-median pay may have surprising political repercussions. It may merely intensify existing polarity in the populace dividing those outraged by great income disparities between workers and managers and those who assume big pay rewards hard work. It is not always possible to use graphic or narrative information relating pay to performance and the result may be less meaningful than it sounds. In fact, other proponents of disclosure as a tonic prescribed disclosing very different information. They would require greater detail concerning the degree to which pay contracts are designed to orient managers on shorter versus longer-term horizons.¹²⁹ Furthermore, of course, the limits of public corporate disclosure are well known and it is infeasible to compel effective disclosure of all useful information.¹³⁰ Ultimately, critics counter that vesting more power in shareholders will exacerbate—not solve—problems created by stock option short-term riveting because some influential shareholders prefer the short-term focus.¹³¹

Whatever value Dodd–Frank may add, and appreciating how controversial even these incremental steps are, it is notable that Congress chose a few among many of a broader range of reform proposals in circulation. These include giving shareholders access to the corporate director ballot (something the Act merely directs the SEC to evaluate), increasing their power to remove directors, eliminating staggered boards, and increasing shareholder power to amend corporate charters and by-laws establishing corporate-governance procedures.¹³² Some call for making proxy fights easier for shareholders to wage¹³³ by reimbursing them for expenses, just as corporations absorb expenses of managerial proxy campaigns. The Dodd–Frank Act left these

¹²⁴ Id. § 953(b).
¹²⁵ Id. § 955.
¹²⁶ Posner, supra note 79, at 1013.
¹²⁷ Bebchuk & Fried, supra note 77, at 667.
¹²⁸ Dodd-Frank Act §§ 951–956.
¹³¹ Bratton & Wachter, supra note 130.
¹³² Bebchuk & Fried, supra note 77.
¹³³ Posner, supra note 79, at 1013.
more rigorous exercises out. It remains to be seen what the SEC will do about shareholder proxy access. But whatever the SEC does, it can have at most an indirect effect on executive pay.

Yet others say increasing marginal income-tax rates on high-income earners, targeted to stock-based pay, would police these contracts more effectively. That may be true. But that prescriptive approach has a long pedigree. And Congress has done precisely the opposite in its tax laws, encouraging stock-based pay under the rubric of “incentive compensation.” Political pressure against changing that law makes it unwise to rely upon Congressional action.

A final reform suggestion equips independent and impartial arbiters with power to review pay contracts for legitimacy. Federal law did that for banks receiving bailout funds during the financial crisis, enlisting Kenneth R. Feinberg to set the pay of twenty-five top managers at seven companies. The Dodd–Frank Act comes close to that for a small group of large banks, requiring federal-bank regulators to prohibit contingent-pay arrangements that can yield excessive compensation or risk material bank losses. Corporations could also create shareholder compensation committees to serve this role.

It is possible to imagine ways of reforming Delaware corporate law and stimulating Delaware’s judiciary to provide this supervision, especially a newly found focus on the fiduciary duties of officers themselves as distinct from directors. Yet Delaware’s law regulating shareholder suits precludes many claims, and its corporate law of director duties and waste has not offered a rigorous forum for judicial review. The judicial-scrutiny avenue should not be neglected, however, and Part III of this Article offers the corrective of substantive contract-law review conducted by courts other than Delaware’s, in addition to whatever reinvigoration of Delaware corporate law courts may adopt.

2. Retention as the Goal.

Many scholars continue to hope that properly designed stock-based pay can help align managerial incentives with shareholder interests, especially of long-term shareholders. Experience casts doubt about such hopes, however. True, the Dodd–Frank Act’s enhanced board independence, shareholder voting, and disclosure imply probable boardroom changes are indicated. Some boards may learn from past mistakes. But that is not inevitable. In the academic literature, the primary rationale offered for stock-based pay was aligning manager incentives

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134 Id.
135 Estreicher, supra note 49, at 612 (stating that “[f]ederal tax laws might be utilized to motivate firms to adopt” more optimal programs).
136 See supra note 107 and accompanying text.
138 See Davis, supra note 34.
139 See Thomas & Wells, supra note 69 (prescribing ways Delaware courts can harness officer fiduciary duties to police executive compensation, especially for officers when renewing their employment agreements); see also Steven C. Caywood, Note, Wasting the Corporate Waste Doctrine: How the Doctrine Can Provide a Viable Solution in Controlling Excessive Executive Compensation, 109 Mich. L. Rev. 111 (2010) (prescribing a litigation strategy that involves using say-on-pay votes against pay packages followed by lawsuits under a revitalized waste doctrine).
140 E.g., Henderson, supra note 76.
with shareholder interests. If that were the only rationale, and if the hopeful are wrong and there
is less realistic chance that stock-based pay can provide such alignment, there would be a strong
case for abolishing stock-based pay.\(^{141}\)

Alternatively, stock-based pay can be justified on grounds other than alignment and
debate over its capacity to promote alignment rendered moot. Even while academics emphasized
alignment as the rationale, companies using stock-based pay declared their purpose as attracting
and retaining managers.\(^{142}\) Many managers come to command extraordinary information about
an enterprise, and many are intensely interested in lateral moves.\(^ {143}\) Retaining them can be
valuable to a corporation and its shareholders. There may be few better ways to induce retention
than dangling valuable stock options that vest in the future.\(^{144}\) Before the stock-based pay boom
that began in the 1990s, the principal rationale of stock-based pay dating to the 1950s was
executive retention.\(^ {145}\)

Though recognizing the retention rationale, some stock-based pay skeptics doubt its
utility for that purpose. They note that competing companies outbid the value of equity interests
left on the table by inducing managers to move through the device of the “golden hello.”\(^ {146}\) Some
companies give stock options after terminating an executive, not to retain or align.\(^ {147}\) Still, it
appears increasingly clear that corporate managers and scholars alike consider the rationale of
attraction and retention to be more legitimate and credible for stock-based pay than the
debilitated alignment rationale.

3. Long Term, Not Short Term

Following the consensus that stock-based pay failures of recent decades were due to
perverse riveting on short-term stock price, an equal consensus appears to reform the device to
focus on long-term business value. Professor Bratton notes that the three largest subcategories of
costs stock-based pay poses from its short-term riveting (deferred investment, earnings
management, and excessive share buybacks compared to dividends) can be mitigated by “[l]ong-
term restraints on the alienation of equity awards.”\(^ {148}\) Judge Posner proposes requiring “that a

\(^{141}\) This alternative is considered infra text accompanying notes 156–68.

\(^{142}\) See Gordon, supra note 95, at 1130 (noting that purposes of stock options include “recruitment and retention,”
especially of “executives who are aggressive, relatively less risk-averse, and willing to trade present compensation
for upside potential”); Thomas & Martin, supra note 53, at 37–38 (among many purposes that corporations, as
distinct from academics, cite for using stock options is to “recruit and keep talented executives and employees”).

\(^{143}\) See Matthew T. Bodie, Aligning Incentives with Equity: Employee Stock Options and Rule 10b-5, 88 IOWA L.
REV. 539, 548, 600 (2003) (noting purpose of binding managers to the issuing firm as the purpose of stock options,
in addition to the “main purpose” of alignment).

\(^{144}\) See Michael W. Melton, The Alchemy of Incentive Stock Options—Turning Employee Income into Gold, 68

\(^{145}\) Period cases all identified retention as the principal purpose of stock-option plans. E.g., Beard v. Elster, 160 A.2d
(Del. Ch. 1953).

\(^{146}\) See Melone, supra note 93, at 537 n.8 (citing Peter Cappelli, A Market-Driven Approach To Retaining Talent,
HRV. BUS. REV. Jan.–Feb. 2000, at 103, 104–05)).

\(^{147}\) See infra text accompanying notes 331–50 (discussing the Disney litigation).

\(^{148}\) Bratton, supra note 87, at 58.
substantial share of executive compensation be backloaded and tied to the future performance of the firm.”  

This prescription has a long pedigree.  

As discussed above, criticism of stock-based pay focuses heavily on its short-term rivet effect, implying that redesign for the long-term would be a fitting remedy.  

There may be reason to believe that boards will act on the recommendation and adhere to a long-term design focus faithfully. The information environment has changed. Boards know the limits of the alignment thesis and limits of stock market pricing. They know the perverse incentives that short-term stock-based pay creates. It may be helpful to give shareholders more influence over boards to promote accountability and fidelity to the new reform agenda’s focus on long-term pay contracts. But it is vital to appreciate that shareholders are not homogenous and the slogan of “empowering shareholders” overlooks how different the interests of different shareholders can be, ranging from those interested in minute-by-minute stock price changes to those interested in intrinsic value measured years into the future.

In light of these concerns in the new reform agenda, leading scholars such as Professors Bebchuk and Fried and Professor Romano prescribe an integrated redesign of pay contracts. All struggle to promote long-term manager orientations. For example, historically, stock options have usually vested within a couple of years and are immediately exercisable then. That fixes attention on the short term. But there is no reason the vesting and exercisability have to happen simultaneously. Options could vest after three years, providing pay and retention incentives. But they could be made exercisable for the stock only years after vesting. Managers would have less incentive to rivet on short-term stock price and more in stock price years later. The required time before exercisability should be predetermined and lengthy. It should not be a function of events that a manager can control, like a recipient’s retirement. That would rivet attention on stock price during the prereirement period, sustaining all known problems with such short-term focus. Equally bad, it can encourage premature retirement, defeating the newly important retention rationale of stock-based pay.

Redesign must lengthen managerial time horizons but appreciate managerial needs for liquidity and diversification. Long-term alienation restraints lengthen managerial horizons, reducing incentives to focus on short-term price. But restraints lower stock-option value to managers by reducing liquidity and capacity for diversification. Too much equity from

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149 Posner, supra note 79, at 1045.
150 Supra note 79, at 1046.
151 See supra Part II.B.
152 Bebchuk & Fried, supra note 9, at 1924 (“Although the end of the vesting period and the earliest cash-out date are almost always the same under current option and restricted stock plans, there is no reason for the two dates to be identical.”).
154 Bebchuk & Fried recommend establishing the preset time using two complementary tools. The first limits exercisability to a stated percentage of periodic grant amounts that gradually increases over time and the second puts an annual aggregate cap on top of that as a percentage of total equity interests. Any given option grant would become exercisable serially, say twenty percent each year over five years, but no one year’s exercise could result in the manager exercising all or even a large portion of total equity held. Bebchuk & Fried, supra note 9, at 1922–36.
excessively tight constraints makes managers too undiversified compared to many outside shareholders; too little makes the recipient a mere “implicit debt holder,” reliant on the firm for salary, with incentives to reduce risk. A modulated restraints–release design pursues the optimal by combining long-term constraints with periodic releases. An alternative would impose long-term restraints in exchange for granting more stock options to increase aggregate value to recipients. But that raises the specter of further upward pressure on total compensation. Another alternative would impose minimum equity holdings. Yet that can exacerbate the problem because when too high, managers may be more risk-averse than many outside diversified shareholders prefer.

If separating the vesting and exercisability dates and capping periodic option exercises were the only redesign changes made, problems would remain for incentives managers have to time and manage the terms of grant dates and exercise dates. Managers picking grant and exercise dates exploit inside information and even shape disclosure policy to influence stock price, reducing it just before grant dates and raising it just before exercise dates. To prevent this mischief requires eliminating associated discretion and current timing practices. Eliminating discretion over grant exercise dates would curtail managers abusing information advantages. Proponents of stock-based pay concur that long-term alienation restraints reduce managerial temptation to manipulate short-term stock price. Locking in grant dates and restricting discretion over exercise programs reinforce that benefit. It is more difficult to manipulate information flows under these constraints and more difficult to manipulate long-term than short-term accounting and stock-price effects.

But these restrictions will not eliminate the potential for incentives for financial or accounting manipulation, though they would moderate them and their significance. It may be more difficult to manipulate information and accounting results over long periods than short periods, but it is possible. Familiar gimmicks to manipulate short-term results, to boost current profits, include premature revenue recognition and capitalization of expenses. That reduces profits reported later. An efficient stock market should see through such charades; actual stock markets do not. But a shift to the medium or long term, especially by staggering the alienability of stock options, only shifts the game’s focus. For example, if stock-option values peak in year six, managers have an incentive to allocate profits to year six. Schedules of revenue recognition and expense allocation can be devised to facilitate just that. The staggered release schedule may reduce this manipulation incentive, but it cannot eliminate it.

156 Melone, supra note 93, at 562–63.
159 Bebchuk & Fried, supra note 9, at 1942–44.
160 Bebchuk and Fried thus propose that grant dates be fixed ahead of time, not be discretionary as they are now, and exercise prices determined not as of those grant dates, but on some other pre-determined earlier date that prevents managerial manipulation of information flows affecting stock price. Thus exercise dates would be fixed ahead of time too, by managerial disclosure of planned liquidation dates according to a fixed, irrevocable schedule. Related prices would be determined not by the single exercise date’s stock price but by an average stock price over the ensuing period.
161 See Thomas & Martin, supra note 53, at 45–46 & n.68.
Many other problems and proposed solutions appear, and delineating them all is beyond this Article’s scope. But highlighting one will suffice to illustrate the challenge and stimulate thought concerning whether to abolish stock-based pay or at least develop a way to adapt a basic contract-law doctrine to police them. Vital to any redesign is a device to prevent managerial evasion of intended effects. Whatever design stock-based pay assumes and whatever alignment, retention, or other virtues are provided, managers can use side deals to reverse the effects. Managers can engage in short sales or sign-swap agreements that have the effect of liquidating or altering the position equity interests ordinarily represent. Even stock-pay proponents who generally favor market and private solutions to governance challenges suggest willingness to prescribe that law ban such end-runs. That consensus explains provisions in the Dodd–Frank Act that require companies to disclose whether managers owning stock are permitted to hedge against stock price declines. But that disclosure is not the same thing as a policy prohibiting it, of course.

C. **The Case for Abolition**

The new reform agenda’s emphasis on stock-based-pay-contract redesign amounts to radical surgery that raises a separate question: whether these devices are worth redesigning or whether they should be abolished. To read some accounts of stock-based pay, it’s a wonder how corporations achieved prosperity for the hundreds of years before it was so well theorized that they proliferated throughout corporate America. Yet, are they vital? Would corporate America or the U.S. economy be worse off without these devices? Berkshire Hathaway, run by noted investor–manager Warren Buffett, has never paid managers using stocks or options, and that company is among the largest and most-respected in the world. Is abolishing stock-based pay, voluntarily by corporations or mandatorily by regulation, a damnable prescription? Setting aside the political obstacles to any such prescription, it’s worth pausing to consider just how vital stock-based pay is, especially for retention, now that it assumes greater importance as a credible rationale. What are the alternatives and how do they compare in complexity and cost?

Several devices readily present themselves as retention tools—and some may promote alignment as well or better than stock options or the like. For senior executives, including CEOs, examples are cash salary and other compensation (like cash bonuses, pension, and severance), plus non-compete agreements. For other top managers, the devices include opportunities for advancement, staffing and reporting arrangements, and titles. All these can be designed to promote retention, and some can even be designed to help align managerial incentives with shareholder interests, such as by making some bonuses tied to business-unit performance under

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163 Thomas & Martin, supra note 53, at 46 (“[T]he government could prohibit executives from using derivative instruments as a way of realizing immediate value on their stock options.”).


165 See Lawrence A. Cunningham, The Essays of Warren Buffett: Lessons for Corporate America 65–74 (2d ed. 2008). Berkshire Hathaway is iconoclastic in corporate America in many ways, of course. These include having a single individual as controlling shareholder, never having paid a dividend, not splitting its stock for decades, and for decades using a shareholder program to allocate charitable giving. Id. Even so, on these and other points, that is why the company can teach corporate America such valuable lessons, including on stock options.
that manager’s control. Most are relatively cheap compared to stock-based pay. They are also simpler in that they present fewer risks of creating unintended perverse incentives.

Opponents of abolition, including Judge Posner, note that stock-based pay can provide some alignment effects, though they were oversold and are a “clumsy instrument for incentivizing managers.” Abolitionists emphasize those weak alignment benefits, the irredeemably impaired contracting process, and how riveting on shareholder wealth, short or long term, has “corrosive effects.” Even the best redesign proposals show that no stock-based pay contract will avoid presenting trade-offs and complexities. Designing effective pay contracts is a Herculean task because of inherent trade-offs.

As Professor Bratton explains, these trade-offs arise because stock-based pay is not sensible if conceived of merely as compensation. For corporations and shareholders, compensation, in whatever amount, is cheaper using cash than stock. Stock-based pay must offer something more than return for labor. It must provide incentives cash does not. In the standard story, those unique incentives are some form of alignment between managerial and shareholder interests. Yet those incentives can only be maximized by imposing long-term alienation restraints that reduce managerial assessments of option value. The upshot is inherent trade-offs.

An important incentive that affects stock-based pay can provide better than cash is to induce managers to remain employed. Boards that design stock-based pay solely for the purpose of retention can skip the incentives alignment angst and set the level and form of options as required to induce valuable managers to stick around, keeping their human capital in place. Although that provides a more credible rationale to continue to use stock-based pay, and against abolition, it does not eliminate difficulties or trade-offs. Even if the purpose is to give managers an incentive to remain with the corporation, effects can be a variety of other skewed incentives. Changing the rationale does not change the device or related design challenges. But it does support changing the conception of the legal lens used to evaluate option-pay legitimacy—a shift from corporate law to contract law.

III. OLD AND NEW COMMON-LAW TOOLS

One disadvantage to statutory or regulatory responses to corporate-governance challenges is their inherently one-size-fits-all quality. Whether in the original securities-law statutes or updates like Sarbanes–Oxley or Dodd–Frank, Congress adopts laws of general applicability. That is true whether they work better or worse for the wide variety of corporate settings they address. Broad general principles like disclosure and materiality work well under such a model. But more intricate matters, such as control and supervision of accounting systems or compensation packages, are less amenable to that kind of regulation. Apart from potentially awkward fit and costliness, the result is a watering down of a law’s strength that misses the target of the most egregious abuses. In contrast, common law’s case-by-case approach is precisely

166 Posner, supra note 79, at 1044 (“Stock options should not be forbidden, as they do have some tendency to align managerial compensation with firm performance.”); see also Walker, supra note 129 (critiquing recent executive-compensation regulations).
167 Melone, supra note 93, at 536, 562–63.
168 Bratton, supra note 87, at 57–59.
targeted and tailored. It catches the egregious cases and yields to the wide range of legitimate practices.

Another advantage of common law is how it usually generates a population of resolved cases that enables stating doctrines that show the boundaries between legal categories, including between what is legitimate and what is unlawful. The corporate doctrine of waste does not share that feature, especially not concerning executive-compensation decisions. The cases all suggest that essentially anything goes, and that does not yield a useful body of case law. If contract-unconscionability law applied, a body of cases with some variety would emerge, with some bargains found illegal while the majority would be upheld. The population of cases would draw on and reflect legitimate business and legal norms, which lawyers and business people would in turn use to make lawful arrangements and eschew unlawful ones. In short, the common law of contracts has a capacity to target and catch what is unmatched by federal securities statutes or state corporation law.

This Part paves the way to the Article’s proposal by exploring the doctrines of waste and unconscionability. It shows that, in theory, corporate law’s waste doctrine should be more demanding than contract’s unconscionability doctrine but that the reverse is true in practice. Discussion then reconciles the two doctrines and shows the appeal of contract law to test the legitimacy of pay contracts. The next Part explicates the route to make that happen and illustrates the opposing results.

A. **CORPORATE WASTE**

Corporate law vests all powers, including the hiring and compensation of officers, in the board of directors, with occasional requirements or opportunities for shareholder input. Boards owe corporations and their shareholders duties of care, presumed discharged under the business judgment rule, and of loyalty, easily met by satisfying formal independence requirements. Corporate-law judges defer overwhelmingly to board decisions within their statutory powers. In theory, boards are not authorized to engage in transactions that constitute a waste of corporate assets, though in practice, judicial findings of corporate waste are rare. Even when palpable waste appears, corporate law insulates related decisions from judicial review by limiting shareholder power to assert legal rights on behalf of the corporation.

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170 Federal law also may require or create incentives for shareholder voice, under both securities and tax law. Federal income tax law grants special treatment to certain kinds of pay contracts if approved by a shareholder vote. See I.R.C. § 162(m)(1) (2006) (allowing corporate tax deductions for employee compensation above $1 million only if it qualifies as performance-based compensation); id. § 162(m)(4)(C)(ii) (providing that performance-based pay plans be approved by a majority shareholder vote).


172 Even well-respected Delaware judges have quipped about the rarity, one equating belief in its very existence to belief in the existence of the Loch Ness Monster, see Steiner v. Meyerson, No. 13139, 1995 WL 441999, at * 5 (Del. Ch. July 19, 1995), and another prescribing its abolition as a discarded vestige of a primitive era, see Harbor Fin. Partners v. Huizenga, 751 A.2d 879 (Del. Ch. 1999).

173 These limitations on shareholder litigation are discussed infra text accompanying notes 291–315.
A successful claim that a corporate payment constitutes waste, and is therefore unprotected by the business judgment rule, requires a showing "that no reasonable [business person] could find that adequate consideration had been supplied for the payment." In practice, that test requires showing the functional equivalent of a gift of corporate assets. Examples are monthly installment payments to a corporation’s former president’s wife because the payments were gratuitous, generating nothing for the corporation in return and motivated solely by sentiment. Similarly, naked bonuses that amount to retroactive salary increases lack consideration absent terms limiting payments according to achieving contract-like objectives.

As a result of functionally equating waste with gifts, massive salaries are outside the doctrine of waste because they so easily meet a long-standing test the Supreme Court stated in 1933 that defines “waste” as occurring when there is “no relation” between what the corporation gives and gets. Delaware courts have generally followed this statement of the doctrine of corporate waste. Even the strictest Delaware Supreme Court opinions, written in the 1950s (and since fallen into desuetude), did not require much. Examples, both focused on stock-option pay, suggest the corporation must receive something in exchange and that stock options exercisable quickly after issuance that do not require continuing employment fail that test. But even such a test can readily be satisfied by showing some relationship between value given and benefit received or, even easier, relying upon approval by a disinterested board coupled with shareholder ratification.

Whether under that old standard or current articulations, it is difficult for shareholders to win claims of corporate waste in any context, including executive compensation. It is nearly impossible to assert waste as a basis to challenge a merger or a corporation’s dividend policy. Even as to compensation claims, success is rare when adequate consideration can be

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174 Cohen v. Ayers, 596 F.2d 733, 739 (7th Cir. 1979).
176 Adams v. Smith, 153 So. 2d 221, 225–26 (Ala. 1963). Notably, this was a derivative action asserting that the transfers were ultra vires. See infra Part IV.A.3.
177 Hurt v. Cotton States Fertilizer Co., 159 F.2d 52, 58 (5th Cir. 1947).
178 Rogers v. Hill, 289 U.S. 582, 591–92 (1933); see also McQuillen v. Nat’l Cash Register Co., 27 F. Supp. 639, 653–55 (D. Md. 1939) (distinguishing between excessive compensation in stock-option case, which it called legal, and wasteful compensation; which it said was illegal, and finding mere excess), aff’d, 112 F.2d 877 (4th Cir. 1940); Heller v. Boylan, 29 N.Y.S.2d 653, 673 (N.Y. Sup. Ct. 1941) (exhaustive examination of exorbitant pay upheld on grounds the court lacked competency to resolve problems of excessive executive compensation).
180 See Yablons, supra note 21, at 1902–04 (discussing the cases cited here).
183 Beard, 160 A.2d at 737.
184 Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 890–95 (Del. Ch. 1999). In theory, a merger or other business combination approved at a price vastly lower than the corporation’s intrinsic value could amount to a gift of the excess value. Yet valuation is a notoriously judgment-laden exercise and so mounting a successful challenge on grounds of a gift would be nearly impossible. Likewise, elaborate procedures for approving a merger are prescribed in corporate law statutes, which almost always require board and shareholder approval or provide dissenting shareholder appraisal rights.
185 Kamin v. Am. Express Co., 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976), aff’d, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976). It is possible for a distribution of corporate assets to deliver less value to shareholders than they could have obtained using other approaches. Consider a board decision to distribute assets, such as investment securities that
found solely from the possibility that an executive may in the future be available to provide consulting services to the corporation.\textsuperscript{186}

Corporate law’s reluctance to invoke the doctrine of waste is due, in part, to its veneration of procedural aspects of board decisionmaking.\textsuperscript{187} This orientation is reflected in the heavy reliance on the business judgment rule and asserted judicial incapacity to evaluate the substantive fairness of corporate exchange. Judges may have a comparative competency to evaluate the procedural integrity of corporate dealmaking. So even a massive payout to an executive, substantively suspect, can be insulated from judicial review by procedural steps like using independent outside consultants, giving directors briefing books about the background and terms of the exchange, and getting approval of disinterested and fully informed directors and/or shareholders. That is so despite deficiencies in the bargaining process boards and managers sometimes use when establishing stock-based pay\textsuperscript{188} and well-known infirmities of shareholder voting.\textsuperscript{189}

**B. Contractual Unconscionability**

Contract law’s doctrine of unconscionability has much in common with corporate law’s waste doctrine—but important differences too. Like corporate law’s waste doctrine, contract law’s unconscionability doctrine is rarely used, especially concerning substantive terms of exchange between commercial actors\textsuperscript{190} and routine transactions.\textsuperscript{191} This aversion rests on freedom-of-contract principles and judicial resistance to paternalism, despite terms that are unreasonable or impose hardship.\textsuperscript{192} Fairness is not necessarily the test, though there may be a tempting case to conceive of courts policing contractual exchange using that term.\textsuperscript{193} Unconscionability signals absence of mutual assent on which contracts and contract law are

\textsuperscript{186} See Osborne v. Locke Steel Chain Co., 218 A.2d 526 (Conn. 1966).


\textsuperscript{188} See Bebchuck, Fried & Walker, supra note 3, at 764–69.

\textsuperscript{189} See id. at 779–83.


\textsuperscript{191} Cnty Asphalt, Inc. v. Lewis Welding & Eng’g Corp., 323 F. Supp. 1300, 1308 (S.D.N.Y. 1970) (“[I]t is the exceptional commercial setting where a claim of unconscionability will be allowed . . . .”), aff’d, 444 F.2d 372 (2d Cir. 1971); Gillman v. Chase Manhattan Bank, 534 N.E.2d 824 (N.Y. 1988) (holding that a provision of a security agreement for the issuance of letter of credit that allowed a bank to deny a business access to a portion of its deposits was not unconscionable).


based. That’s why the doctrine is scarcely used in arm’s-length transactions and more often in cases involving fiduciaries and consumer transactions.\textsuperscript{194}

As the following discussion shows, contract law’s propensity to use the unconscionability doctrine to police exchanges intensifies according to a fairly coherent logic, which is quite different than corporate law’s waste doctrine. The unconscionability doctrine is least likely to be used in true arm’s-length transactions, even on lopsided terms. Examples are a grubstake contract that pays off 200:1, even when made by one of uncertain mental competency,\textsuperscript{195} and an emergency loan contract that pays off 80:1, even in a time of war and famine.\textsuperscript{196} Arm’s-length contracts require essentially infinite disparity in the substantive terms of exchange to warrant invoking unconscionability, as where the quantity in a goods contract is formulated to exceed the world’s total supply of the good,\textsuperscript{197} or the price term increases exponentially according to an essentially random function.\textsuperscript{198} It is not enough that one party’s profit on the transaction is equal to the other party’s contractual payments.\textsuperscript{199} The strikingly lopsided terms are not inherently objectionable but signal lack of mutual assent to a bargain.

It is more likely that courts in equity will invoke the unconscionability doctrine to address obnoxious arrangements. Equity courts have refused specific performance of a land-sale contract with a value ratio of 40:1, though money damages for its breach could still be available.\textsuperscript{200} Courts may refuse specific performance of commercial transactions in goods solely on the basis of a spike in price between contract formation and performance, though allowing that other remedies may be available.\textsuperscript{201} Those other remedies, including contract damages, may nevertheless be reduced in light of the equitable impulse that denies equitable relief.\textsuperscript{202} Nor is this reluctance limited to courts in equity, for courts also refuse to enforce bargains that shock the conscience.\textsuperscript{203}

\textsuperscript{195} Embola v. Tuppela, 220 P. 789 (Wash. 1923).
\textsuperscript{197} See James v. Morgan, (1662) 83 Eng. Rep. 323 (K.B.); 1 Lev. 222 (refusing to enforce an agreement to sell a horse where the price would increase exponentially based on the number of nails in the horse’s shoe).
\textsuperscript{198} See William B. Davenport, \textit{Unconscionability and the Uniform Commercial Code}, 22 U. MIAMI L. REV. 121, 125 (1967) (noting Thornborough v. Whitacre, (1704) 87 Eng. Rep. 1044 (K.B.); 6 Mod. 305, where a purported consideration for a £4 payment was two grains of rye doubled weekly for a year so that this quantity term would exceed all rye that existed in the world).
\textsuperscript{199} Cal. Grocers Ass’n v. Bank of Am., 27 Cal. Rptr. 2d 396, 403 (Cal. Ct. App. 1994) (holding that banking fees to customers equaling twice the bank’s cost were not unconscionable).
\textsuperscript{200} Wollums v. Horsley, 20 S.W. 781 (Ky. 1892).
\textsuperscript{201} See Campbell Soup Co. v. Wentz, 172 F.2d 80 (3d Cir. 1948) (holding that unconscionability bars specific performance though perhaps not other remedies when, in the sale of carrots, the contract price was $23 to $30 per ton but the market price seven months later at the time of delivery rose to $90 per ton).
\textsuperscript{202} Scott v. United States, 79 U.S. (12 Wall.) 443, 445 (1871) (“If a contract be unreasonable and unconscionable, but not void for fraud, a court of law will give to the party who sues for its breach damages, not according to its letter, but only such as he is equitably entitled to.”).
\textsuperscript{203} See John A. Spanogle, Jr., \textit{Analyzing Unconscionability Problems}, 117 U. PA. L. REV. 931, 938 (1969) (“Both law and equity courts refused enforcement of contracts considered too shocking . . . without developing a unitary doctrine justifying that refusal.”).
Policing is most common when a contract is between those in a confidential or fiduciary relationship, such as brother–sister and business manager–client. In such settings, courts have invoked constructive fraud to refuse enforcement of a land-sale contract with a value ratio of as little as 15:1. Additionally, a court held a contract unconscionable where it was formed at the urging of a trusted relation, such as an intimate partner, to exchange a contractual annuity right for one-fourth its economic value (a 4:1 ratio). Unconscionability is also invoked to refuse enforcement of a prenuptial contract on massively lopsided terms. All these cases involve such obnoxious terms to warrant skepticism about whether an actual bargain was intended.

Contract law’s policing of unconscionable bargains is more frequent concerning employee or consumer contracts. A standard example concerns the terms of retail insurance contracts. Particular terms susceptible to challenge in employee and consumer contracts concern matters like arbitration and other impositions against legal recourse. Even in commercial contexts, judicial (and legislative) scrutiny is especially applied to terms limiting contract remedies. The context of limitations on remedy is among the more likely in which judges regard a term as unconscionable, and the Uniform Commercial Code supplies statutory support for this stance.

Over time, the classification of exchange types as arm’s-length or fiduciary in nature can change, along with contract law’s propensity to intensify scrutiny for unconscionability. A good modern example concerns franchise arrangements. These were once considered arm’s-length transactions, so that even a unilateral termination right was unobjectionable so long as the franchisor pointed it out and explained the clause to prevent unfair surprise. Gradually, however, courts and legislatures grew increasingly attracted to treating these more nearly as fiduciary in nature, policing lopsided termination and other clauses.

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208 Ingle v. Circuit City Stores, Inc., 328 F.3d 1165, 1180 (9th Cir. 2003).
209 Fensterstock v. Educ. Fin. Partners, 611 F.3d 124, 135 (2d Cir. 2010) (applying California law); Discover Bank v. Superior Court, 113 P.3d 1100, 1107–08 (Cal. 2005) (holding probably unconscionable an arbitration agreement used to prevent class action lawsuits where the stronger party seemingly deliberately cheated many weaker parties out of small amounts of money).
211 Maxwell v. Fid. Fin. Serv., 907 P.2d 51, 59 (Ariz. 1995) (en banc) (considering U.C.C. §§ 2-302 and 2-719(3) to conclude that “a claim of unconscionability can be established with a showing of substantive unconscionability alone, especially in cases involving either price-cost disparity or limitation of remedies”).
212 See Zapatka v. Dairy Mart, Inc., 408 N.E.2d 1370, 1376–77 (Mass. 1980) (holding a termination clause in a franchise agreement not unconscionable because stronger party pointed out and explained the clause to the weaker party, so there was no unfair surprise).
213 See We Care Hair Dev., Inc. v. Engen, 180 F.3d 838 (7th Cir. 1999); Johnson v. Mobil Oil Corp., 415 F. Supp. 264, 268 (E.D. Mich. 1976) (holding that unconscionability may apply to party who is technically a merchant but, in terms of education, business acumen and experience, functions like a consumer where an operator of a filling station who could barely read signed a contract with a major oil company containing a limitation of liability); Weaver v. Am. Oil Co., 276 N.E.2d 144 (Ind. 1971) (holding unconscionable an exculpatory clause limiting franchisor’s liability for negligence due to franchisor’s abuse of gross disparity in bargaining power and based on public policy).
Two additional features of contract law’s unconscionability doctrine are important. First, even a term not so repugnant as a substantive matter may be stricken for other reasons loosely classified as procedural.\textsuperscript{214} This refers to the background leading to contract formation, including the sophistication of the parties and how the term was presented and documented. For example, boilerplate terms in dense fine print using legalistic language that few people understand are suspect.\textsuperscript{215} The rationale for relief emphasizes limits on traditional assumptions of mutual assent and freedom of contract that warrant sparing use of unconscionability doctrine.\textsuperscript{216} Second, when any clause in a contract is unconscionable, the tendency is to strike the entire contract to discourage overreaching.\textsuperscript{217} When this is not a risk, it is possible to sever obnoxious clauses and enforce the rest of a contract.\textsuperscript{218}

To synthesize this doctrine, unconscionability is available primarily when traditional assumptions of contract law, mutual assent, and free bargaining cannot be relied on. Further, unconscionability is most likely to be invoked when some fiduciary or confidential relationship appears, equitable remedies are at stake, or the interests of certain groups, like franchisees, consumers, or employees, are in need of protection.\textsuperscript{219} The doctrine is an outgrowth of more fundamental judicial impulses to police unfairness, a formal expression of a tool not generally found elsewhere in traditional contract law.\textsuperscript{220} It is not a stretch to think about adapting the doctrine on behalf of shareholders making claims in equity that directors, who are fiduciaries, authorize odious pay contracts without serious bargaining.

C. \textbf{Reconciliation}

Comparison of corporate law’s waste doctrine and contract law’s unconscionability doctrine shows several unsurprising affinities—and yet some surprising and striking differences. Both are rarely invoked to upset an exchange transaction. Contract law’s sparing use is based on the freedom-of-contract principle, along with doubt about judicial competence to evaluate the substance of exchanges. Corporate law’s more sparing use is based on the principle of business judgment, along with similar doubt. Both doctrines are rarely used in order to avoid an avalanche of lawsuits seeking to rescind contracts and reverse corporation transactions.

Related doctrines in contract and corporate law use overlapping concepts. Both bodies of law are averse to gifts, though for different reasons. Corporate law’s doctrine of waste prohibits gifts of corporate assets when the absence of a bargain means the corporation received nothing in


\textsuperscript{215} See FARNSWORTH, supra note 19, at 332–33.


\textsuperscript{217} Ferguson v. Countrywide Credit Indus., Inc., 298 F.3d 778 (9th Cir. 2002) (finding arbitration clause in an employment agreement unconscionable and thus holding the entire agreement unenforceable because the clause could not be removed from the agreement).


exchange. Contract law’s basic principle of consideration marks off as unenforceable promises to make gifts that lack the indicia of a bargain seen as central to enforceable exchange transactions. A sharp contrast appears concerning completed gifts, however, which the common law of contracts and property recognizes as irrevocable and yet corporate law would rescind.

Neither body of law requires equivalence of the bargaining terms. In contract law, this is the peppercorn theory of consideration, and works to the extent that even nominal consideration performs functions required to separate exchanges from gifts. In both contract and corporate law, the issue is whether there is any consideration and, in corporate law, on occasion at least some relation between what the corporation transferred and what it received. Both bodies of law place a premium on the procedural side of transactions. In contract law, the unconscionability doctrine is customarily distinguished between substantive and procedural aspects. Procedural unconscionability addresses how a transaction originated, the way it was documented, how terms were presented and other aspects of bargaining and documenting the exchange. In corporate law, judges place great weight on the process a corporation follows to approve a transaction.

Above all, both bodies of law establish limits posing similar questions using similar syntax. In contract law, an exchange or term may be found unconscionable only if no fair-minded person would propose it and no rational person would assent to it. In corporate law, a transaction may be upset only if the consideration received is so inadequate in value that no person of ordinary, sound business judgment would deem it worth what the corporation paid. Both look to the relationship between economic and business risk on both sides of the exchange.

Despite affinities, differences appear in these contract and corporate law doctrines. Contract law is premised on freedom of exchange and encourages parties to act in their own self-

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221 See, e.g., Hurt v. Cotton States Fertilizer Co., 159 F.2d 52 (5th Cir. 1947); Adams v. Smith, 153 So. 2d 221 (Ala. 1963).
222 RESTATEMENT (SECOND) OF CONTRACTS § 17 (1981) (requiring a bargain); id. § 71 (requiring an exchange).
223 See Farnsworth, supra note 19, at 50.
224 Lon L. Fuller, Consideration and Form, 41 COLUM. L. REV. 799 (1941).
226 See Leff, supra note 214, at 554–55 (providing framework to distinguish procedural and substantive elements of unconscionability that drove later doctrinal distinction).
227 Mitchell, supra note 187.
228 Clermont v. Clermont, 603 N.Y.S.2d 923, 924 (N.Y. App. Div. 1993); Earl of Chesterfield v. Janssen, (1751) 28 Eng. Rep. 82 (Ch.) 100; 2 Ves. Sen. 125 (describing unconscionability as a bargain that is “such as no man in his sense and not under delusion would make on the one hand, and as no honest and fair man would accept on the other”).
230 See Bank of Ind. v. Holyfield, 476 F. Supp. 104, 109–10 (S.D. Miss. 1979) (describing a contract case noting that the standard definition of substantive unconscionability involves terms that “bear no reasonable relationship to business risks assumed by the parties”).
interest so long as the parties are competent and have legal capacity; \textsuperscript{231} corporate law is primarily fiduciary-based and premised on imposing duties on corporate managers to elevate corporate and shareholder interests above personal interests. \textsuperscript{232} Contract law’s roots are in law courts, and standard remedies are money damages, not equitable relief; corporate law’s roots are in equity courts, which Delaware courts expressly retain, and standard remedies include equitable relief. \textsuperscript{233} Given these two fundamental distinctions—corporate law as fiduciary and equitable, and contract law as arm’s-length and legal—one could expect the otherwise roughly equivalent policing doctrines to be more frequently or robustly used in corporate law than in contract law.

Casebooks, cases, and scholarship suggest exactly the opposite. Indeed, contract law tends to resort to the unconscionability doctrine only when no other grounds exist to provide traditional doctrinal excuse, such as lack of capacity or competency, nondisclosure, misrepresentation, duress, or fraud. \textsuperscript{234} In striking contrast, a corporate law claim of waste is so difficult to sustain that there usually must be some other grounds for challenging a transaction, such as breach of fiduciary duty, \textsuperscript{235} fraud, \textsuperscript{236} or ultra vires (corporate law’s functional equivalent to lack of capacity or competency). \textsuperscript{237} These all can be tough to show, sometimes requiring such extremes as absorbing the corporation’s entire earnings, preventing shareholder distributions, or risking insolvency. \textsuperscript{238} One explanation is the lesser-perceived need for judicial superintendence and protection of shareholders compared to consumers, employees, franchisees, and other vulnerable types. \textsuperscript{239} But many shareholders are as vulnerable as those other types. A majority of American households increasingly rely on stock ownership as a savings vehicle, directly or through intermediaries. \textsuperscript{240}

Yet since the 1930s, corporate law has insulated executive pay contracts from judicial review for scrutiny by using the anemic waste standard. Scores of articles suggest how corporate law could be strengthened to provide requisite policing, but the suggestions have not been adopted. The population number of successfully contested stock-based pay cases under corporate law is miniscule. No appellate court has ever affirmed an order against a public corporation to


\textsuperscript{237} See Greenfield, \textit{supra} note 25, at 1302.

\textsuperscript{238} See Marx, 88 N.Y.2d 189.

\textsuperscript{239} Overwhelmingly one-sided is a vital notion in unconscionability, because mere absence of mutuality is not enough to strike a clause. See Harris v. Green Tree Fin. Corp., 183 F.3d 173, 179–81, 183 (3d Cir. 1999); \textit{see also} Daniel D. Barnhizer, \textit{Inequality of Bargaining Power}, 76 U. COLO. L. REV. 139, 196 (2005) (discussing how an inequality of bargaining power is sufficient to find unconscionability in many jurisdictions).

\textsuperscript{240} \textit{The WORLD ALMANAC AND BOOK OF FACTS} 57 (2011) (table showing stock ownership of U.S. families, 1989-2007, showing that in 2007, 51.1% of all families have direct or indirect stock holdings, and the figures were 50.2% in 2004, 52.2% in 2005 and 31.7% in 1989).
reduce its managerial compensation under a waste theory. In less than one-third of Delaware corporate law cases asserting waste in the executive pay context have shareholders prevailed at even the preliminary stages, such as motions to dismiss or for summary judgment (though the rate for non-Delaware cases is closer to half). If pay contracts are to remain an important part of U.S. corporate life, it is necessary to find other routes to judicially scrutinize them, and contractual unconscionability is promising.

IV. CONTRACT LAW SCRUTINY

Stock-based pay arrangements are made pursuant to corporation–manager contracts. They are contracts like any other and should be rescinded when unconscionable—whether or not they amount to waste under corporate law. That a board approved the contract should not be dispositive—nor should a shareholder vote. Several hurdles must be navigated to enable this treatment. The hurdles mean that few cases would succeed through the gauntlet, catching only the most odious pay contracts and not touching legitimate ones or other categories of corporate contracts (like merger agreements, loan agreements, leases, and the like).

To encapsulate the proposal and its appeal, consider a thumbnail sketch comparing how corporate law works with how contract law would work. Under corporate law, disputes involving a corporation’s internal affairs are governed by its state of incorporation, most often Delaware for public corporations, according to that state’s principle of conflicts-of-laws. Under corporate law, compensation decisions are protected by the business judgment rule. Even if shareholders assert board breach of duty of loyalty, that does not mean judges scrutinize pay contracts for fairness. Contracts are reviewed under the doctrine of waste, which few board decisions fail. Courts often cite any shareholder approval of related stock-pay plans to support deference to board decisions, though acknowledging limits in disclosure and voting. Shareholder challenges are usually treated as derivative, meaning to proceed the shareholder first must demand that the board redress the claim or show that to be futile, requiring proof that the pay or procedure leading to it were unprotected by the business judgment rule. Shareholders rarely win, even when challenging extravagant payouts.

In contrast, a contract-law claim of unconscionability would begin by asserting that today’s pay contracts are not inevitably matters of internal affairs governed by the company’s state of incorporation, but by law determined under other conflicts-of-law principles. First, that would mean that contract law applies, not corporate law. Second, which state’s contract law applies would be determined according to which state has the greatest interest, influenced by where the contract was formed and performed, with contractual choice-of-law clauses being relevant, but not dispositive. Under contract law, no special deference is due to boards authorizing corporations to enter into unconscionable contracts. A shareholder allegation that a stock-based pay contract is unconscionable, ultra vires, and thus should be rescinded is the kind of claim that even corporate law may treat as direct rather than derivative. If such claims are treated as derivative, they should at least support excusing demand as futile. Accordingly,

obstacles to shareholder litigation are reduced and shareholders more often proceed to the merits of the unconscionability determination.

The following provides a detailed evaluation. Part IV.A evaluates the hurdles and how surmounting them serves a screening function. Part IV.B illustrates how the contract-law approach would work in comparison to the corporate-law approach.

A. Hurdles and Screens

To enable shareholders to test executive compensation contracts using contract law raises challenges of the internal-affairs doctrine, contractual choice-of-law clauses, the classification of litigation as direct or derivative (which includes how to apply the ultra vires doctrine), and issues of judicial comity and competence.

1. Internal Affairs

The first issue is whether pay contracts are matters of a corporation’s internal affairs so that its state of incorporation controls without regard to any other factor, or whether they are like other contracts governed according to broader conflict-of-law principles. The internal-affairs doctrine is deeply embedded, 242 though claims that it is founded in constitutional-law principles are contested. 243 Its rationale rests on how the incorporating state has an interest in relationships among the corporation and its officers, directors, and shareholders. Those participants have a recognizable and protectable expectancy in knowing what laws apply to them in their relations with other participants. Subjecting them to inconsistent laws, especially multiple state laws, as opposed to a single federal law, should be minimized. Those interests are strong concerning governance matters like shareholder voting rights, board elections, corporate dividend policy, and transfers or protection of corporate control. 244

Other states may have an interest in those matters too, though they are seen to be weaker. States with an interest in a corporate contract include those states where the corporation has a large presence, measured by property ownership (including headquarters), sales, employees, shareholders, lenders, or other metrics. 245 For internal affairs, however, even such interests do not necessarily justify altering the usual choice-of-law rule. As a result, state statutory efforts to reach out and regulate the internal affairs of corporations incorporated elsewhere but having some contacts with the local state are rebuffed. 246 Even so, not all states embrace the internal-

242 RESTATEMENT (SECOND) OF CONFLICT OF LAWS, § 301 (1971).
244 See P. John Kozyris, Corporate Wars and Choice of Law, 1985 DUKE L.J. 1, 24–25 (cataloging cases of this sort and other authorities providing more elaborate enumerations but substantially akin to those listed in the text).
245 E.g., CAL. CORP. CODE § 2115(a), (b) (West 2010); N.Y. BUS. CORP. LAW §§ 1317–1320 (McKinney 2003).
affairs doctrine with equal enthusiasm, and scholarly critiques based on fundamental principles of republican democracy test the doctrine’s legitimacy. Delaware courts seem to overstate the constitutional pedigree of the internal-affairs doctrine, largely in a political bid to retain its dominant position in U.S. corporate-law production, rather than on traditional legal argumentation.

Still, there is a class of contracts that do not fit within the internal-affairs doctrine and in which states other than the state of incorporation have a strong, or stronger, interest. Corporations enter into numerous contracts with third parties that are clearly external matters. Contracts between corporations and auditors, lenders, landlords, suppliers, and labor unions are all external, rather than internal, affairs. Citizens of the state of contract formation and performance—and any breach with resulting legal enforcement—have a clear interest in these. The terms of those relationships, contractual and otherwise, need not be governed under the internal-affairs doctrine’s choice of domestic law, but either by contractual choice of law or general tests of interests under conflicts-of-law principles.

Where do pay contracts between the corporation and officers fall? In one sense, they are internal affairs. They are internal affairs because the contract is authorized by the board on behalf of the corporation and its shareholders with corporate officers as the counterparty. The arrangement regulates the relationship of the corporation to the officer. It contemplates making the manager into a shareholder. The case for seeing the contract as such an internal affair is strong, especially if the recipient is also a director, chairman, or CEO. It is strengthened by standard academic talk that conceives of the stock-based pay device as a way to align manager incentives with shareholder interests. That is a way to reduce agency costs, quintessential matters of the internal affairs of the corporation.

It is at least equally valid to classify manager-pay contracts as external affairs. The simplest case for that view occurs when a corporation enters into a contract with someone who

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247 See Nedlloyd Lines B.V. v. Superior Court, 834 P.2d 1148, 1169 n.13 (Cal. 1992) (en banc) (making the “status” of the internal affairs doctrine in California “doubtful”).
250 See Clay v. Sun Ins. Office, Ltd., 377 U.S. 179 (1964) (holding that Florida’s five-year statute of limitations, not Illinois’ one-year statute of limitations, applied to insurance contract case brought in Florida against Illinois corporation); see also McDermott Inc. v. Lewis, 531 A.2d 206, 218 n.14 (Del. 1987) (discussing Clay and agreeing that it did not involve the internal affairs of the corporation).
251 AIG Group, 965 A.2d 763, 817 (Del. Ch. 2009).
253 See supra text accompanying notes 46–62 and sources cited supra note 6.
was not previously a director, officer, or shareholder of the corporation. The contract is simply an employment agreement with an outsider. In that view, it is akin to other contracts, including labor union contracts, nonmanagerial employment agreements, and loan agreements.\textsuperscript{254} That viewpoint does not change radically when an existing manager is the counterparty.\textsuperscript{255} It remains even if that person is already a shareholder. The contract is about compensation, the cost of an external resource imported into the enterprise, not about power among internal participants, like shareholder voting rights and related procedures for corporate decision making.

Consider an extreme case of a contract that no state would recognize as enforceable—an illegal bargain of any sort. It could be a contract for illegal gambling, narcotics trafficking, pollution, prostitution, employment discrimination, or the like. Suppose a Delaware corporation is operating casinos and garbage removal from New Jersey. Its board approves and shareholders ratify an employment contract with the casino manager and sanitation manager. Both provide for corporate payment of bonus compensation triggered by the manager violating state law, say the casino manager staging dog fights or catering to minors and the refuse manager dumping excess waste in environmentally protected areas.

Are those contracts to be seen as internal affairs and governed by Delaware corporate law, or can New Jersey contract law apply? Perhaps no one could say that the contracts violate Delaware corporate law. The board approved and shareholders ratified them following statutory procedures and consistent with standards of fiduciary duty in that state. But does that make them enforceable as a matter of contract law? They violate state law in New Jersey. Just because a board approves and shareholders ratify such a contract, or a stock-based pay contract violating unconscionability doctrine, does not make it an internal affair; it is a contract just like all others and susceptible to evaluation by courts in states where the contract is formed or to be performed.\textsuperscript{256}

For a more closely analogous case, suppose a corporation–manager contract contains a covenant not to compete, barring the manager from post-severance employment for five years for firms in the same industry and geographic region. Is that contract’s enforceability merely a question for the state where a corporation filed its charter, or is it instead also subject to the contract law of the state of its formation or performance? Is that a question for the state where a corporation filed its charter, or is it instead also subject to the internal affairs doctrine, does not make it an internal affair; it is a contract just like all others and susceptible to evaluation by courts in states where the contract is formed or to be performed.\textsuperscript{257}


\textsuperscript{255} Notably, Professors Thomas and Wells propose increasing corporate-law scrutiny of existing officer employment agreements under the recently invigorated principle that existing officers owe their corporations fiduciary duties. \textit{See} Thomas & Wells, \textit{supra} note 69, at 37–47. That proposal thus dovetails with this one by promoting contract-law scrutiny of newly recruited officer employment agreements—as well as to existing officer agreements.

\textsuperscript{256} Delaware courts applying the internal-affairs doctrine might reconsider if doing so would produce “draconian” results. \textit{Cf.} McDermott Inc. v. Lewis, 531 A.2d 206, 219 (Del. 1987) (deciding, under the internal-affairs doctrine, to apply Panama corporate law permitting subsidiary shareholders to vote on parent mergers though no U.S. state would permit that, and entertaining, but ultimately rejecting, the argument that doing so is somehow draconian).

\textsuperscript{257} Curtis 1000, Inc. v. Seuss, 24 F.3d 941, 948 (7th Cir. 1994) (Posner, C.J.) (rejecting contractual choice of Delaware law, state of incorporation, in favor of Georgia, which had a strong interest in the validity of the contract); \textit{see also} Kelton v. Stravinski, 41 Cal. Rptr. 3d 877 (2006).
Few cases directly address whether a stock-based pay contract is within the internal-affairs doctrine or governed by the contract law of another state. In an unusual setting, shareholders of a Delaware corporation challenged a stock-option plan, approved by the board and ratified by shareholder vote. The Delaware Chancery Court, under precedents that now seem discarded, agreed with the shareholder that the plan was a mere gift in violation of Delaware corporate law. In doing so, the court rejected the proponents’ argument that New York contract law governed and supported enforcing it as an option contract, which a New York statute declared in certain cases would be enforceable even absent consideration.

The chancery court disagreed that New York contract law applied under the internal-affairs doctrine (it also disagreed that the New York statute supported the proponents’ position even if it were governing law). The court’s justifications were: stock options are not ordinary transactions, but matters of corporate structure; the plaintiff’s stock certificate was issued in compliance with Delaware law; the certificate created rights under Delaware law; the stock options were approved by the board and shareholders; and the resulting controversy involved the internal affairs. The Delaware Supreme Court, though reversing the chancery court’s view that the plan amounted to a gift in violation of Delaware corporate law, agreed that Delaware corporate law governed, not New York contract law. It was impatient with the proponents’ choice-of-law argument, dismissing it in a paragraph, referring to the chancery court opinion, and saying it needed no further discussion.

The chancery court opinion, after reciting the foregoing five arguments, then relied heavily on a famous United States Supreme Court case, Rogers v. Guaranty Trust Co. It held that the internal-affairs doctrine governed matters of state corporate law about the processes a board and shareholders followed in approving a corporate action. It was an odd citation — there was no question throughout the protracted Rogers litigation that the law of the state of incorporation governed. The wrangling was entirely about whether a federal district court sitting in a different state should decline jurisdiction given the uncertain state of the incorporating state’s laws. Neither the Supreme Court nor any of the other courts, nor even the plaintiffs in the case, ever asserted that any law other than the incorporating state should apply.

Both these cases and all the opinions addressed stock-option plans, broad corporate programs applicable to hundreds of employees. Shareholders objected to corporate procedures,

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259 Id. (relying on Kerbs and Gottlieb, curtailed in Beard and questioned in Lewis v. Vogelstein, all as noted in supra text accompanying notes 181–83, 235).
260 Id. at 225.
261 Id. at 224–25.
263 288 U.S. 123 (1933).
264 Id. at 130–32.
265 By wrangling I refer to the Supreme Court’s split decision over a vigorous dissent by Justice Stone, preceded by a split decision of the Second Circuit on the merits, preceded by a District Court opinion declining jurisdiction. See Harwell Wells, “No Man Can Be Worth $1,000,000 a Year”: The Fight Over Executive Compensation in 1930s America, 44 U. Rich. L. Rev. 689 (2010).
share dilution, disclosure, and whether all that corporate machinery comported with the corporate statutes of the state of incorporation. There were no claims involving the common law of contracts. Given that disputation, it was difficult not to see the cases as entirely about internal affairs. Even the assertion of the one case’s plan proponents that New York contract law governed and supported the arrangement was far-fetched given how deeply into internal corporate procedures the case had plunged.

An important implication of the *Rogers* case, however, concerns jurisdiction. Some courts that identify an issue as governed by the internal affairs doctrine, and thus another state’s corporate law, take that to bar jurisdiction. Others recognize that the internal-affairs doctrine is a choice-of-law principle and does not bar jurisdiction, enabling them to hear a case though applying another state’s corporate law. In the middle, courts recognize the internal-affairs doctrine as an issue, but neither a bar to jurisdiction nor a bar to applying that state’s own noncorporate law. This stance is justified when the court’s exercise of jurisdiction and adjudication would not “inextricably involve” it in the internal affairs of a foreign corporation. A helpful example appears in an employee’s breach-of-contract claim, which included stock-based pay, against a Delaware corporation in a Pennsylvania court. The Delaware corporation sought dismissal for lack of jurisdiction under the internal-affairs doctrine, but the court rejected the argument and heard the case.

2. **Choice of Law; Choice of Forum**

If managers both control the contracting process and know there is risk that their pay contracts may be declared unconscionable by some states, they will select the laws of the jurisdiction most favorable to managers—those with the weakest contractual unconscionability laws. If so, that could make the contract approach to executive-pay contracts a dead end, no more capable than corporate law of policing obnoxious pay arrangements.

On the other hand, a choice-of-law clause is not dispositive on conflict-of-law questions. True, many courts defer to contractual choice-of-law clauses, even when that means overriding a law or regulation of that state. But other relevant factors include where the contract was formed and where the corporation or manager are located. An important issue is which contending state has the greatest interest in a contract’s enforceability. Relevant are factors that appear in state quasi-domestic corporation laws, like where sizable portions of a corporation’s assets are located, revenues generated, payroll made, or shareholders reside.

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269 Id. See [id.](#)


271 *See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 (1971).*

272 *E.g., CAL. CORP. CODE 2115(a), (b) (2010); N.Y. BUS. CORP. LAW §§ 1317–1320 (McKinney 2003).*
Furthermore, an assertion of unconscionability could render the entire contract unenforceable, including any choice-of-law clause. Imagine an employment contract with stock-based payments containing both an otherwise enforceable choice-of-law clause and obnoxious clauses alleged to be unconscionable. Suppose the stock-based pay contract contains both a choice-of-law clause and an obnoxious payout clause. And suppose holders file a case in state court where the corporation is headquartered or has other requisite contacts to give that court jurisdiction. Reviewing courts may apply the chosen law in deciding whether the contract is unconscionable, except when that would produce a result inconsistent with the public policy of the reviewing court’s state. If found to be unconscionable, the court is authorized to declare that and grant rescission.

Even a Delaware choice-of-law clause would mean Delaware contract law, rather than corporate law, would apply, potentially changing the analysis and outcome. Two principal Delaware Supreme Court cases state the contract standard, one addressing franchise termination and the other dealing with an insurance-contract arbitration clause. These cases adopted familiar tests from other jurisdictions, stating that unconscionability requires showing “absence of meaningful choice and contract terms unreasonably favorable to one of the parties.” They ask whether a contract is “such as no [person] in his [or her] senses and not under delusion would make on the one hand, and as no honest or fair [person] would accept, on the other.”

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273 See RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981) (courts faced with an unconscionable contract term “may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term”); FARNSWORTH, supra, note 19, at 384–85 (noting judicial approaches to declarations that contracts are invalid as a matter of public policy and how courts sometimes refuse to enforce any part of a contract containing a repugnant clause along with mediating doctrines that enable striking the obnoxious clause while preserving others).

274 E.g., Discover Bank v. Superior Court, 113 P.3d 1100, 1118 (Cal. 2005) (stating this as California law when giving guidance to lower court faced with deciding whether to enforce a Delaware choice of law provision in the face of a challenge to an arbitration clause as unconscionable); Am. Online, Inc. v. Superior Court, 108 Cal. Rptr. 699 (Cal. Ct. App.) (showing California court refusing to recognize Virginia choice-of-law clause in the face of unconscionability challenge under California law); Briceño v. Sprint Spectrum, L.P., 911 So. 2d 176, 179 (Fla. Dist. Ct. App. 2005) (showing Florida court reviewing unconscionability challenge to arbitration clause contained in contract choosing Arkansas law reversing lower court that applied Florida law given that applying Arkansas law does not contravene any Florida state public policy); Coady v. Cross Country Bank, 729 N.W.2d 732, 737 (Wis. Ct. App. 2007) (applying Wisconsin unconscionability law to test validity of arbitration agreement purporting to be governed by Delaware law).

275 There is a prudential case for this assertion apart from positive law. Dating to Joseph Story’s famous articulations of the notion of unconscionability in equity, the history, theory, rhetoric, and prevailing substantive content of unconscionability law suggests that reviewing judges should be authorized to apply their own jurisdiction’s laws and order rescission based on unconscionability. See JOSEPH STORY, 1 COMMENTARIES ON EQUITY JURISPRUDENCE AS ADMINISTERED IN ENGLAND AND AMERICA 256–58 (3d ed. 1842) (coining the phrase “shock the conscience”). The judicial determination of unconscionability should be made according to the law of that court’s jurisdiction, not some other one. When a court determines whether an arrangement so shocks the judicial conscience to be unenforceable, the relevant conscience is that judge, that court, and its jurisdiction’s laws. With jurisdiction over the case, the same logic would extend to a determination to order rescission.


278 Tulowitizki, 396 A.2d at 960.

279 Id. (citing Williams v. Walker-Thomas Furniture, 350 F.2d 445, 450 n.12 (D.C. Cir. 1965)).
The test also considers the “business practices of the community” to test “whether the terms are so extreme as to appear unconscionable according to the mores and business practices of the time and place.” Though both cases upheld the contract at issue, and numerous lower Delaware court opinions have followed suit, other Delaware cases have found contracts to be unconscionable, constituting an inventory that appears greater than cases finding corporate waste. Examples appear in a famous real-estate transfer setting, in overpayments based on erroneous corporate valuation calculations, and in attempts to limit liability in commercial transactions.

Finally, as the Delaware Supreme Court cases indicate, Delaware has no peculiar comparative advantage or special skill in contract law the way it has in corporate law. Its own body of contract law draws more heavily on broader common-law principles from other jurisdictions than its corporate law does. Just as many other states look to Delaware corporate law when developing their corporate law, Delaware contract law looks to the law in states with better developed contract law. The distinction of particularly well-developed state contract law likely would go to states like California, Massachusetts, or New York. The body of contract unconscionability law is certainly more robust in those states than Delaware’s corporate law of waste. Accordingly, at least at the margin, even Delaware contract law could incrementally expand the population of pay contracts found unconscionable compared to those found to violate its corporate law of waste.

Aside from choice of law, a corporate contract could also contain a forum-selection clause, naming as the sole forum for litigation a management-friendly state, such as Delaware. In fact, dozens of Delaware companies during 2010 adopted by-law amendments purporting to name Delaware as the sole forum to resolve intra-corporate disputes. This wave was prompted by a Delaware Chancery Court opinion suggesting that Delaware corporations adopt Delaware

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280 Id. at 960.
285 The Delaware Supreme Court’s most important contractual unconscionability cases, Tulowitzki and Graham, referenced above, draw heavily on influential opinions from other jurisdictions. That court’s corporate-law opinions are virtually exclusively reliant upon other Delaware corporate law precedents (along with citations to scholarship and other secondary legal materials). Graham v. State Farm Mut. Auto. Ins. Co., 565 A.2d 908 (Del. 1989); Tulowitzki, 396 A.2d 956.
forum clauses in their charters. This gambit is limited to intra-corporate affairs, however, usually expressly describing claims for breach of duty, statutory violations, and other matters within the internal-affairs doctrine. Accordingly, they would not apply to corporate pay contracts seen as external affairs. In any event, the enforceability of such clauses—whether appearing in by-laws, charters or contracts—depends generally on analysis analogous to that just discussed concerning choice-of-law clauses.

3. Direct Ultra Vires Suits and Derivative Demands

Under unavoidable corporate-law rules, shareholder challenges to pay contracts as unconscionable would have to be classified as “derivative” or “direct.” If derivative, the claim is brought on behalf of the corporation as a whole. Shareholders would face the hurdles all such suits pose under corporate law that grants considerable power and deference to the board. The issue of whether a shareholder claim is direct or derivative is about the corporation’s internal affairs and therefore governed by the home state’s corporate law.

Many corporate-law statutes, including Delaware’s, state expressly that claims alleging that an action was beyond a corporation’s power may be asserted in a direct action. They authorize that recovery of any compensation in such cases is made to the corporation, though the form of the case is direct, not derivative. This is the strongest ground to justify classifying challenges to pay contracts as unconscionable as direct claims, avoiding the hurdles derivative litigation poses. Even for states with such statutes, however, a preliminary question is whether a shareholder can allege that an unconscionable employment agreement is ultra vires—beyond the corporation’s power. Modern corporations are empowered to engage in any lawful activity, but are not empowered to engage in any unlawful activity.

Corporations have no power to enter into bargains that are unlawful because they violate positive law expressed in statutes or judicial doctrines. Contracts are illegal when they violate

289 In re Revlon, Inc. S’holders Litig., 990 A.2d 940 (Del. Ch. 2010). Deeper causes for the popularity of this by-law amendment, and for the court’s advertisement about it, may include how Delaware in recent years was losing market share in the lucrative business of intra-corporate litigation to other states. See John Armour, Bernard Black & Brian Cheffins, Is Delaware Losing Its Cases? (Northwestern Univ. Law Sch., Law and Econ. Working Paper No. 174, 2010).


291 In addition to rules requiring shareholders to first make a demand for redress on the board, derivative shareholder litigation requires shareholders to meet other hurdles, including specialized standing rules and posting a bond as security for the corporation’s expenses. See supra note 23.


293 See, e.g., DEL. CODE ANN. tit. 8, § 124(1) (West 2006); N.Y. BUS. CORP. LAW § 203(a)(1) (McKinney 2003); MODEL BUS. CORP. ACT § 3.04(b)(1) (2007); PRINCIPLES OF CORP. GOVERNANCE § 2.01 (1992).


295 E.g., DEL. CODE ANN. tit 8, § 101(b); N.Y. BUS. CORP. LAW § 201; MODEL BUS. CORP. ACT § 3.01 (2007); see also KENT GREENFIELD, THE FAILURE OF CORPORATE LAW 80 (2006) (discussing corporate charters tracking corporate statutes).

296 See RICHARD A. LORD, 5 WILLISTON ON CONTRACTS § 12.2 (4th ed. 2009).
anti-bribery, antitrust, environmental statutes, or common-law rules prohibiting unlawful restraints of trade. Such illegal activities are ultra vires. (Further examples of illegal bargains that people lack legal capacity to form and are more likely to involve individuals than businesses, are those for arson, murder, prostitution, narcotics trafficking, and tax evasion.) Toward the opposite, but equally easy, extreme are bargains that are merely unenforceable because they lack requisites of valid contracts, such as consideration or mutual assent. But such defects do not make them illegal.

Unconscionable bargains can fall into either of those extremes or in between, depending on the exact reasons why they shock the conscience of a court. Some are both procedurally and substantively unconscionable while others are either one or the other but not both. Those that suffer from both infirmities more likely warrant being called illegal than those suffering from only one that may be declared merely unenforceable. Some fail because the terms of exchange demonstrate that assent was defective, and thus they seem more akin to merely unenforceable, but not illegal, bargains. An overly broad covenant not to compete may be an example. Others fail because they are repugnant on grounds of public policy, though not expressly outlawed. A contract providing for a bonus to an employee for staging dog fights is illustrative. Executive-pay contracts challenged as unconscionable would not automatically fit into either category, but those plagued by both procedural and substantive unconscionability and violating public policy would be classified as ultra vires.

But not all states have statutes authorizing direct actions for ultra vires claims, and though ultra vires claims are often treated as direct, they are not always treated that way. Those points require a more complete evaluation of the line between direct and derivative suits, which is not always clear. The ultimate issue is whether an alleged harm to be remedied is better conceived as individual to a shareholder or to the corporation as a whole. If the corporation suffers the alleged harm and the corporate interest is remedied by a favorable judgment, the corporation is the real party in interest. But that conception is loaded with inherent difficulty, reflected in how corporation law provides that directors owe duties to their corporations and its shareholders. Thus, breaches of duty, a fundamental element of corporate law, may result in harm to the corporation, the shareholders, or both. The result of that inherent

297 Greenfield, supra note 25.
298 See LORD, supra note 296, § 12.2.
299 But see Douglas M. Branson, Recent Changes to the Model Business Corporation Act: Death Knells for Main Street Corporation Law, 72 Neb. L. Rev. 258, 293 (1993) (“Suits to enjoin ultra vires acts . . . are always direct.”).
301 Id.
302 Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1035–39 (Del. 2004) (noting difficulties of making the distinction and overruling numerous Delaware cases struggling with it by calling them “amorphous and confusing”). The new test addresses solely who is harmed and whom the benefit would remedy. It is not obvious that the new test will prove any less “amorphous” or “confusing” than any number of other tests used to make the classification. Notably, one case the Tooley opinion expressly overruled had treated a shareholder challenge to stock-based pay as derivative. Elster v. Am. Airlines, Inc., 100 A.2d 219, 221–24 (Del. Ch. 1953), overruled by Tooley, 845 A.2d 1031.
conceptual difficulty is that factors inform the analysis and classification decision, not scientific algorithms or natural-law truths.\(^\text{303}\)

A common approach to classifying claims as direct or derivative recognizes that there are some clear examples at the extremes. Claims for breach of duty often are derivative, and those for denying shareholders’ particular rights (like inspection, voting, or preemptive rights) are invariably direct.\(^\text{304}\) Similarly polar, a claim that a contract should be enforced is usually derivative, as are most claims seeking money damages, whereas a claim that corporate action was beyond the corporation’s power (the ultra vires claim) is usually seen as direct\(^\text{305}\) (as are most claims seeking injunctive or other prospective relief\(^\text{306}\)). Likewise, claims seeking cancellation of a stock-issuance plan are seen as direct if grounded on a theory of improper purpose but derivative when grounded on a theory of inadequate consideration.\(^\text{307}\)

As these examples suggest, when classifying elusive cases, two factors are particularly useful: the theory of liability and the remedy sought. In challenging a stock-based pay contract, shareholders are more likely to succeed in classifying the case as direct if they assert that its unconscionable character puts it beyond the corporation’s authority to execute it and the primary remedy sought is rescission.\(^\text{308}\) The liability theory of unconscionability aligns the case with those asserting ultra vires claims more often, though not always, seen as direct and not derivative.\(^\text{309}\) The remedial theory of rescission aligns the case with those seeking equitable relief, likewise more often, though not always, seen as direct not derivative.\(^\text{310}\) If the claim

\(^{303}\) While it is not necessary for purposes of this Article, or the new legal theory it offers, for a dissertation on the distinction between direct and derivative classifications of shareholder lawsuits, see LINDA O. SMiddy & LAWRENCE A. CUNNINGHAM, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 793–833 (7th ed. 2010), which provides a sampling of how various categories of claims have been classified. The following were classified as direct: dividend policy, inspection rights, preemptive rights, voting rights, minority oppression, cash-out mergers, and entrenchment for board resistance to hostile takeovers. \textit{Id.} The following were treated as derivative: breaches of the duty of care for internal control or statutory violations; breaches of the duty of loyalty for self-dealing or exploitation of corporate opportunities; recovery of greenmail paid when board resisted hostile takeover. \textit{Id.} There are no cases in that or other sampled corporations casebooks concerning contractual-unconscionability challenges to executive-compensation agreements.

\(^{304}\) See \textit{id.}

\(^{305}\) See \textit{PRINCIPLES OF CORP. GOVERNANCE} § 7.01 cmt. c (1992).

\(^{306}\) Id. § 7.01 cmt. d.

\(^{307}\) See Bennett v. Breuil Petroleum Corp., 99 A.2d 236, 241 (Del. Ch. 1953) (evaluating a complaint by a minority shareholder against majority who sought cancellation of stock issuance on two grounds, direct improper purpose and derivative inadequate consideration).

\(^{308}\) See Grimes v. Donald, 673 A.2d 1207 (Del. 1996) (classifying as direct a claim seeking to invalidate a CEO employment agreement as an illegal contract under Delaware corporate law), \textit{overruled on other grounds}, Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

\(^{309}\) See Greenfield, \textit{supra} note 25, at 1352–55.

\(^{310}\) See \textit{Grimes}, 673 A.2d 1207 (specifically approving approach of the American Law Institute which notes greater judicial likelihood of treating case as direct when remedy is injunctive or declaratory relief rather than money damages); \textit{id.} at 1213 (affirming trial court classification as direct on grounds that relief requested was a declaration that executive employment agreement was illegal under Delaware law); Tooley v. Donaldson Lufkin & Jenrette, 845 A.2d 1031 (Del. 2004) (reaffirming \textit{Grimes} and overruling any prior Delaware corporate law opinion distinguishing between direct and derivative claims using any test other than a sole focus on who suffered the harm and who would get the benefit of any remedy); \textit{id.} at 1036 (emphasizing that a characteristic of direct suits is “the recovery or other relief flows directly to the stockholders, not to the corporation”); \textit{id.} at 1039 (holding a claim not derivative in part because “no relief would go to the corporation”).
included an assertion of restitution for value transferred, the statutes authorizing direct actions for ultra vires support awarding that amount to the corporation, without disturbing the direct-action classification.\textsuperscript{311}

It is not essential to classify the case as direct for the non-Delaware contract law approach to work. Even when an ultra vires claim is for some reason classified as derivative, it often has the minimum effect of justifying the excusing of shareholder demand on the board as futile.\textsuperscript{312} That surmounts an important hurdle shareholders face in getting a decision on the merits in derivative litigation.\textsuperscript{313} Demand can be excused for other reasons, too, and a challenge to an executive-pay contract heard on the merits.

Additional hurdles may appear, however. Corporation law allows independent board members to take control of the litigation and announce it is in the corporation’s interest to dismiss the case.\textsuperscript{314} Courts are inclined to allow this, applying corporate law that venerates board independence and is averse to second-guessing even the most extravagant board decisions. But a shareholder advancing to that stage of litigation armed with an assertion of contractual unconscionability has a new arrow in her quiver. Stronger than the anemic doctrine of corporate waste, this new arrow could tip the balance to shareholder victory in an appropriate case.\textsuperscript{315}

4. \textbf{Comity and Judicial Competence}

Despite credible grounds for displacing the internal-affairs doctrine and lowering the hurdles to shareholder litigation, courts may understandably hesitate to venture into this territory. Legal uncertainties may appear concerning the internal affairs doctrine versus other conflict-of-law principles, and it may be challenging to faithfully apply another state’s corporation law to classify the case as direct or derivative. Even the most conscientious judges may find these difficulties too daunting and invoke comity to dismiss a case.\textsuperscript{316}

Judges may be even more cautious about their competency on the merits of a claim, given contract complexity.\textsuperscript{317} Limited judicial competence is a common rationale for corporate law’s business judgment rule, for judicial reticence to invoke corporate law’s waste doctrine, and for the rarity of judicial declarations finding contractual unconscionability. Concern about judicial

\textsuperscript{311} Many cases challenging pay contracts are treated as derivative, but that is because they assert claims such as waste, breach of duty, or dilution. See \textit{Tooley}, 845 A.2d at 1036–39 (discussing cases). A shareholder would not make such assertions challenging a stock-based pay contract as unconscionable and seeking its rescission.


\textsuperscript{313} Other hurdles remain, like standing and bond-posting requirements, but these are less formidable. See supra note 23.

\textsuperscript{314} E.g., Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979).

\textsuperscript{315} Review of the formidable hurdles of derivative litigation may simply show the limitations of the value of the contemporary derivative suit, at least in Delaware, and provide a basis for endorsing some of the various proposals to reform it. See JONATHAN R. MACEY, CORPORATE GOVERNANCE 133–36, 147–53 (2008).


\textsuperscript{317} Determinations of contractual unconscionability are questions of law for judges to decide, not juries. E.g., Zapatha v. Dairy Mart, Inc., 408 N.E.2d 1370, 1375 (Mass. 1980).
competence may strengthen in proportion to the complexity of a corporate contract. Many opinions showing cautiousness in policing stock-based pay state this competence modestly. Even when using sophisticated experts to referee a dispute, courts say it is thorny to estimate the value of pay that stock-based devices yield and harder yet to estimate the value a recipient contributes in exchange.

The solution appears in the strict tests judges apply under both corporate law and contract law. The doctrine of corporate waste eases the challenge by invoking the doctrine only in cases so extreme that everyone can see the payment was merely a gift; contractual unconscionability ameliorates the difficulty by limiting its use to cases in which everyone can see a contract or term is obnoxious. Evaluation under either doctrine does not require judicial review using advanced financial calculus. Judges will not find this more daunting than many other problems they face every day. (And remember the question of contract unconscionability is a question of law for judges, not for juries, so there is no risk of runaway juries upsetting legitimate corporate pay contracts.)

As in corporate law and contract law generally, judicial competence is probably stronger concerning procedural aspects. Evaluation of contract formation would not be confined to corporate law’s narrow focus on nominal or formal director independence or information. It would consider the bargaining process. Professors Bebchuk and Fried show how the formal process sometimes lacks bargaining. The process can be meaningless, even though it may give the appearance of legitimacy by formal board independence supported by documentation supplied by consultants. And those procedures may be no more reliable when undertaken in compliance with Dodd–Frank Act requirements concerning director and consultant independence. Nor would shareholder voting required by that Act be dispositive, though shareholder votes against pay proposals that a board simply ignores would support an inference of procedural unconscionability. Shareholders, acting through their board agents, may purport to be bound by contracts that are worse than take-it-or-leave it contracts of adhesion. Absence of bargaining would support characterizing the resulting stock-based pay contract as afflicted by procedural unconscionability.

Analysis of substantive unconscionability would be more complex. It would also be contextual, so stating broad principles is difficult. But two tests may be suggested. One would compare the substantive terms of the option pay contract with model terms such as those offered by academics in the new reform agenda reviewed previously. Those prescriptions endorse the validity of an option pay contract containing long-term alienation restraints, limitations on

319 See supra text accompanying notes 148–63.
321 Bebchuk & Fried, supra note 9, at 1915.
323 Dodd–Frank explicitly provides that the shareholder votes on pay it requires are not binding on boards or corporations and have no legal effects on the scope of a director’s fiduciary duty. Dodd-Frank Act § 951. The Act leaves open the possibility that the vote has other legal consequences, including treating negative shareholder votes that boards ignore as evidence of procedural unconscionability.
324 See supra note 148–63.
managerial discretion in determining grant and exercise dates and procedures, and prohibiting hedging instruments to circumvent the plan. Contract terms containing such features should be viewed favorably. These models rebuke pay contracts with stock options that vest and become exercisable within brief time periods, allowing managerial determination of grant and exercise dates and procedures, and permitting managerial use of circumvention devices. Contract terms containing these features should be viewed skeptically. A primary issue would be whether the terms are reasonably designed to induce retention or transfer corporate value with little received in exchange.325

Another approach, though more intricate, would compare dollar amounts, relating the value of stock-based pay to the value contribution managers make in exchange. This would resemble the proportionality test Delaware courts once applied to test pay contracts for corporate waste.326 For some arrangements, either part may be difficult or impossible to measure with reasonable certainty.327 In such cases, it would be imprudent to declare the contract unconscionable, and modesty regarding judicial competency provides reasonable grounds for restraint. In some cases, however, it may be relatively easy to identify or estimate the amounts with reasonable certainty. In the vast majority of those cases, the ratio, even if substantial, would pass judicial scrutiny, given that the doctrine of contractual unconscionability still gives substantial deference to freedom-of-contract principles and recognizes limited judicial competence. But in the few cases where that ratio can be measured with reasonable certainty and does shock the judicial conscience, the contract should be declared unconscionable and rescinded.

Even so, these points about judicial competence present another hurdle to shareholders—and another reason skeptics should not oppose this proposal in principle. The hurdles shareholders face to obtain independent judicial review are formidable, so there is scant risk of any floodgate effect in promoting the doctrine of contractual unconscionability as a way to police pay contracts.328 It offers an incremental increase in the population of disputes susceptible to judicial rebuke for overreach. One or a few cases entertaining the claim or declaring a stock-based pay contract unconscionable would yield the desired effect of providing a legal check against corporate boards being excessively solicitous of senior managers.

B. APPLICATIONS

The following illustrates some applications of this theory. As mentioned in the Introduction, it begins with a detailed comparison of The Walt Disney Company case followed

326 See supra text accompanying note 181 (noting two earlier Delaware cases applying a moderate proportionality standard to test the validity of pay contracts under the corporate waste doctrine).
328 Nor would this prescription allow judicial interference with any corporate transactions within the internal affairs doctrine, like mergers or asset or stock purchases or sales. All of these are firmly within the internal affairs doctrine, evidenced by elaborate corporate statutory law provisions governing their approval, voting, dissenters’ rights, and other matters. See VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108 (Del. 2005). Nor would it risk judicial interference with other types of contracts, like loan or lease agreements, which have not demonstrated any absence of bargaining or the kind of unconscionable terms that contract law would scrutinize.
by a brief illustration concerning the New York Stock Exchange case, along with notes on a pending Citigroup case.

1. **The Walt Disney Company**

The Walt Disney Company is a Delaware corporation headquartered in California. Its board entered into an employment contract, which included stock-based payments, with an outsider it recruited into a senior executive position. Negotiation, execution, performance, and termination of the contract all took place in California (and incidentally in some other states during travel and remote negotiations, though never Delaware). The contract stated that it was to be governed by California law.\(^{329}\) The contract provided for a lucrative payout, consisting dominantly of very short-term stock options, if the company fired the executive without cause. Fourteen months later, the company did fire the executive without cause, triggering a payout to him of nearly $140 million in cash and stock. The massive payout in relation to the modest work drew intense criticism throughout the United States.

Shareholders sued under Delaware corporate law and eventually lost. The proceedings were extensive and resulted in a series of shifting Delaware corporate law judicial opinions. The first trial-court opinion dismissed the complaint.\(^{330}\) Notably, the court said the contract was just like a board decision to authorize a loan and/or to borrow money.\(^{331}\) That analogy is interesting in the context of this Article since it supports the view expressed here that pay contracts do not implicate the internal-affairs doctrine, but may be governed by the law of a state other than the state of incorporation. Despite that recognition, neither that opinion nor any other in the litigation gave any further consideration to contract law issues but examined the entire case through the lens of Delaware corporate law.

The first appellate opinion reversed this dismissal of the complaint and allowed leave to amend.\(^{332}\) The court said this is a “troubling case on the merits”; the board and its processes were “casual, if not sloppy and perfunctory”; the contract gave an “exceedingly lucrative, if not luxurious” payout compared to the executive’s value to the company; and the “sheer size” of the payout “pushes the envelope of judicial respect for the business judgment” of the board.\(^{333}\) Even so, while this justified reversing dismissal and allowing leave to amend the complaint, the court denied that all this satisfied derivative litigation’s demand requirement or excused it as futile. Thus, although they have no corporate law significance, those harsh judicial excoriations could have been nearly decisive of a claim for contractual unconscionability.

The second trial-court opinion held that demand was excused because the shareholders raised sufficient doubt that the pay and procedure were protected by the business judgment rule.\(^{334}\) The allegations did not merely suggest directors were being grossly negligent and failing

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\(^{331}\) Id. at 350.

\(^{332}\) Brehm, 746 A.2d at 248.

\(^{333}\) Id. at 249.

\(^{334}\) In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003).
to become informed—all of which the court signaled might not justify excusing demand—instead, the allegations suggested directors had “consciously and intentionally disregarded” their duties. Still, all this meant was that demand was excused as a matter of corporate law. Again, under contract law, those assertions would strongly support a determination of absence of arm’s-length bargaining amounting to a defect in contract formation and justifying, along with the exorbitant payout, a finding that the contract was unconscionable and therefore unenforceable.

The third trial-court opinion, reaching the corporate law merits after hearing the case, resolved the issues differently. The directors fell short of best practices, but that did not violate Delaware corporate-law duties, which are far weaker. They did not act in bad faith and were not grossly negligent. Nor did they commit waste, despite the “breathtaking amounts of severance pay.” Waste is “rarely found in Delaware courts” because it puts an “onerous burden” on the one asserting it. The court added: “waste is a rare, unconscionable case[] where directors irrationally squander or give away corporate assets.” The quoted reference to unconscionability is curious, incorrectly suggesting equivalence between corporate law’s doctrine of waste and contract law’s doctrine of unconscionability.

The final appellate opinion affirmed this outcome, saying the board did not breach any Delaware corporate-law duty, though repeating that directors did not live up to best practices. No waste occurred under Delaware corporate law because there was a “rational business purpose” to the deal, one of inducing the executive to leave other employment to work for Disney, and there could be no waste when merely paying amounts pursuant to a contract. There was no inquiry about whether the contract was valid as a matter of contract law. The lawyers and the judges all focused solely on questions of corporate law.

It is not difficult to imagine that a California court applying contract law may respond differently. To begin to see this, consider how the case would have been handled if the executive were suing Disney. He would not have filed a corporate law case in Delaware under Delaware corporation law. He would have filed a breach-of-contract case, probably in California, under state contract law. If the board wished, it could possibly have defended against such an action by invoking contractual unconscionability. There would have been essentially no remote reason to think that the issue was a matter of the internal affairs of the corporation so that Delaware law governed. It would have done the board essentially no good to defend the case by saying that performing the contract would amount to waste under Delaware corporate law. But there would have been a strong case that it was unconscionable under California contract law.

335 Id.
336 In re Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005).
337 Id. at 760–79.
338 Id. at 698.
339 Id. at 748.
340 Id. at 749 (alternation in original) (emphasis added).
341 Id. at 73–75.
343 The Disney-executive contract contemplated a payment on contract termination by Disney. In contract law terms, that is the equivalent of a liquidated-damages clause. There is a good argument that such an amount of damages on breach is unenforceable as a penalty. That is not an issue that could be considered when viewing the case solely within the lens of corporate law. On the other hand, as a matter of contract law, such arrangements can instead be
Now suppose, as this Article suggests, shareholders had not sued the board and the executive under Delaware corporate law. Suppose instead they sued in a California court under state contract law asserting the contract was unconscionable, seeking rescission (and, to the extent any payments had been made, restitution and, to the extent they had not, an injunction). The applicable law is California contract law because the contract was formed, performed, and terminated there between California citizens, one human and one corporate. The internal-affairs doctrine does not change that and the choice of California law.

As to whether the claim is direct or derivative, the remedy of rescission strongly supports classifying the case as direct and could be accompanied by an injunction against any payouts under the contract. The only real issue is, to the extent payments had been made, whether recovering the payments in restitution should change the characterization. The statutes authorizing direct actions for ultra vires conduct support retaining that characterization even when the resulting award of compensation is paid to the corporation. The theory of liability supports treating it as direct, at least insofar as shareholders assert that the contract is both procedurally and substantively unconscionable, if not because the public-policy stakes are acute. If the case were classified as derivative, demand would readily be excused in any event for the reasons the Delaware courts gave when they excused demand.

On the merits, there are deep defects in the process, not amounting to an arm’s-length bargain between the board and officer. With those shareholder agents shortchanging the process, the case for procedural unconscionability is strong. The substantive inquiry focuses on the deal at the time the contract was formed. At that time, a fair-minded and rational person might have agreed to pay a top executive like this millions of dollars for performance. If the person performed badly and turned out to be worth far less, that would be chalked up to an unwise or improvident bargain, as many bargains in fact turn out and that contract law does not disturb. But the clause at issue here did not involve high payments for uncertain performance. It involved high payments upon being fired. The contract, when written, contained this exploding payment due precisely when the company had determined that performance was subpar.

What the company claimed it received for dangling that lucre was attracting the executive to the company in the first place. The company had to induce the executive to join Disney instead of pursuing other opportunities. As the Delaware courts suggested, it is difficult to measure what inducements would be reasonable. That is a function of the executive’s opportunity costs and the company’s alternatives. But that is readily and more rationally handled by payments targeted to that initial attraction, like a signing bonus, a high annual pay rate, a high annual bonus amount or percentage, or something of the sort. To agree up front on a payment drafted and interpreted to invite alternative performances, rather than stipulated damages, and be validated on that basis. See STEWART MACAULAY ET AL., CONTRACTS: LAW IN ACTION 111 (3d ed. 2010).

345 As noted, attorneys have informed the author that they did file such a suit but it was withdrawn or stayed in light of the Delaware action. See supra note 33.

346 See Employment Agreement, supra note 329, ¶ 21 (f).

347 Furthermore, there does not always have to be a perfect relation between a theory of a case as direct or derivative and a theory of the remedy as direct or derivative. The famous case of Perlman v. Feldman followed that route, treating a claim as derivative but awarding damages that were essentially direct. 219 F.2d 173 (2d Cir. 1955).

348 In re Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).
that would clearly reach into the tens of millions of dollars and could easily be payable within short order defies rationality and fairness. Combined, the board’s inexcusable process and the questionable initial commitment to pay someone upon being fired makes a credible case for a court applying traditional contract law to rescind it as unconscionable.  

2. The New York Stock Exchange  

The corporate law case concerning the $140-million payday of the ousted CEO of the New York Stock Exchange (“NYSE”), Richard Grasso, may have turned out the other way too, had the court applied contract law. In the years right before the NYSE became a public corporation, it was a nonprofit New York corporation governed by that state’s corporate law governing nonprofits. Serving the NYSE as Board Chair and CEO was Richard A. Grasso from 1995 until he resigned in controversy in 2003. Grasso served under a series of contracts made in 1995, 1999, and 2003. From 1995 to 2002, the NYSE paid Grasso a base of just over $1 million, plus annual bonuses that were less than $1 million in 1995 but exceeded $10 million in 2002. Though generous by ordinary worker standards, these payouts were modest by corporate CEO standards.  

That changed in 2003 when Grasso’s contract called for a lump-sum payment of $140 million on the spot plus another $50 million payable over the next four years. He procured this contract over strenuous objections of many NYSE board members. Grasso used a suspect approval procedure. The board members approved the contract at a board meeting whose agenda did not list the subject. Many board members who opposed it were therefore absent from the meeting. Those voting for approval did not represent a majority of the board. Board members opposed to the contract promptly objected to the exorbitant payout blessed using this irregular practice.  

The ensuing fury engulfed Grasso in a public and private firestorm that led to his forced resignation. His successor as interim chair investigated the affair and asked the office of the New York Attorney General (“AG”) to pursue formal legal enforcement proceedings. The AG did so, seeking rescission of the contract on grounds specifically authorized in New York’s nonprofit corporation law and associated common-law theories related to those statutory grounds. But the New York Court of Appeals granted Grasso’s motion to dismiss most of the AG’s claims on jurisdictional grounds.  

The corporate-law statute giving the AG jurisdiction to sue nonprofit corporations detailed some of the types of claims the AG was authorized to bring. Those included the two being brought—wrongful transfer of corporate assets and breach of fiduciary duty. But all

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349 A rough analogue between the base corporate case and contractual unconscionability appears in Waters v. Min Ltd., 587 N.E.2d 231 (Mass. 1992). A seller transferred an annuity investment contract worth $189,000 to a buyer in exchange for a cash payment of $50,000 in a transaction brokered by the seller’s intimate partner, with the partner receiving a side payment from the buyer. The court declared this unconscionable as a matter of contract law. It is little different than a company like Disney transferring to an officer like Ovitz equity interests worth a multiple of his contribution to corporate value, in transactions brokered by Disney’s board, which like the intimate partner in Min, is on both sides of the transaction, and failed to act faithfully for shareholders.  
351 Id.  
352 Id.
authorized actions required the AG to prove some element of fault. The court therefore dismissed all claims the AG brought that did not require such a showing, which included claims for unjust enrichment based on statutory provisions limiting compensation to reasonable levels and restitution based on a statutory requirement that a board majority approve executive compensation.  

Neither the AG nor the courts, including the New York Court of Appeals, ever considered a more fundamental and simple question: whether the contract was unconscionable. There is a compelling case that it was. The procedure used to approve the contract was defective. Taking up action on a material matter not listed on a business meeting agenda is irregular. Taking final action on a controversial matter at such a meeting when known opponents are consequently absent is aggressive. Approving this executive’s compensation by less than a majority board vote violated the New York nonprofit corporation law. The amount—including the immediate $140 million—was shocking, particularly when it was far from obvious what, if anything, the NYSE was to get in return. (The transfer was so shocking that it is tempting to suppose that it even triggered corporate law’s waste doctrine, but that is not a sturdy doctrine to rely upon.)

Those features of unconscionability manifest the elements of fault that the New York Court of Appeals said were the only kinds of claims that the New York’s nonprofit-corporation statute authorized the AG to bring. A claim of contract unconscionability, therefore, would have had a greater chance of success than those the AG brought and that the court of appeals dismissed. It seems that the AG did not bring such a claim because that office made the understandable assumption that the question was entirely one of corporate law—a widespread assumption that the scope and tenor of the court’s opinion shows the New York Court of Appeals also shared. Indeed, the New York court’s opinion concentrates entirely on the corporate-law features of the transaction and litigation, riveting upon the statutory and common-law aspects of corporate governance—board duties, the business judgment rule, conflicts of interest—without ever thinking outside that box about the possibility that the case was about the enforceability of a contract under basic and ancient principles of the common law of contracts.

3. **Citigroup Inc.**

A $68-million severance payment went to CEO Charles Prince of Citigroup Inc. just after that company self-destructed for its role in the financial catastrophe that began in 2008. Shareholders filed a derivative lawsuit in Delaware alleging that the payout was waste. The company’s board moved to dismiss on the ground that the shareholders had failed to make a demand on the board as the law governing derivative litigation requires. The shareholders

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353 *Id.* In subsequent proceedings after the NYSE had converted from a nonprofit to for-profit corporation, a lower New York court dismissed even those statutory claims on the ground that the AG lacked jurisdiction to prosecute them once the NYSE’s nonprofit status ended. People *ex rel.* Spitzer v. Grasso, 861 N.Y.S.2d 627, 638 (N.Y. App. Div. 2008).


356 *Id.* at 112.

357 *Id.*
persuaded the court that such a demand would be futile.\textsuperscript{358} They are therefore in the same place that the Disney shareholders got to by the middle of their litigation challenging the $140-million payout to the Disney executive in that case. If this case proceeds under the waste theory, the shareholders stand an extremely small chance of success on the merits. After all, the company can point out that it got something in exchange: Prince signed an agreement with non-compete, non-disparagement, non-solicitation, and release-of-claims provisions.\textsuperscript{359} If the case made the claim of contractual unconscionability, the odds of success would improve since those promises could persuasively be described as trivial formalities. The probability of success would rise more significantly if the case were heard by a court outside of Delaware.

**CONCLUSION**

Compensation for corporate executives skyrocketed in the past two decades, with a particular proliferation of stock-based components. Recent experience challenges many of the theories supporting the trend, especially the once-heralded notion that they align managerial incentives with shareholder interests. The new reform agenda prescribes rehabilitation by redesigning contracts, especially stock-based components, to focus managerial attention on long-term business value rather than short-term price, with suggestions for expanding shareholder power to increase board accountability.

Yet it remains doubtful whether those steps suffice to restore the erstwhile appeal of stock-based pay in many cases. Still missing is legal oversight of pay contracts, and there are few prospects for providing any. Though some see no problem with prevailing conditions while some opponents might prefer abolishing stock options, this Article offers what amounts to a middle position: identifying problems and offering a new legal theory of contractual unconscionability to police obnoxious cases without upsetting legitimate deals.

A fundamental objection to this proposal is how investors may recoil at the prospect of gadfly fellow shareholders challenging corporate pay contracts. Existing corporate law and governance controls the gadfly shareholder. Statutes give directors plenary power and shareholders limited rights. Most decisions are made by directors and officers, not shareholders. That protects fellow shareholders from each other. Though appealing on a wide range of subjects, especially routine business transactions and strategy, the system does not work perfectly for all subjects. The subject of executive compensation illustrates.

There is widespread national debate and valid criticism of executive pay. Although some believe that the corporate-governance system is self-correcting, supporting evidence is limited, and most policy levers that have been tried to aid correction have either backfired or seem unlikely to succeed. Further, the proposed shareholder redress is narrow, faces substantial hurdles that screen out gadflies, and is subject to judicial supervision that controls gadfly risks.

An additional benefit arises from accepting some cost of risking having gadflies upset the equilibrium. It is a way to restore a modicum of external pressure on the State of Delaware, the leading promulgator of corporate law for national use. Historically, Delaware faced such

\textsuperscript{358} Id. at 120–38.
\textsuperscript{359} Id. at 138.
pressure from other states when states competed with each other to attract corporate-chartering business. Many scholars believed that this competition led to optimal law, and though others said it led to suboptimal law, the practical reality is that the competition has ended, and Delaware faces no such pressure today.

The federal government still provides some pressure. In the past decade, the two most propitious times for action occurred in 2002 in the wake of the frauds accompanying the bursting of the Internet bubble and in 2010 after the financial destruction accompanying the bursting of the housing bubble. Each episode prompted significant statutory reform: in the Sarbanes–Oxley Act of 2002 and the Dodd–Frank Act of 2010. Both contained provisions that preempted traditional state corporation law in a few areas—in 2002, the law targeted boards concerning accounting-related matters, and in 2010, the law targeted risk-related matters, including executive compensation.

Though these are nontrivial incursions, they leave Delaware enormous leeway that could stand an external check from sister states. This Article provides a roadmap for a judicial review of obnoxious executive-pay packages. In part, it is an invitation to enable Delaware’s sister states to project incremental pressure on Delaware. That could stimulate a greater appreciation within Delaware for the effects of its approach to corporate affairs outside the boundaries of the small state.